Proceedings of the
International Conference on E-Commerce
ICoEC 2015
20-22 October 2015. Kuching, Sarawak, MALAYSIA

Available online at www.icoec.my

The Impacts and Challenges of Electronic Commerce on Taxation

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Abstract: *This paper seeks to discuss the impact and challenges for tax authorities toward electronic commerce (e-commerce) activities. The discussions also highlight the draft issued by OECD in regards to tax challenge of the digital economy. The rapid growth of e-commerce adds value to company in term of cost saving since the customer can be reached all over the world without having physical presence in the customer's country. This will give a positive relationship with the government tax revenue whereby increase in profit of the company will increase in tax revenue collection. However, there are some impact and challenges for tax authorities to deal with particularly related to tax evasion by the taxpayer because e-commerce seems as the new way for taxpayer to avoid tax payment. The borderless of e-commerce produce specific administration issues on identification of business, determination of the extent of activities, information collection and verification and identification of customers.*

Keywords: Electronic commerce, taxation, Malaysia

1. INTRODUCTION

Electronic Commerce (E-Commerce) can be defined as a new way of conducting business between buyers and sellers without either of them coming into physical contact with each other (Kirti & Namrata Agrawal, 2014). Adoption of E-Commerce leads to the company to change their business model from physical business to virtual business and it has become the crucial channel for the company in conducting their business. In fact, not only physical product such as books, clothes, food and computer has been sold virtually but also services such as web tutorial for financial consultancy, education etc. This new business model has been evolved and become the norm in conducting business worldwide. More importantly, e-commerce transaction has also challenged the tax authorities across the world especially when the local businesses are being transformed into global market. Thus, the traditional tax rules also have to be changed and amended based on the present business transaction.

1.1. Types of taxation systems

In Malaysia, there are two types taxes collected which are direct taxes administered by Inland Revenue Board Malaysia (IRBM) and indirect taxes administered by Royal Malaysian Custom Departments (RMCD). The IRBM is responsible to all policies in regards to income tax, petroleum income tax, real property gains tax and stamp duty whereas the RMCD is responsible to all policies of Indirect taxes such as customs duties, excise duty, sales tax, and service tax. Since April 2014, Malaysia Government has implemented goods and services Tax (GST) to replace sales and service Tax. Thus, IRBM and RMCD have to change and amend the tax policy since all the goods and services are imposed by GST and business entity is allowable to claim back their tax credit from the tax authority. For business and personal income derived from E-Commerce transaction, the IRBM has issued a guideline on taxation of e-commerce in January 2013. This guideline states that whatever income derived from resident or non-resident as long as the business operation is carried on in Malaysia and the business income from e-commerce is deemed to be derived from Malaysia regardless of the location of the server (include webhost/server located outside Malaysia), those income are subjected to tax in Malaysia. The RMCD also has issued the "Guide on E-Commerce" as at 20 August 2014 for GST purposes particularly for transaction via e-commerce activities. The GST is based on a

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territorial basis and must be neutral or in other words, it may not interfere with the commercial flow. Both guideline issued by IRBM and RMCD is destination based principle which means as long as the income/goods/services is deemed to be derived in Malaysia, thus income/goods/services has to be taxed. However, there are some impacts and challenges for tax authorities to deal with e-commerce activities.

This paper seeks to discuss the impact and challenges for tax authorities toward E-Commerce activities. The discussions also highlight the draft issued by OECD on "BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY (April 2014). It is the OECD act as meeting ground for 30 countries and provides a forum for discussing issues and reaching agreements some of which are legally binding. The organizations of this paper are as follows. Section 2 discusses the impacts and problems of e-commerce activities on taxation. Section 3 provides the summary of tax administrators' challenges on electronic commerce. Finally, the conclusions are clearly presented in Section 4.

2. THE IMPACTS OF E-COMMERCE ACTIVITIES ON TAXATION

The growth of e-commerce activities lead to emerging issue especially on taxation and provide impact on tax revenue collection in the country. Agrawal (2014) explains that the growth of e-commerce transaction in India leads to the need for special tax provision to reduce the number of tax evasion and emphasises that e-commerce is the new way for tax evasion by traders. A record for cash payment and receipt through electronic payment is currently maintained but there is no record exists for accrual expenses or receipt for electronic payment. Thus, for cash payment/receipt, the tax authorities can match the payment and receipt through electronic payment but for accrual expenses, there is no such records are maintained. Therefore, the situations of understated reporting of income are common in such systems

2.1. Permanent establishment

Furthermore, it is reported that the corporate income tax revenue also decrease due to the introduction of e-commerce transactions particularly on the permanent establishment (PE) issues which have been highlighted in few countries especially in European Union countries. There is a study done by Mclure (2001) stated which that the introduction of e-commerce leads to significantly reduce the corporate income tax revenues especially in developed countries. This is because it is possible to make sales of both tangible products and digital content without having a PE in the market nation. Besides, there is also possibility to use off-shore tax havens in e-commerce activities in order to sabotage the revenues of all nations.

2.2. Characterisation of income

Besides the issues of PE, the OECD (2014) also highlighted the issues on the characterisation of income derived from e-commerce. Under most tax treaties, business profits would be taxable in a country only if attributable to a PE located therein. In contrast, royalties may be subject to withholding tax in the country of the payer, depending on the terms of any applicable treaty. Whether a transaction is characterised as business profits or as another type of income, it can result in a different treatment for tax treaty purposes. When considering questions regarding the characterisation of income derived from e-commerce it will therefore be necessary to examine the rationale behind existing rules, in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms. Based on a study by Agrawal (2014), the issue of characterization is very important because different categories of transactions may have different tax consequences. When the transfer is of partial rights in the product, it will constitute a royalty. Consequently, such a payment can be taxed in the state where it arises. However, if the website owner has a PE in the source state, the payment will be classified as business profits. The country of source can tax royalty and also services which are of technical nature but it cannot tax business profits.

As far as India is concerned, under Explanation 2 to section 9(1)(vi) of the Income Tax Act, 1961, the term royalty has been defined to mean the consideration arising on the transfer of all or any rights in respect of a copyright or a scientific work. The broad definition of royalty allows for the taxation of payments arising from transfers of all kinds. In this context any payment made in India for transfer of software or other digitized products on the internet will be classified as royalty under the Income Tax Act, 1961. Thus, any payment made by internet users for the transfer of software or other digitized products will be subject to tax deduction at source under section 195 of the Income Tax Act, 1961. Thus, Agrawal (2014) recommended that a threshold is set for revenue generation within a country. Anyone receiving more than the threshold will be liable to file his tax returns in India irrespective of whether the transaction is categorized as business profits or royalty and thus to pay the tax. The payers will deduct tax at source and deposit it to the Indian Government.

2.3. Nexus

In addition to PE and characterization of income issues, the OECD (2014) highlighted the nexus issues which may also lead to significant existence without being accountable to pay tax. E-commerce can enhance the ability of the company to reach the potential customers over the world without having many investments in infrastructure such as marketing, advertising and customer support. The issues of nexus are related to the country taxation for income derived from non-residents enterprise. This will increase the flexibility of business to choose any place to carry out their business and spread the business personnel, servers and customers among multiple locations at different jurisdictions. Therefore, there is a possibility for the Company to generate more sales without taxable presence. Even though the tax treaties does not permit the taxation of business profit without having PE but it appears in the absence of the limitations imposed by tax treaties, many jurisdictions, would not under their domestic laws tax income derived from non-residents from sales to customers located in the jurisdiction concerned.

Some members of the EU and OECD also provide preferential tax regimes for certain activities in tax havens country (MClure, 2001). For example, Ireland levies a 10 percent rate on income foreign taxpayers earns from manufacturing and Belgium and the Netherlands provide special tax treatment of “coordination centers” to attract headquarters of multinational corporations. However, this initiative has been limited to financial and other highly mobile activities.

2.4. Goods and services tax

Besides the issues discussed above, the OECD (2014) also highlighted the issues on the e-commerce transactions also lead to difficulties to tax administrators to ensure the GST and corporate income tax are correctly collected and paid by the company. The taxpayer can easily make incorrect declarations and it is difficult to tax authorities to enforce the compliance among companies. The evolution of technology has dramatically increased the capability of private consumers to shop online and the capability of businesses to sell to consumers around the world without the need to be present physically in the purchaser’s country. This may lead to no collection of GST being levied at all level of transactions. There are two main issues related to GST collections which are: (1) exemptions for imports of low value goods and (2) the complexity to enforce the compliance particularly for the company who are not having physical presence in the country.

The mechanism for collection of GST for imported goods is based on customs collections mechanisms or many countries give exemptions for low value good in which the threshold has been set up by the countries. However, this exemption leads to GST not collected. Based on study by McLure (2001), the tax authority may improve the exemptions for small shipment in order to resolve for this problem. However, it will affect both economic neutrality and the fairness of the systems and also the government’s revenue. The company are deliberately structure their affairs to take this opportunity of low value threshold and sell the goods to customer without paying any GST. As the results, the GST’s revenue will be decreased and lead to unfair competitive pressure on domestic retailers who are required to collect GST on their sales to domestic customers. Besides, this will encourage domestic retailer to relocate to offshore area in order to avoid GST payment and may lead to negative impact on domestic employment and direct tax revenues.

E-commerce allow the goods delivered from remote location to customers around the world without having physical presence which may lead to no GST is collected and create potential competitive pressures on domestic suppliers. The non-residents suppliers are voluntary to register and collect GST on behalf of the tax authorities. Mclure (2001) stated that there are several problems may arise if non-residents’ vendor are required to collect the tax on behalf of tax authority such as uncertainty of customer’s location, weaknesses of legal protection for intangible product (e.g copyrights and other intellectual property) in the market states and lack of incentives to collect tax. Based on OECD report, there are significant number of non-residents suppliers register in GST jurisdiction and collecting and remitting tax on their remotely delivered services due to reputational reasons. However, it is difficult to assess the compliance level for digital goods and services. For example an online supplier of streaming digital content such as movies and television shows. The supplies are made mainly to consumers who can access the digital content through their computers, mobile devices and televisions that are connected to the internet. If the supplier is resident in the same jurisdiction as its customers, it would be required to collect and remit that jurisdiction's GST on the supplies. However, if the supplier is a non-resident in the consumer's jurisdiction, issues may arise. As the result, many non-residents supplier are likely fail to register and remit the GST and this may lead to loss of GST revenue and potential unfair competitive pressures on domestic suppliers.

2.5. Others

In addition, there are also potential implications on the failure to collect taxes by the tax authorities. The Company has intention to relocate their production and sales activity in order to avoid tax collection responsibility, thus lead to impose economic efficiency losses on the total economy. GST also become more regressive due to offline purchase is more likely to pay GST rather than online purchase. A rapid growth in e-commerce transactions lead to government loses billions of dollars via online transactions due to rapid transaction made by computers (Omar, 2008). They are also unidentifiable because the internet does not require the users to reveal their location or correct identity (Omar, 2008). Thus, the absence of actual physical presence of the seller, buyer and goods make the difficulties to tax enforcement. Based on a study by Omar (2008), many states are not collecting taxes on online transactions due to issue on who should standardize the online taxing congress, state or local government. The outcome of this study shows that the estimated revenue losses of $13.3 Billion in 2001 will rise to $62.1 billion by 2011. Losses from e-commerce revenues have been found to have a significant impact on state economies. Basically, the public can get benefit through e-commerce taxation. However, the potential loss of tax base will impair the governments' ability to improve education, health, roads, public safety, creating dedicated local and state revenue source for youth programs, and many other essential services.

3. TAX ADMINISTRATORS CHALLENGES IN E-COMMERCE ACTIVITIES

Based on discussion draft issues by OECD (2014), there are four main challenges for tax administrators in e-commerce activities which are identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. Further explanations for each challenge are as follow;

3.1. Identification

The tax administrators having difficulties to identify the business and trace back the sales transaction made by the non-residents to domestic customers since the non-residents are voluntary or not required to register and remit the tax on behalf of the tax authorities and also located in different tax jurisdiction. Therefore, it is also difficult to tax authorities to enforce the tax law in the country. Based on guideline issued by IRBM with regards to Double Taxation Agreement between Malaysia's Government and the foreign country, the allocation of taxing rights over business income between countries that are partner to a tax treaty is based on Permanent Establishment (PE) concept. PE can be defined as fixed place of business through which the business is wholly or partly carried on where premises or facilities such as machinery or equipment are existed and fixed. Therefore, if the non-residents do not have fixed place in Malaysia, the business income is not taxable in Malaysia. However, the issue may arise related to GST when the non-residents are selling goods/services to domestic customers. Based on the guideline issued by RMCD, if the imported goods purchased from outside of Malaysia, then GST is payable upon importation but if the services are supplied by non-resident to Malaysian customer, these services are not subjected to GST for private used. However, GST-registered business has to account GST on the reverse charge mechanism where he is deemed to make taxable supply to himself and he can recover the input tax in full, whereas, if non-registered business purchased the imported services from non-residents, he has to declare and pay GST to RMCD upon the importation of service. The issues may arise when the non-registered business do not declare and pay GST for the transactions made from non-residents through electronic commerce.

3.2. Determining the Extent of Activities

Basically, the identity of domestic entity can be determined but it is difficult to determine the extent of sales without information from the offshore seller. This is because of no access or records are being kept in the local jurisdiction. The tax authorities can obtain the information from third parties such as customers or bank but it is dependent on privacy or financial regulation laws. Based on Section 79, Income Tax Act 1967, IRBM has power to call for statement of bank account in Malaysia for tax audit purposes. The IRBM can directly request the bank statement from the bank with the consent of the bank accountholders in Malaysia. However, the issue may arise when the IRBM or RMCD would want to get financial information from the offshore seller or non-residents due to different jurisdictions and confidentiality of information.

3.3. Information collection and verification

The tax authorities can exchange the information with other country's tax authorities to trace back the transactions. However, it also depends on the information retained or accessible by the tax authorities. Besides, it may create a challenge for tax authorities to verify the information given by the offshore entity. The principles of transparency and effective information exchange for tax purposes are reflected in the 2002 OECD's Model Agreement on Exchange of Information on Tax Matters and in Article 26 of the OECD Model Tax Convention on Income and on Capital. However, the issue may arise if Malaysian government would want to get and verify the information from non-OECD members or offshore entity.

3.4. Identification of customers

The tax authorities also can trace back the transactions occurred by vouching and tracking the customs documentation and card billing address. However, it may burden the business to identify the customers location and not possible to implement if the customers are able to hide the actual location. Based on study by Mclure (2001), it was a problematic issue for vendor to collect the tax of the nation where the customer resides due to vendor does not necessarily know the location of their customers.

4. CONCLUSION

The rapid growth of e-commerce adds value to company in terms of cost saving and gain more profit since the customers can be reached all over the world without having physical presence in the customer's country. This will give a positive relationship with the government tax revenue whereby increase in profit of the company will increase in tax revenue collection. However, there are some impacts and challenges in e-commerce activities for tax authorities to deal with particularly related to tax evasion by the taxpayer. E-commerce seems as the new way for taxpayer to avoid tax payment. This may lead to decrease in corporate income tax and GST revenue. Besides, it is unfair to domestic retailer when non-residents are trying not to pay tax but the local company have to register and collect tax due to permanent establishment issue. As the results, the domestic company will relocate to offshore area in order to avoid tax payment and lead to negative impact on domestic employment and income tax revenue. Furthermore, tax authorities also having difficulties in enforcing the compliance among taxpayer due to record keeping and different tax jurisdictions. The tax authorities can trace and match the cash payment and receipt through electronic payment but it is difficult to trace for accrued revenue/expenses due to no such records are maintained.

The borderless of electronic commerce also produces specific administration issues on identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. More importantly, the potential loss of not collecting tax revenue from e-commerce activities may lead to impair the governments' ability to improve other benefits for the public and increase the efficiency of public services as whole. Beside, these implications and challenges of e-commerce activities seem as the way forward for researcher to pursue e-commerce in taxation studies.

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