

## E-commerce: A Taxing Regime to Tax

Noraza Mat Udin<sup>a\*</sup>, Lamidi Wasu Adebayo<sup>b</sup>

<sup>a</sup>School of Accountancy, College of Business, Universiti Utara Malaysia, Malaysia

<sup>b</sup>Othman Yeop Abdullah Graduate School, Universiti Utara Malaysia, Malaysia

**Abstract:** *E-commerce is a new mechanism to transact business either locally or globally by using the internet or web. In line with the terrific development of e-commerce technology, taxation of e-commerce has also become a major challenge in the world which needs to be addressed seriously. The tax authority has found that the taxation of online transaction is taxing because of the nature of e-commerce and the way it operates. This paper discusses the e-commerce environment including its features and nature which consequently leads to the challenges and difficulties in charging relevant taxes on this kind of business transaction. Discussions on taxation principles and taxes related to e-commerce are also included. In addition, this paper explains various aspects of challenges to tax e-commerce transaction which may cause revenue losses to the Nations. The paper ends with a brief conclusion and recommendations in order to sustain the competitive advantage of e-commerce.*

**Keywords:** Electronic commerce, Taxation, Business

### 1. INTRODUCTION

E-commerce has great influence and become an important aspect in our daily lives. It provides a fundamentally new way of conducting commercial transactions and has potentially far-reaching economic and social implications on many parts of life (OECD, 2001). E-commerce can be referred as the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the marketplace (Abrams and Doernberg, 1997). In 2001, the Organisation for Economic Co-operation and Development (OECD) defined e-commerce in two perspectives: narrow and broad. However, in 2009, the definitions has been revised to combine the two perspectives. Therefore, e-commerce transaction is defined as “the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, government and other public or private organizations” (OECD, 2011). Specifically, computer networks involve the use of

the internet or web to transact business either locally or globally.

E-commerce is different from the traditional way of doing business as it incorporates all day and all night accessibility, the velocity of access, a more extensive determination of products and services, openness, and worldwide scope. On the other hand, its drawbacks are restricted client service i.e. not having the capacity to see or touch an item physically before buying and the required to sit tight time for item transporting. To guarantee the security, protection and adequacy of e-commerce, organizations ought to verify business transactions, control access to assets, for example, website pages for registered or selected clients, encrypt interchanges and execute security advances, for example, the Secure Sockets Layer (Sengupta, Mazumdar and Barik, 2005).

In line with the terrific development of e-commerce technology, taxation of e-commerce has also become a major challenge in the world which needs to be addressed seriously. The tax authority has found that the taxation of online transaction is taxing because of the nature of the business and the way it operates (Cockfield, 2006; Azam, 2007). For example resident of a country can order for a

\* Corresponding author. Tel.: +6012-5060699  
E-mail address: [nora896@uum.edu.my](mailto:nora896@uum.edu.my)

product in another country, how would the transaction is going to be taxed, is it going to be taxed in the origin country or the destination country, what is the suitable rate of tax to be used and what mechanism to implement in order to avoid the product being taxed twice.

The objective of this paper is to discuss the e-commerce environment and its features and nature which consequently leads to the difficulties in charging relevant taxes related to international business transactions. The remainder of this paper includes discussions on e-commerce features, taxation principles and taxes related to e-commerce and various aspect of challenges to tax e-commerce transactions which may cause revenue losses to the Nations. This paper ends with a brief conclusion and recommendation in order to sustain the competitive advantage of e-commerce.

## 2. E-COMMERCE FEATURES AND TAXING REGIME

The difficulty to impose tax on income derived from e-commerce transactions are mainly due to its nature of operation which is online while the tax rules were designed in the era of traditional business i.e. prior to the emergence of e-commerce (Smith, 2002, Azam, 2007). Basically, e-commerce is characterized by the following features:

- i. *Potentially virtual*: the presence of an enterprise in another country may be wholly based on the hosting of a web-site on a server located there;
- ii. *Disintermediated and less labor intensive*: the main enterprise no longer requires intermediaries in foreign countries to be able to conduct business there. Moreover, e-business activities require far less human intervention, if any, than that otherwise required to trade by in a traditional manner;
- iii. *Global*: the scope of market-penetration is unlimited and knows no borders; and
- iv. *Anonymous*: business is transacted on a non-face to face basis and therefore the seller and the consumer may not know each other.

Essentially, there are three types of trade or transactions that can be conducted over the internet; these are electronic trade in intangible goods, quasi or semi-intangible goods and intangible goods (Chen & Smekal, 2009).

**Electronic trade in tangible goods:** E-commerce can be utilized to carry out conventional buying and selling of products, for example, to place an order, to reach agreement on a particular transaction, and to perform monetary transaction through advanced

technology. This sort of e-trade does not change the primary character of conventional retail that is to trade between two identifiable partners. For transaction that is international or cross-border, the seller needs to find the buyer and vice versa. The transaction is based on physical goods.

### **Electronic trade in quasi or semi-intangible goods:**

This kind of product can be reproduced without altering the content and quality, which means many copies of it can be made. The use of internet for business transaction has improved the way intangibles are being offered for sale. For instance, individual can buy software from any part of the world and the access to download it is given to the buyer directly.

### **Electronic trade in intangible goods (services):**

Using information communication technology, many services can be exported and imported through electronic trade. A show or a theatre presentation can be televised worldwide. The restriction of having to enjoy the show at the site of the event has been removed. Modern information communication technology has made services internationally tradable. For instance, a song, a concert, a film, and so on can be downloaded by a buyer in any country directly from the Internet. Likewise, software can be downloaded by a purchaser in a foreign country via the Internet. A newly developed tele-health (diagnostic) system can provide diagnostic services for health care directly from the internet. Electronic banking provides both internal and international banking services through the internet. Accounting services can also be provided to a user from a foreign provider through the internet. E-learning that is a modern kind of distance training using advanced information communication technology to carry out distance education. Professional services such as software development, consultancy and consultative services can be provided by the internet, which gets rid of the distance between providers and users.

Due to its nature discussed above, there is a mark of intermediary lack in e-commerce activities. E-commerce has created dislocation in certain business practices where the companies are moving nearer to their clients. The internet gives companies the opportunity to trade directly with the consumer in a more meaningful manner, thus eliminating sophisticated intermediaries such as sales agents or marketing associates. This situation has two primary effects that cause problems in the application of tax regulations. First, taxpayers, who are less sophisticated than businesses, are commanded to

comply with certain tax reporting and filing duties. Second, the value of these transactions individually is relatively low, and it is hard to use the tax rules to smaller flows of money. One approach is a *de minimis* rule that eliminates the application of certain taxes. This advance has caused great fear among the taxing authorities of many nations on the presumption that e-commerce will cause tax loss to the government (Avi-Yonah, 1996; Davis & Chan, 2000, Viboonthanakul, 2009).

Specifically, the internet has created the electronic trade in intangible goods to be borderless. As the economic consumption of the internet can be carried out everywhere in the receptive world of cyberspace, the identification of transactions respectively of trading partners by national authorities is not possible. Therefore, border controls or import regulations become useless (Chen & Smekal, 2009).

### 3.0 TAXATION PRINCIPLES AND E-COMMERCE

Specifically, in Malaysia, the concern on the difficulty to tax e-commerce has been raised over a decade ago. For instance, Othman and Mohd Hanefah (2006) report their investigation on the application of the Malaysian tax law in terms of the determination of permanent establishment in an e-commerce environment. The findings point to the need of a guideline on e-commerce taxation to be issued by the tax authority. Later, Mohd Hanefah, Hassan and Othman (2008) document the tax problems posed by e-commerce in the Malaysian environment. The findings show that tax administration is the highest potential tax problem, followed by tax evasion, double taxation, tax avoidance and tax free. It was only in January 2013 that the Malaysian Inland Revenue Board issued "Guidelines on Taxation of Electronic Commerce" to provide guidance on basic tax issues and income tax treatment in respect of e-commerce transactions. The delay signals the cautious actions to tackle the complex e-commerce transactions. The guideline must be read together with the Income Tax Act (1967) and other relevant legislations and legal procedures that are in place.

The OECD through its Taxation Framework Conditions states that the taxation principles that guide governments in relation to conventional commerce should also guide them in relation to electronic commerce (OECD, 2001). These principles are as follows:

**Neutrality:** Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

**Efficiency:** Compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.

**Certainty and Simplicity:** The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

**Effectiveness and Fairness:** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counter-acting measures proportionate to the risks involved.

**Flexibility:** The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

It is emphasized that the application of these principles to e-commerce regime should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from e-commerce between countries and to avoid double and unintentional non-taxation. The process of implementing these principles should involve an intensified dialogue between OECD member countries with business and also with non-member economies.

#### 3.1 Taxes Charge on E-commerce Transactions

There are two bases of tax jurisdiction specified in the international tax regime developed in the 1920s (Azam, 2007). First, source-based or territorial taxation where a country has jurisdiction to tax income derived from its territory. This type of taxation requires determination of income source which is distinguished by categories of income. Second, residence-based or personal taxation where a country has jurisdiction to tax its residents on their worldwide income. In this system, the determination of residence status is vital. However, the problem of double taxation exists under these two bases of tax system. Thus, bilateral or international tax treaty is applied to prevent this issue.

The treaty may be described as a special arrangement or agreement between one country and other. Treaty guides the way country taxed foreign national resident in their country. Tax treaty is important because (i) it explains taxes covered on the residents and non-residents and the entitlement to claim benefits; (ii) regularly diminishes the amount of tax to be withheld from interest, dividends, and royalties paid by citizens of one nation to citizens of the other nation; (iii) minimises tax of one nation on business income of a resident of the other country to that income from a permanent establishment in the first country; (iv) may accommodate exception of specific sorts of associations or people; and (v) provides legal backing for enforcement of tax laws and resolution of dispute among countries.

The OECD tax treaty model provides that the authorized jurisdiction to tax business income is given to the country that hosts the permanent establishment of the business i.e. fixed place of business through which the business of an enterprise is wholly or partly carried out. Therefore, the concept of permanent establishment has invited various debates under the e-commerce environment in order to determine the 'fixed place' criteria. This phenomenon has created challenges to the tax authorities and the business owners worldwide. Perhaps, due to this reason, since the beginning of online transaction of buying and selling of goods and services which is around 1990s, e-commerce transaction is not subjected to any taxation.

Besides income tax, there are also other taxes related to e-commerce transactions. In the United State to be precise, when some states find that online transaction may be another means of generating revenue for the government, they started to charge tax on online transaction. In 1998, the "Internet Tax Freedom Act" was signed into law in order to encourage education and online dealings. There are two types of taxes collected by various states in the US i.e. sales tax and use tax. Taxable goods and services purchased within the state are subject to sales tax while for taxable products and services purchased interstate and brought back into the state is charged use tax. The amount of use tax is given as tax credit if sales tax had been paid in the other state for the purchase transaction (Ward and Sipior, 2004).

Another type of tax related to e-commerce transactions is consumption tax (OECD, 2001).

Value-added tax (VAT) or goods and services tax (GST) is a type of consumption tax. The core elements of the Taxation Framework Conditions related to this type of tax are:

- i. Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.
- ii. For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.
- iii. Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.
- iv. Countries should ensure that appropriate systems are developed in co-operation with the World Customs Organization (WCO) and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers.

Many countries have issued their own guidelines related to VAT/GST on the e-commerce transactions for instance Canada, New Zealand, Switzerland, United Kingdom and Malaysia. Since July 2003, the European Union's (EU) directive on e-commerce (E-commerce VAT Directive) requires all non-EU companies selling digital goods and services online to customers within the EU to register with an EU tax authority and charge, collect and remit VAT (Cockfield, 2006).

The problem of international trade is about which country's taxation system should be applied to e-commerce cross-border dealings. For economic efficiency, any tax system that will be used must not give room for importer or exporter to shift or divert their trade location or income in order to avoid tax. Therefore, for effective taxation of commodity, the design of the GST is influenced by the principle of destination (as well as the principle of origin) and three key policy objectives (Bird, 2003; Li, 2003).

**Destination Principle:** under this principle, tax is imposed on goods and services are sold and presumed to be consumed for personal use. Goods and services are exempted from tax in the country

where the goods are bought, that is the exporting country and are subject to tax in the receiving country. This principle makes sure that goods and services are similarly taxed in the country in which they are consumed. Thus, the country need to differentiate between goods and services provided for domestic consumption or export so that they do not subject to domestic tax rate.

**Origin Principle:** under this principle, tax is imposed where the value is added to those goods and services. Goods are taxed where they are produced and services are tax where they are rendered. Goods and services are taxed in country where they are bought but exempted from tax in the importing country. The problem associated with this principle is that if the origin of the goods and services is not known this principle cannot be applied. This principle is only used in the EU for intra-EU trade (Li, 2003).

Besides the destination principle, the design of GST is influenced by the three key policy objectives of raising revenue, equitable treatment of taxpayers as well as neutrality and administrative efficiency (Li, 2003).

#### 4.0 CHALLENGES OF E-COMMERCE TAXATION

Azam (2007) discussed three challenges for the application of the current international tax regime to e-commerce due to its features. They are: feasibility challenges, normative challenges and acceptability challenges. He also posed three questions related to the challenges as follows:

- i. Can the current international tax regime apply to e-commerce income?
- ii. Should the current international tax regime apply to e-commerce?
- iii. Will countries accept application of the current regime to e-commerce income?

**Feasibility Challenges:** The lack of compatibility between the current international tax regime and the features of e-commerce raise feasibility challenges in implementing the current regime. It is not clear that the current regime could be applied to e-commerce. The premises, perspectives and concepts of the two are different. There are five main feasibility challenges in the e-commerce regime, they are categorization of income rules, source rules, permanent establishment, residency and enforcement (Azam, 2007). The challenges of taxing online transaction are difficult to be resolved especially when the transaction involves resident

and non-resident, there is possibility of the authority not to be able to trace the transaction.

**Normative Challenges:** this type of challenge argues whether the current international tax regime is appropriate to be used as the basis to tax e-commerce transactions. The issues such as inter-individual equity and inter-nation equity have been brought to discussion. Will the e-commerce taxpayers and non-e-commerce taxpayers be taxed equally? Will the countries involved will received fair share of tax revenue derived from the e-commerce transaction? In addition, it is also argued that whether applying the current international tax regime to e-commerce income achieves economic efficiency.

**Acceptability Challenges:** The international consensus is a must in any international tax regime. Such consensus was made later on a protracted series of negotiations in the 1920s, when the current international tax regime was designed. But a great deal has changed since that consensus. E-commerce upsets the consensus of the 1920s because countries have varying and conflicting thoughts on taxing international e-commerce income. The challenge is to regenerate or rebuild the international consensus concerning taxing international e-commerce income (Azam, 2007). The OECD has taken some reform efforts related to these issues which have reflected changes to the OECD model tax treaty or its commentary (Cockfield, 2006). Specifically, these reforms are related to income characterization, server/permanent establishment, changes to the place of effective management concept as well as services and permanent establishment. These reforms are important because the model treaty and/or the commentary they are often recognized by courts as secondary sources of authority to assist with treaty interpretation (Cockfield, 2006).

Besides the challenges highlighted by Azam (2007) there are also other challenges discussed in various studies.

**Record Keeping Challenges:** Audit trails depend on accurate records and e-commerce as well raise issues under the record keeping requirements that are central to tax administration. Taxpayers are asked (stated in the tax rules) to maintain accurate books and records, which are open to review by the revenue authorities in order to verify the income and expenses reported on the taxpayer's return. Traditionally, these books were maintained in hard copy format. However, taxpayers engaged in the

sale of electronic goods or services may never create paper records because customer orders are ordered and executed electronically and hence the only record that survives of these transactions could be an electronic version. Such electronic records can be easily modified. Even taxpayers engaged in the sale of tangible goods may soon pick up orders and issue invoices electronically. Therefore, electronic records and business documents must be verifiable in order to belittle the potential for tax dodging (Avi-Yonah, 1996)

**Software and Service Providers Challenges:** Besides the revenue authorities, the taxation on e-commerce also provides challenges and burdens the software manufacturers and service providers. This is because they are the most reliable parties to track e-commerce sales. They would have to rewrite their software codes to accommodate the new tax requirements and later required to provide detailed information on e-commerce transactions to banks. This requirement leads to another issue i.e. the party that would ultimately absorb the cost of the information gathering either the provider or the consumer. Furthermore, it also leads to serious privacy issues as information on consumers would be passed through the software manufacturer and service provider as well as the bank that handle the tax processing (Chan, 2000).

## 5.0 CONCLUSIONS AND RECOMMENDATIONS

The rise of e-commerce serves as a means of furthering international business deals, lifts some associated barriers but as well creates another challenge for the revenue authorities in the world.

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