ARRAY Logo

Ten Tax Issues Relating to Conducting Business in Cyberspace

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The rise of Internet commerce will present a range of challenges for the Australian Taxation Office (ATO), as it will transcend state and national borders and commerce will become truly global in every sense. Small and medium enterprises (SMEs), and more consumers than ever before, will have the opportunity from the comfort of their personal computers or WebTVs, to buy and sell goods internationally.

Already in Australia, large telecommunications companies such as Telstra are running advertisements encouraging people to conduct their businesses through their "Big Pond" Internet service, touting as one of its advantages that consumers can be multinationals too and have access to an international market.

Next ponder the prospect of these goods and services being downloaded electronically and the entire transaction being protected by sophisticated encryption technologies. In this environment, the challenge will be for tax administrators to determine which government is entitled to tax?

A simple example will serve to illustrate the nature of the challenge involved here: A consumer in Australia could download software made in England, marketed via a web site in Los Angeles and delivered by a server located in the Cayman Islands. In this scenario, two issues that immediately arise are:

i) To identify whether a transaction has occurred and, if so, in what jurisdiction.

ii) To assess whether tax should be applied and how it should be paid.

It is quite evident that electronic commerce will have a considerable impact on the way in which transactions are conducted and considered for taxation by the ATO. Once the full impact of electronic commerce is fully experienced, the present tax system that was designed for an industrial world, will face many challenges. As noted above, the process of industrialisation shifted the tax base from land to capital and labour. The new economy, facilitated by the growth of electronic commerce, will require an equally fundamental change to cope with the issues that will arise.

The issues of taxation that arise in Cyberspace include challenges to tax administration, consumption tax and finally, questions will need to be raised in relation to concepts that have become entrenched in our income tax law, such as the concept of what constitutes a "permanent establishment".

Ten major challenges are summarised below.[1]

a) Establishing identity

In order to properly carry out taxation laws, the ATO needs not only to identify whether a transaction

has occurred, but also needs to ascertain where it has taken place and by whom. Verifying the identities of parties to a business transaction may be difficult in the world of e-commerce. For example, it may be impossible to identify the true owner of a web site conducting Internet business. The problem here is that the mechanisms for tracing identity are weak, in that it is a relatively simple matter to arrange for the untraceable use of an Internet web site. The correspondence, furthermore, between the Internet address (the computer "domain name") and the location where the activity is supplied, carried out or consumed is tenuous: although the address will tell you who is responsible for maintaining that site, it may not tell you anything about the computer that corresponds to the actual Internet address, or even where that machine is located.[2]

Authorities will need to think carefully before responding to this problem by instituting identification and registration requirements as it is likely such requirements will have limited success due to the growing ease with which web sites can be located offshore.

The Committee for Fiscal Affairs of the OECD has responded to this issue by recommending that:

Revenue authorities may consider requiring that business engaged in electronic commerce identify themselves to Revenue authorities in a manner that is comparable to the prevailing requirements for businesses engaged in conventional commerce in a country.[3] (Emphasis added).

This recommendation, while adhering to the desirable quality of trying to achieve neutrality between physical business enterprises and virtual business enterprises operating via the Internet, is essentially advocating voluntary compliance. Indeed, the OECD believes that many businesses will provide information on their web sites that can be used to accurately identify the business and its physical location, but also believes that it would be helpful if the information is provided as a matter of "common business practice."[4] Nonetheless, as is the case in the physical world, any voluntary compliance regime that may be contemplated for the electronic world, will need to be reinforced with other methods to enable the ATO to trace businesses that do not provide this information as a "matter of course." An example of a supplementary measure could be the authorising of access for the ATO to Internet Protocol (IP) number allocation records to validate identity.

Finally, it is observed that both the current government and the opposition Labor Party are proposing to introduce an Australian Business Number (ABN) as part of their respective tax reform proposals leading up to the October 1998 Federal election. While it may not have been specifically proposed for this purpose, the ABN may nevertheless assist in making identity easier to ascertain in an electronic commerce world, by providing common registration for a range of Government authorities (including the ATO) in a single process.

b) Establishing location

Assuming a transaction can be identified and the identity of the parties ascertained, the next problem is to determine whether a taxable transaction arises, and if so, in which jurisdiction that transaction should be taxed. Individuals and entities engaging in electronic commerce will be able to create an Internet address in almost any taxing jurisdiction irrespective of the location of their residence or the source of their activities. For example, an individual may establish an Internet address in the United Kingdom to claim the benefits of a reduced rate of withholding tax specified in the UK-US double tax treaty. One issue that arises in this context is how the payer would verify that the payee would be actually entitled to this treaty benefit. The challenge presented here is that traditional taxation concepts rely on physical presence or economic connection to a physical location; e-commerce, however, has little dependence on physical location. Thus, as physical location becomes less important in an electronic commerce world, it will become more difficult to determine where an activity has been carried out.

c) Obtaining acceptable documentation of proof will become more difficult

It is generally accepted that the ATO has extensive powers to obtain information from taxpayers and these powers are relatively easy to enforce within Australia. Obtaining information on activities carried out in other taxing jurisdictions, however, requires the use of exchange of information provisions found in tax treaties. Moreover, where books and records are maintained in a tax haven, the ATO will encounter particular difficulties in trying to obtain access to them. Thus domestic disclosure requirements become difficult to enforce. In any event, it is also questionable whether the evidence that tax administrators would be able to produce on transactions that take place in Cyberspace would satisfy the documentation and evidence standards set by tax laws. These "problems" should in theory be easily overcome by appropriate amendments to existing laws governing record-keeping requirements

under the ITAA.

However, corresponding legislative changes will need to be considered to cover encrypted data to ensure that it will be no excuse for businesses to claim that they have lost encryption keys and according cannot produce requested information - that is, the onus of production of information must remain with taxpayers.

d) Dematerialisation of trade

Increasingly, it can be expected that in an electronic commerce world, trade will turn more and more toward services rather than goods. This can lead to many problems, including the removal of the ATO's ability to audit an assessment based on comparing inputs and outputs.

For example, if one considers a software company that distributes its programs on floppy disks, the ATO can check the number of blank disks the company purchases and can use that as a rough guide as to how much software it sells. But in the world of e-commerce, when a program can be downloaded over the Internet, the physical check on the scale of business will no longer exist.

Thus, the growth of electronic commerce and the rise of the intangible economy could potentially lead to erosion of the tax base.

Looking again at the Internet, the potential for revenue leakage becomes apparent. Currently, people who shop on the Internet mainly use it to order tangible products, such as books or CDs. In an electronic commerce environment, it is already possible to go on-line and buy books and CDs from a mail-order service such as Amazon.com or Cd Now, who then post the physical item to consumers. There is nothing very different about transacting over the Internet in this way compared to buying it in a shop, as the physical good is still delivered via the post and hence the customs authorities can check it and collect any applicable duties or taxes.

However, as more products become intangible - for example, instead of receiving a physical CD ordered on-line and despatched via the post, consumers can now download it to their personal computers. In this context, VAT/GST taxes become vulnerable to avoidance.

The ability in the future to download products such as videos, CDs and software, combined with being able to reprint books, will pose a serious threat to the ability of the ATO to detect any taxable transaction. This, of course, is unless some form of technology (for example, a "tax chip") is installed into every computer, a prospect that would no doubt raise the ire of civil libertarians. Also, the government has ruled out the use a "bit tax" that involves taxing each bit of digital information flowing across global networks.[5]

e) The impact on Wholesale Sales Tax (WST) and VAT/GST taxes

Australia currently does not have a VAT/GST, but relies on a wholesale sales tax (WST) that applies to goods. Goods are currently defined as being items of tangible property. As already observed, electronic commerce makes it possible for goods that were previously only available in a tangible form, and therefore subject to the WST regime, to be delivered in an intangible form which will not be subject to WST. Returning to the example of music that can now be downloaded directly from the Internet, practically, this will have the same function as music sold as a CD in a shop but it will not subject to WST as no "good" arises on which WST could be levied.

As more goods and services become capable of being converted into electronic form, the application of sales tax, or for that matter, a VAT/GST, becomes more complicated and the potential for revenue leakage increases considerably. Already intangibles such as travel and ticketing services, [6] software, entertainment (on-line gambling, games, and music), insurance and brokerage services, real-estate services, banking, information services, legal services, and increasingly health-care, education and government services are appearing on the Internet. This trend will no doubt continue to increase, both in number and diversity of services that become available.

It is beyond the scope of this Paper to examine in detail the many challenges to consumption taxes. [7] However, there are two final points worth mentioning in relation to the application of a VAT/GST in an electronic commerce world:

i) Tax administrators will experience three main problems in relation to the application of VAT/GST rules, particularly as they may apply to international services:

- Ascertaining when a transaction occurs;
- Determining where the place of supply is; and
- Attaching a value to the transaction: that is, what would be the consideration applicable to the transaction.

ii) For most businesses, VAT/GST is not a real cost but normally flows through to the final customer who ultimately bears the economic burden of VAT/GST. However, for some businesses that are exempt from VAT/GST, consumption taxes can be a real cost, as they may not be able to claim a credit for VAT/GST charged on their business inputs. A good example of this is businesses that operate in the financial sector, such as banks. As banks cannot recover fully the VAT/GST normally charged on their business expenditure, they may look to the Internet to try to achieve real cost savings. As an example, banks may try to avoid VAT/GST by seeking out non-resident suppliers that have no business or other fixed establishment within Australia.

Such businesses could then establish by contractual arrangements an "artificial" source of supply outside Australia, thereby avoiding VAT/GST. This type of arrangement would undermine the "place of supply" rules that are a feature of traditional VAT/GST systems.

Hence, the advent of electronic commerce not only has implications for the current WST system but will have implications for a VAT/GST, should Australia eventually introduce such a tax.

f) Impact of Electronic Commerce on Customs Procedures

To assess the impact of electronic commerce on Customs procedures, it is necessary to distinguish between "on-line" supplies and "off-line" supplies of goods and services.

Goods or services ordered via the Internet and physically delivered may be described as "off-line" supplies. Activities involving international mail order transactions of goods will, in principle, continue to be dealt with by the Customs authorities at the point of importation with regard to the collection of both Customs duties and VAT/GST as appropriate. In other words, for the off-line supply of goods and services via the Internet, no new problems are presented to VAT/GST authorities, other than the significant increase in the number of transactions that can be expected. This in turn raises a question mark over the ability of Customs' authorities to be able to cope with the resulting demand.

In this regard, three issues need to be considered:

i) More resources will need to be directed to Customs authorities to ensure they can cope with the expected increase in the volume of transactions consequent upon electronic commerce.

ii) The ongoing review of the Kyoto Convention [8] by the World Customs Organisation (WCO) was presented to the WCO Council in June 1999. At this forum, some options to deal with the streamlining and simplifying of Customs clearance procedures were suggested in a common effort toward achieving the full potential of a global market place for consumers.

iii) A review of the customs duty and sales tax free limit (currently $50) needs serious consideration. Certainly, the OECD has indicated that such a review is appropriate in the context of the global marketplace. [9] The Joint Committee of Public Accounts and Audit has recommended that the current $50 limit should remain, pending a survey being conducted by the Government, which may validate a change of this value to $150. [10]

By contrast, the supply of "on-line" activities in the form of digitised information poses a serious challenge to the current "place of supply" rules contained in most VAT/GST systems. This in turn creates a real possibility of either no taxation or double taxation being levied in an environment where supplies can be made without the supplier having any form of physical presence.

In examining the overseas experience, the United States has stated that:

The Internet [should] be declared a tariff-free environment whenever it is used to deliver products or services. [11]

The US believes that this concept of a "duty-free" zone should be limited to goods or services delivered electronically. Thus, if a customer downloads some software from the Internet, the transaction should

be free from any customs duties. The reasoning here is that in the case of software, tariffs are only imposed on the value of the media (for example, the floppy disk) and not the value of the software itself. Therefore, if the floppy disk disappears through an electronic transaction, then there is no longer a transaction to which tariffs could be applied.

However, when physical goods are ordered over the Internet and delivered through conventional means, such as a mail-order sale of shoes, then the transaction should be subject to any generally applicable duties, as if the goods had been ordered via the telephone or by mail.

The US approach therefore recognises the distinction between "on-line" and "off-line" supplies and the policy stance taken seems reasonable and contains nothing that would limit the application of VAT/GST (as appropriate) in respect of importations of relevant goods and services.

g) Disintermediation will remove convenient "taxing points"

One of the far-reaching consequences that electronic commerce is expected to have is the elimination of "middle-men," which has been described as disintermediation. The potential impact of disintermediation can be understood by two recent examples.

The first example is that of a company called Daisytek that has enjoyed massive cost and time savings through its SOLOnet electronic commerce network by adopting a business practice known as "drop-shipping" - where the product is shipped direct from the manufacturer to the customer, thereby by-passing the distributor.

Amway has also experienced similar benefits by establishing its ELVIS (Electronic Link via Internet Services) Internet site. Big savings have been achieved in ordering electronically, where it has been reported that an electronic order can save up to $3 per transaction, which amounts to a considerable savings given about 700,000 orders are placed a year. [12] Other benefits have included provision of on-line information including catalogues and full integration into Amway's back-end systems, which include finance, ordering, inventory and distribution. [13]

Also, the importance of the potential savings in transaction costs through disintermediation cannot be overlooked. For instance, one estimate places the cost of buying software over the Internet at $0.20-0.50 per transaction as opposed to $5 for a telephone order and $15 for a traditional retailer. [14]

Disintermediation will lead to a diminished role of intermediaries, such as banks and similar institutions. Banks and other financial institutions have been traditional intermediaries for the ATO and in that role have collected taxes such as withholding taxes on behalf of the ATO. If consumers become able to by-pass these intermediaries, the result will be that the ATO will no longer be able to rely on them to collect withholding taxes, which may therefore become less viable sources of revenue for the government.

Extending the analysis, the elimination of "middle-men" could therefore force the ATO to collect smaller amounts of revenue from a larger number of taxpayers. This would be undesirable, in that it will increase the administrative and compliance costs of the taxation system.

Apart from removing convenient taxing points, disintermediation could lead to a transformation of traditional banking systems, due to the expected availability of a large number of banking facilities on the Internet, many of whom would operating in an off-shore environment and some in tax havens.

This raises other concerns. Should the Reserve Bank lose control of even a portion of the money supply through pervasive electronic cash systems, then this could place Australia's current transaction reporting regime in jeopardy. [15] The Financial Transaction Reports Act 1988 (Cth) (FTRA) relies on the ability of financial intermediaries, such as banks, to identify suspicious transactions as well as those over certain prescribed limits.

Studies have shown that E-cash, combined with smart card technology:

> Could be used to smuggle currency in an out of countries in violation of those [country's] laws. It can also be used to transact normal business without the knowledge of the authorities, which could make it very useful to the "underground economy."[16]

This would create a need for some very creative and determined work on the part of AUSTRAC to keep ahead of the money launderers.

The issue of non-bank involvement in the provision of electronic purse services may require regulatory intervention to ensure that only banks are allowed to issue electronic purses.[17] This is because banks and similar financial institutions would need to follow the standard requirements of identification and reporting. Non-bank institutions, on the other hand, are subject to fewer regulatory requirements and examinations, making them potentially more susceptible to money laundering activities.

h) Tax havens and off-shore banking facilities will become more accessible

Tax havens and offshore financial facilities, once the domain of the rich, will soon be within the reach of the "average" taxpayer. Already a number of tax havens are offering numbered and coded bank accounts, combined with services such as on-line international money transfers other payment options.

Whilst the principles which govern off-shore banking are similar to those which govern traditional banking, the ways in which banking over the Internet may operate in the future will make a crucial difference to the ability of the ATO to counteract international tax evasion and avoidance. Internet banking will offer an ease of access, an immediacy of transferability of money, a degree of anonymity, and low transaction costs, which is not available today. If these features can be combined with well run off-shore institutions in circumstances that provide security, one can expect that a much wider group of consumers will be attracted to electronic commerce.

In a commercial context, the capital of a business can in this way be passed thousands of times through tax havens, in some cases on economic grounds, and finally deposited in its own accounts once it is perfectly clean and backed by a completely lawful activity.[18] In other words, taxpayers could try to take improper advantage of the globalisation of the international financial system and the fact that these systems operate across multiple jurisdictions, providing easy access and security.

Strategies such as this will make it difficult and costly for the ATO to follow their transactions. As Neil Warren has noted:

For tax evasion to be successful, the complicity of countries prepared to set themselves up as tax havens is fundamental. This complicity must extend to providing a low or zero tax regime for all internet commerce. This must extend to internet businesses and internet banks which deal with internet commercial transactions. The banking system has an important role in facilitating the laundering of any profits made back into the country where the real owner of the commercial website resides. While tax havens have always been with us, what is different now is that the internet makes them accessible to the masses. With bank secrecy ensured in the tax haven, everyone has the potential to participate in large scale tax evasion. [19] (Emphasis added).

i) A Cashless Society?

With the further development of electronic money technologies such as e-cash, the future of money itself as a form of payment could be in doubt. Cyberpayments [20] are quickly emerging as an innovative mechanism for conducting financial transactions.

The advantages of these types of systems include:

i) When transactions occur, either through the Internet or through use of so-called "smart cards", they will provide a speedy, convenient, secure, and anonymous method of transferring monetary value. Because of the anonymity associated with such cards, it may be necessary to consider limiting the use of these cards to low-value transactions to curtail any potential abuse that may be associated with such a facility.

ii) E-cash systems can be used over networks, such as the Internet. Real time e-cash therefore closely emulates paper money, in that it provides person-to-person payments, may have no audit trail and no interchange.

It is recognised that all of these systems are still in their infancy and there are no guarantees that they will meet with market acceptance. Nevertheless, a number of E-cash vendors (including large organisations such as Mondex) are confident that their products will eventually displace cash as the principal method of payment.

So what are the risks associated with these emerging forms of payment?

At present, tax authorities can monitor physical records, such as bank statements and other data.

In the electronic commerce world, there will be two types of systems governing cash - "accounted" and "unaccounted" systems. Accounted systems provide many of the safeguards currently available through physical records such as bank statements; however, unaccounted systems pose significant risks. The problem with unaccounted systems lies in the fact that such transfers would leave no physical record, and when instantaneous transfers of money become a reality, there will be no time interval between purchase and supply making it difficult to establish an audit trail of the transaction.

So while we remain in a society where large banks, cash and paper still loom large, transactions are not difficult to track. In future, however, audit trails may be more difficult to find, especially those associated with unaccounted systems. Accordingly, the ATO should ensure that electronic payment system providers operate their systems in a way that enables the flow of funds to be properly accounted for, consistent with current laws that apply to the physical world. [21]

j) Income Tax Concepts: Some of the challenges

Many issues arising in relation to the administration of Australia's taxation system have already been identified, along with the issues arising for VAT/GST systems and Customs procedures.

The scope of this Paper is to examine the impact of tax havens, bank secrecy laws and electronic commerce on the administration of the Australian taxation system by the ATO. As such, it is beyond the scope of this analysis to examine in detail the many issues arising for specific concepts that are contained within the income tax law.

Nevertheless, it is useful to briefly summarise some of the issues that electronic commerce raises in relation to these concepts.

i) Tax treaties

The issues under this heading may be summarised as follows: [22]

- the definition of when a permanent establishment exists and what profits should be attributed to it;
- the characterisation of income, particularly as regards digitised information and the definition of royalties; and
- the application of special rules, found in some tax treaties, dealing with income from services.

ii) Source and residence taxation

Traditional concepts of source-based taxation rely on there being a strong connection between an economic activity and a specific location. Given that technological developments may make the location and identity of an entity difficult to determine and easily moveable, the implications for source concepts become apparent.

Likewise, traditional residency concepts are based on concepts such as physical presence, incorporation and place of central or effective control. However, technology can make management and control less location-specific. For example, by holding company board meetings via a videoconference in a chosen country, it may be easy to manipulate the rules governing central management and control and thereby, the residency of the company. Thus, the implications for residency need to be considered.

iii) Transfer Pricing

While electronic commerce may not necessarily present any unique problems for transfer pricing, the growth of electronic commerce will be likely to make some of the transfer pricing problems more common. Some of the issues that need thought include:

- possible difficulties in applying the 1995 OECD Transfer Pricing Guidelines;
- the likely difficulties in determining profits of enterprises where a high level of "integration" within businesses (especially Multinational enterprises) will be possible consequent upon

electronic commerce.

- the likely difficulties in identifying, tracing, verifying and quantifying transactions in highly integrated enterprises.

CONCLUSION

Even if the challenges outlined in the previous 10 points only erode the fringes of the tax system, the impact could be considerable, because the public sector is inherently inflexible and dependent on taxes to fund political commitments given by governments. Consider the following example:

France collects about 50 per cent of its GDP in taxes. If it were to lose 10 per cent or so of that (about 5 per cent of GDP), its budget deficit would have to double, or else, to keep public spending stable, funding for health would be halved. [23]

In other words, a relatively small cut in the tax take could leave politicians with painful choices.

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