

International Taxation of Electronic Commerce

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International Taxation of Electronic Commerce

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ABSTRACT

Recent advancement of technology has made possible of new types of business transactions over the internet called E-commerce. E-commerce includes sales of digital products like downloading music, software, and so on, as well as sale of tangible products such as books by internet. According to eMarketer's latest forecast, the global E-commerce sales in 2014 amounted to 1.5 trillion dollars in B2C sales and it is expected to continue growing furthermore. On the other hand, it has also caused difficulties in taxation under the current international tax principles regarding business profits derived from such transactions.

According to the current international income tax principles on business profits, a taxpayer is taxable in a source country only if it has a permanent establishment (PE) such as a branch in a source country, which is a fixed place of business through which the business of an enterprise is wholly or partly carried on. Otherwise, those incomes are exempted from taxation in a source country. However, different from conventional types of transactions, E-commerce transactions need no physical presence to do business continuously in the source country since the core activities of business can be conducted online. Therefore the permanent establishment no longer functions as an effective criterion to measure the nexus of the taxpayer with the source country. Nevertheless, if the business profits derived from E-commerce is not taxable in absence of PE under the current definition of PE, it will not only unfair to traditional business, but also it will dramatically reduce the government income for years to come. Accordingly the concept of PE needs some modification to match the new situation.

Likewise, E-commerce has caused problems regarding Consumption Tax equivalent to VAT in EU. Under the current rules, Consumption Tax is due where the transactions are made. In case of E-commerce, the core activities of transactions are all done on computer servers. Hence, if a foreign taxpayer conducts the E-commerce by using the computer server located outside of a country in demand, the E-commerce transaction is not taxable by Consumption Tax whereas a domestic taxpayer in the country in demand conducts the same business with the same customers are taxable. It is against fairness and neutrality in taxation of Consumption Tax.

Thus, with regard to E-commerce taxation, issues are different between Corporate Income Tax on incomes derived from E-commerce and Consumption Tax on the values added by E-commerce. This paper addressed the issues of taxation, from the viewpoints of the source rules and the definition of PE

for Corporate Income Tax, and the place of transaction for Consumption Tax, as well as how to realize the compliance of the new system and the possibility of reaching international consensus.

I reached conclusions upon the research in reference to and comparison of the systems introduced in the EU and the United States, new international tax rules proposed by prominent tax scholars and the BEPS/G20 Report, as follows:

- I. Consumption Tax on E-commerce
 1. E-commerce transaction should be regarded to take place where the consumer is situated;
 2. If the E-commerce is B2B transaction, the reverse charge system should be introduced;
 3. If the E-commerce is B2C transaction, the voluntary compliance system by the seller should be introduced;
- II. Corporate Income Tax on business profits from E-commerce
 4. Creation of new income category as “Active income from E-commerce” which is composed of royalties, sales of tangible properties, and fees for rendering services, derived from E-commerce;
 5. Creation of new source rules regarding “Active income from E-commerce”: Active income from E-commerce shall be regarded sourced in a country where a buyer is located;
 6. Active income from E-commerce may be always taxable by a country where the buyer is located;
 7. If the E-commerce is B2B transaction, the buyer is obliged to withhold Income Tax at a fixed rate each time the transaction is made;
 8. If the E-commerce is B2C transaction, the voluntary compliance system by the seller should be introduced under which the seller pays the tax at a fixed tax rate on his aggregate annual Active income from E-commerce to the Japanese Government, on parity with B2B transactions;
- III. Common in both Consumption Tax and Corporate Income Tax
 9. In order for a foreign seller to identify whether the buyers are business persons or consumers, my number system to be introduced into Japan should be used;
 10. In order to deal with the failure of voluntary compliance by foreign taxpayers conducting E-commerce, the international tax treaty for mutual assistance of tax administration should be facilitated quickly.

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LIST OF ABBREVIATIONS

B2B	Business to Business
B2C	Business to Consumer
B2G	Business to Government
BEPS	Base Erosion and Profit Shifting
CEO	Chief Executive Officer
C2C	Consumer to Consumer
CITA	Corporate Income Tax Act
CTA	Consumption Tax Act
CTACO	Consumption Tax Act Cabinet Order
CTL	Cooperation Tax Law
EC	European Commission
EU	European Union
G20	The Group of Twenty
GST	Goods and Services Tax
HR	House of Representatives
HTTP	HyperText Transfer Protocol
MNEs	Global Multinational Enterprises
MOF	Ministry of Finance
OECD	Organization for Economic Cooperation and Development
S.	Senate
TAG	Tax Advisory Group
ICT	Information and Communication Technology
IT	Information Technology

ITFA	Internet Tax Freedom Act
ITL	Income Tax Law
PE	Permanent Establishment
SSUTA	Streamlined Sales and Use Tax Agreement
UK	United Kingdom
U.N.	United Nation
U.S.	United State of America
USC	United State Code
VAT	Value Added Tax
VIIES	VAT Information Exchange System
WWW	World Wide Web

CHAPTER 1

INTRODUCTION

1.1 Issues and Overview of Taxation on E-commerce

Electronic commerce (hereinafter referred to as E-commerce) is a newly emerged transaction tool of business, where all transactions are done within a computer system through the internet. E-commerce transactions consist of sales of tangible goods from the website as well as sales of digital goods such as software and music. It has enabled even a small-size business to reach a global market. It is expected that its annual transaction amount will be hundreds billion U.S. dollars soon.

In taxation on business profits derived by foreign corporations of non-residents in the source country, the conventional international taxation rule provides that the profits are taxable as far as there is a “permanent establishment” (hereinafter referred to as PE) and the profits are attributable to the PE, which is defined as “a fixed place of business through which the business of an enterprise is wholly or partly carried on” (OECD Model Tax Treaty Article 5, para. 1). Typical examples of PE are branch, factory and mine. This conventional principle presumes that it is hard to conduct business or trade in foreign countries, on a permanent base, without establishing PE therein with conventional trade or business tools.

With E-commerce, however, business can be easily conducted in foreign countries, on a permanent base, through website, server, and ISP without the presence of branches. Then it becomes an issue of international taxation what can be an effective benchmark in determining whether profits derived from non-residents or foreign companies through E-commerce, replacing the conventional taxing rule on business profits.

If profits from international E-commerce are not taxable in source countries just because there are no PE under conventional international tax principles, it will be not only unfair to conventional business, but also it will lead to a dramatic reduction of government revenue of source countries in the future. On the other hand, if different tax rules are adopted in different countries, it may also cause double taxation or under taxation on profits from international E-commerce transactions.

Amazon.com is an international world's largest E-commerce company which sells everything from books, to electronics product like DVDs, VHSs, CDs, video, software, video games, to furniture, cosmetics, food, and jewelry and so on.¹ The company starts as an online retailer in 1994 with headquartered in Seattle. Amazon firstly started the company as an online bookstore, and soon it notably expanded to all consumable and electronic products and goods.² In 2007, Amazon introduced the e-book hardware industry of Kindle reader that represents the most advance e-reader.³

Amazon has speedily grown in 2010 the company's net sales reached \$34.20 billion, increased 40% compared with \$24.51 billion in 2009.⁴ Kindle books currently sell three times more than those of paperback books.⁵ As already explained above, the internet enables an enterprise to conduct borderless business electronically. An Amazon Kindle's case can raise several tax issues, whether or not the income from Kindle books considered as sole income, royalties, or rental income. In case, a customer A resides in country B access to Amazon and orders a book and the book is to be delivered to him. In addition, he also downloads an e-book to this Kindle, which takes a few minutes and he gets it in hand immediately.

Thus, while the global E-commerce has grown tremendously and expected to rise even more in the future, it gives rise to many challenges to current international tax administration.

¹ Amazon, <www.amazon.com>.

² Ibid.

³ Ibid.

⁴ Amazon annual report summary for 2011, <<http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=1521090&highlight=>>.

⁵ Ibid.

The current international rule is based on residence taxation and source taxation and allocates the two taxing rights by determining taxing rights of source jurisdiction and obliges the resident jurisdiction to eliminate double taxation through the credit method or the exemption method. However, it's not easy to apply the current rule to cross-border E-commerce transactions since E-commerce is borderless and business can be done from any part of the world without any physical presence in countries of demand.⁶

For example, according to the current Article 7 of the OECD Model Tax Treaty (hereinafter referred to as OECD Model), business profits are taxed in a country of source only if a taxpayer has a permanent establishment. Otherwise, it should be taxable only in a resident country. In addition, under the current OECD Model, tax treatments are different according to the category of incomes. Royalties are exempted from taxation in a source country by Article 12 of OECD Model. Incomes from services are treated as sourced where the service is performed and taxable in the source country. Since an income category of E-commerce is not necessarily clear, the different tax treatments in accordance with categories of incomes could raise uncertainty in taxing income from E-commerce.

New international tax rules are required on incomes derived from international E-commerce transactions which shall replace the conventional tax rules by taking into consideration international E-commerce transactions including international trades of digital products and services.

This paper focuses on the new international taxation rules on Income Taxation including the concept of "Permanent Establishment" and Consumption Tax, regarding E-commerce transactions.

1.2 Objectives of the study

The objectives of the research are :

⁶ Azam Rifat, *Global taxation of cross-border e-commerce income*, Va. Tax Rev 642 (2012).⁶

- I. With regard to Income taxation
 - 1. To reconsider the source rules which allocate taxing rights based on jurisdiction of source regarding income generated through E-commerce transactions;
 - 2. To reconsider “permanent establishment” as the nexus benchmark with a source country in the taxation of business profits, by taking into consideration international E-commerce transactions;
 - 3. To explore a new a ‘nexus’ of business profits derived from E-commerce with the source country, including whether or not any nexus benchmark should be retained;
 - 4. To explore how to introduce the new system into the laws and how to implement it;
- II. With regard to Consumption Tax,
 - 5. To reconsider the current rules to determine where a transaction is conducted by taking into consideration international E-commerce transactions including international trade of digital products and services;
 - 6. To explore how to introduce the new system into the laws and how to implement it.

1.3 Research Methodology and Research Approach

The first stage of this dissertation paper is the study of literatures about E-commerce in general and current international tax rules in order to understand features of e-commerce correctly and clarify problems on the current international taxation system. The primary literatures are collected from OECD Model Tax Treaty Commentary, United Nation Model Tax Treaty Commentary, online library, LexisNexis, EU VAT Directives, Sales and Used Tax, Consumption Tax Law, law cases. Secondary literatures are past research papers by scholars, text books, and reports on discussion made by the scholars on the internet and OECD/G20.

As a research methodology, comparative law approach of the system of Japan, U.S., and the EU is primarily used for comparison of taxation systems on incomes from international E-commerce transactions and consumption tax setting. The case laws are explained and compared throughout the paper as to discuss the problem encountered in taxation on E-commerce transactions.

At a second stage, the research is focused on the permanent establishment of E-commerce. The research includes historical approach on how concept of permanent establishment was defined, arguments in OECD fiscal committee and proposals made by other countries.

Thirdly, the new concept of permanent establishment is discussed in light of various kinds of E-commerce transactions in accordance with products or service traded in order to verify whether the new concept can work effectively in every conceivable type of E-commerce transactions.

The dissertation approach is mainly analytical approach. Firstly, the data is carefully evaluated and then discussed in details to find the possible solutions for E-commerce problems. Finally, after evaluating the solutions adopted by other countries, then proposals are made on income taxation and consumption tax regarding E-commerce transactions.

1.4 Research Questions

- II. With regard to income taxation on incomes derived from E-commerce
1. Is the current international principle of source rules, proper and effective for a base of taxing rights in a jurisdiction of source?

In case of conventional international transactions, it was necessary for enterprises to appear in a country of demand even for a short period. In case of E-commerce, enterprises are in no need to appear to have a business in a country of demand. Hence the presumption of the current principle of source rules seems already obsolete, and there needs a new source rule is necessary considering new business environments.

2. Is the current PE appropriate as a benchmark to grant taxing right in a source country?

In case of conventional international transactions, enterprises have to establish a physical nexus in a country of demand for conducting business continuously and broadly. In case of E-commerce, such a physical nexus is not required any longer for enterprises to have business continuously and broadly. Hence the presumption of the current principle of PE seems already obsolete, and there needs a new rule replacing the current PE rule is necessary considering new business environments.

3. Is the current categories of incomes appropriate?;

Should E-commerce divide the category of the income? As the nature of the business conduct online is distinctive from the conventional type, if the income is to be taxed, then how to tax intangible product as it delivers online and it's also possible that the payment is made online.

4. Are new rules suggested to replace the current rules possible to implement properly with fairness and compliance by taxpayers abroad?;

If those incomes are to be taxed, then how can the government enforce on those incomes as E-commerce has no physical or very less physical presence in the source country?

III. With regard to Consumption Tax on the value added by E-commerce transactions

5. Is the current rule to determine where the transaction takes place proper and effective as a benchmark to to make Consumption Tax due?

In case of conventional international transactions, it was necessary for service providers to stay in a country of demand even for a short period. In case of E-commerce, it becomes possible for service providers to render services from remote places so that there are no needs for them to appear to have a business in a country of demand. Hence the presumption of the current rule that services are rendered in

a country where the service provider was located seems already obsolete, and there needs a new rule is necessary considering new business environments.

6. Are new rules suggested to replace the current rules possible to implement properly with fairness and compliance by taxpayers abroad?

As the principle of consumption tax is to be taxed at the place where the is actually consumed. On the other hand, the cross-border of E-commerce transactions make it difficult to enforce taxation in the consumption countries as digital goods and services are provided directly to consumers online without passing the customs. If the taxes are to be enforced, who would be responsible collecting the taxes and remit those taxes to the government of consumption country? Hence, a new system enforceable must be explored.

1.5 The Scope and Limitation of the study

This dissertation paper is focused on taxation of Corporate Income Tax and Consumption Tax related to E-commerce. Therefore possible issues regarding other taxes are not discussed such as local taxes. For reference, the VAT taxes in the EU and Sales and Use Taxes in the U.S. are mainly referred to because these countries have a longer history and more experiences of general consumption taxes than the other countries. Goods and Service Tax of Canada and New Zealand are not referred because of time constraints and lack of enough information, but ideas of these countries are reflected in the OECD/G20 reports.

New types of E-commerce have been introduced almost everyday at present and it is impossible to cover all types of E-commerce transactions in this paper. Therefore, this paper discussed on three main types of E-commerce transactions: (a) Sales of tangible goods, (b) Sales of intangible goods, and (c) Provision of services, by internet.

I believe, however, that the solutions proposed by this paper can be extended to the other types of E-commerce transactions emerging later to a considerable extent.

1.6 Structure

This dissertation paper consists of 9 chapters.

The current issues of international taxation of E-commerce are described in Chapter 1. They are current problems regarding international income taxation such as the source rules of income and a permanent establishment as nexus for business profits, and international consumption taxation such as a place of transaction as well as proper tax administration for tax compliance.

In addressing the issues, Chapter 1 also explains about the purpose of this research paper, the methodology used, the scope of the study, and the conclusion.

Chapter 2 explains the definition of E-commerce in general, the features and types of E-commerce, the historical growth of E-commerce in the past, its application and the function in transactions. Then, it further reviews the difficulties in resolving the issues by referring to differences between conventional and E-commerce transactions.

Chapter 3 addresses the issues of the current source rules on incomes when applied to incomes derived from E-commerce. It compares the source rules of incomes in the U.S. and Japan in accordance with types of incomes respectively. Then it argues why the criterion of Permanent Establishment as an indicator of nexus with a source country adopted by both tax treaties and domestic income tax laws is considered obsolete in dealing with the business profits derived from E-commerce transactions.

Chapter 4 explains the issues of current Japanese Consumption Tax in dealing with the E-commerce transactions, after explaining about the current Japanese Consumption Tax System. For the purpose of comparison, the VAT in EU and the U.S. Sales Tax and Use Tax System are introduced together with case laws related and the instances of New York State Sales Tax which amended the

definition of transactions subject to the Sales Tax in order to make taxable of E-commerce transactions represented by Amazon (“the Amazon Tax”) and still in- pending the “Marketplace Fairness Act”.

Chapter 5 reviews the discussion made by OECD/G20 on how to deal with the digital economy, knows as the Base Erosion and Profit Shifting (BEPS). It introduces the options proposed by the BEPS Report as reference for possible solutions.

Following Chapter 5, Chapter 6 reviews a guideline proposed by the OECD regarding the place of transactions where Consumption Tax is due. More in-depth reviews are made according to the difference of Business to Business transactions (B2B) and Business to Consumer transactions (B2C) of E-commerce.

Chapter 7 reviews the past researches conducted by scholars regarding issues of income taxation and consumption tax related to E-commerce in addition to a new tax of Bit Tax .

Chapter 8 discusses about my own views on desirable solutions to the Consumption Tax issues

Chapter 9 discusses about my own views on desirable solutions to the Income taxation issues

CHAPTER 2

FEATURE OF E-COMMERCE

2.1 Definitions of E-commerce

Electronic Commerce is commonly known as all kinds of business conducting business online by using internet.⁷ The definition provided by the OECD is “An electronic transaction is the sale or purchase of goods or services, whether between businesses, households, individuals, governments, and other public or private organizations, conducted over computer- mediated networks. The goods and services are ordered over those networks, but the payment and the ultimate delivery of the good or service may be conducted on or off-line.”⁸

The U.N. Definition defines it as “commercial activities conducted through an exchange of information generated, store or communicated by electronic, optical, or analogous means E-commerce has completely changed the way to conduct business borderless.”⁹

According to the U.S. Treasury E-commerce Paper, it defines E-commerce as “the exchange of goods or services using electronic tools and techniques.”¹⁰ However, there is no single definition to define the meaning of E-commerce universally yet. Before explaining the issue and tax policy, it’s important to start from explaining the basic features of E-commerce; category, how it works, and its growth.

⁷ Richard Doernberg, Luc Hinnekens, Walter Hellerstein & Jinyan Li, *Electronic Commerce and Multijurisdictional Taxation*: 37 (2001).

⁸ Measuring the information economy, ANNEX 4. *The OECD definition of internet and E-commerce transactions* 89 (2000), < www.oecd.org/sti/ieconomy/2771174.pdf >.

⁹ Richard Hill & Ian Walden, *The Draft UNCITRAL Model Law for Electronic commerce: Issues and Solutions*, 13 Computer L.18 (1996).

¹⁰ The United States, Department of the Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* (Washington, D.C., U.S. Government Printing Office, 1996).

2.2 Typical E-commerce Transaction

E-commerce can be categorized into four main categories: Business to Business (B2B), Business to Consumer (B2C), Business to Government (B2G), and Consumer to Consumer (C2C).

Business to Business (B2B)

B2B simply means the business between companies such as manufacturers, distributors, wholesalers, and retailers. Most of the E-commerce is B2B type and it greatly occupies more than 80%. Most experts predict it will grow even more in the future.¹¹

Business to Consumer (B2C)

B2C is a business selling a product to consumer through internet, and it holds the second largest place. It includes tangible product, for example books, consumable goods, cosmetics, and clothes or it also covers digitized goods such as downloadable software, music, books, which are intangible. Examples of B2C are online shopping like Amazon,¹² Rakuten,¹³ and Yahoo.¹⁴

Business to Government (B2G)

Business to Government is a commerce that involves public sector companies and government, such as procedure of registration, licensing, advertising, web-based communications and other related to government matters.¹⁵

Consumer to Consumer (C2C)

Consumer to consumer also known as citizen to citizen is defined as a transaction between individuals whereby they can easily sell; buy through an online auction like eBay. The amount generated through this auction reaches million dollars a day, which is not a small amount.¹⁶

¹¹ Zorayda Ruth Andam, *E-commerce and E-business*, 9 (2003).

¹² Zorayda Ruth Andam, *supra* note 11, at 11.

¹³ <http://www.rakuten.com/>.

¹⁴ <http://www.yahoo.com/>.

¹⁵ Zorayda Ruth Andam, *supra* note 11, at 12.

¹⁶ *Ibid.*

Among these four categories, the political debate mostly focused on the B2B and B2C type of activities. Most Multinational enterprises use the internet to get access to the rest of the world in a same way as small and medium size of enterprise.¹⁷ According to the survey on the National small business of the United States conducted by Arthur Anderson, 85% mainly uses internet for e-mail and research, 53% own a website or plan to have it soon, and 23% use internet as a tool to do a business like selling goods.¹⁸ At the same time, professional services from different fields also use internet to advertise and promote their services.¹⁹

2.3 Types of E-commerce

E-commerce can be divided into two types; digital transaction and non-digital transactions. Digital transaction means all the procedure starting from sale of product to payment and delivery are done online while non-digital transaction needs some kind of physical requirement to deliver good or services.²⁰

a. Tangible Goods

An internet shopping offers variety kinds of goods and almost anything can be purchased online. Accessing to a website, they can purchase a tangible product like books,²¹ shoes, clothes, beauty products, CD, toys, tools, flowers and so much more.²² Amazon is one of the examples, standing at the top of the E-commerce business providing all kinds of merchandise.²³ A tangible goods of E-commerce

¹⁷ Jeffrey Owens, *Electronic commerce answering the emerging taxation challenges*, 2

<<http://govinfo.library.unt.edu/ecommerce/document/JeffOwens.doc>>

¹⁸ Arthur Anderson and National Small Business United, *Survey of small and mid-sized businesses-Trends for 2000*.

¹⁹ Ibid.

²⁰ Jinyan Li, *Consumption Taxation of Electronic Commerce: Problems, policy implications and proposal for reform*, Vol 38, Can. Bus. L.J.425, 426 (2003).

²¹ Id, at 427.

²² <http://www.amazon.com/>

²³ Ibid.

is most similar to the traditional type of business.²⁴ Potential online buyers are usually people who do not have the time and want a better product with a wider choice when compared with the old type of traditional shopping.²⁵

b. Digital Goods

The word as “Digital products” is a general term to explain the information sold and delivered online in electronic form. Generally, it includes “computer software, text, sound and images,”²⁶ downloadable e-books, music, digital images and so on.²⁷ Many kinds of information can be acquired through the internet in a form of open data. Some information can be accessed only by paying fees each time, or subscribing it.²⁸ Lexis Nexus, which is a provider of legal information source, business, academic and government database, is an example of service providers of text.²⁹ Many more downloadable digital goods are available online and believed that it will continue to grow as the technology develops. Currently, online playable game, and many kinds of entertainment are accessible online.³⁰

c. Service Goods

In the old days, a person must meet face to face and discuss matters in order to get a service. But along with the innovation of technology and the capability of the internet, the service can be easily provided through telephone, email, video image or other ways of connecting across the border. It is believed that online service industry is growing fast worldwide as of now. Nowadays, even most of well known international law firms provide their service online with their own website. Apart from that, a

²⁴ Clayton A. Chan, *Taxation of Global E-Commerce on the internet: the underlying issues and proposed plans*, 4 (2000)

<http://www.winthrop.com/portals/0/pdf/claytonchan.pdf>

²⁵ Jinyan Li, *supra* note 20.

²⁶ *Id.*, at 428.

²⁷ Amazon, *supra* note 16.

²⁸ Jinyan Li, *supra* note 20, at 428.

²⁹ www.lexis.com/

³⁰ Jinyan Li, *supra* note 20, at 428.

profession like doctors, consultant and engineers are also possible to perform service online.³¹ For instance, the doctor can stay in one country and treat a patient living in a different country by working with a doctor in that country, using the advanced technology tools to examine the patient's body including internal organs.³² The iCloud is one of the example of service by providing space for storage and computing online service. By creating an account, one can store data on the cloud for free with some limit or if they want more space can be added with an additional monthly fee.³³ Online language is an another example where one can learn any language they want through online by signing up to the website and paying fees. Then, they can learn the language at their convenient time.³⁴ Apart from service, there is also an intermediary service described by OECD Technical Advisory Group Report³⁵ such as “web hosting services, application hosting, application service providers, online auction services, online shopping portals, sales referral programs, data warehousing, data retrieval services, and data delivery services.”³⁶

2.4 Historical Growth of E-commerce

From the beginning of 1990, E-commerce has been growing tremendously and progressively. According to the survey made by Japanese Ministry of Economy, the E-commerce sale of B2C in 2009 was amount of ¥6.7 trillion, 10 % increase from the previous year.³⁷ The B2C market scale holds a tremendous amount of sales ¥131 trillion with expectation to continually grow in the future.³⁸

³¹ Jinyan Li, supra note 20, at 428-429.

³² Ibid.

³³ <https://www.apple.com/icloud/>

³⁴ <http://www.skypedeenglish.com/>

³⁵ OECD Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments, *Tax Treaty Characterization Issues Arising from E-commerce: Report to Working Party No.1 of the OECD Committee on Fiscal Affairs* (Paris, OECD, 2001), Annex 2.

³⁶ Jinyan Li, supra note 20, at 428-429.

³⁷ Japan Association of New Economy, <<http://jane.or.jp/english/whitepaper/e-commerce.html>>.

³⁸ Ministry of Economy, Trade and Industry, *Survey Results 1. Trend of E-Commerce Market Scale, 2009*. <www.meti.go.jp/english/press/data/pdf/20100720_02a.pdf>.

The data of U.S. Census Bureau stated that E-commerce retail sales from, 2000-2009 was \$27.6 billion to \$143.3 billion at the growth rate of 20.11%.³⁹ As reported by Forrester Research in 2011, U.S E-commerce sales will grow at 10% annually. It reached \$289 billion in 2012 and it is estimated that it will reach \$327 billion in 2017.⁴⁰

According to European E-commerce press release, sale of goods and services Europe reached € 311.6 billion in 2012 which grew at 19% from the previous year and occupied the largest B2C market in the world with 35.1% share of global market. Wijnand Jongen, vice-president of E-commerce Europe stated about the rapid growth of E-commerce related to the “internet usage and mobile devices” in Scandinavian countries and that 70 % to 80% of internet users shop online. The amount of B2C market in Europe is estimated to become double at the amount of €625 billion by the end of 2016.⁴¹

As stated in eMarketer research, the total sales of global E-commerce reached \$1.22 trillion in 2012 at 21.1 % growth rate for the first time. It's also anticipated that the sale will grow at 18.3% globally this year with the estimation; E-commerce in Asia-Pacific market will become a first place to overstep the North America marketplace.⁴² Unsurprisingly, with 220 million Chinese online buyers, Chinese market alone grew at 65% from \$ 110 billion in 2012 to \$181 billion this year. The numbers of online buyers are expected to be double during year 2012-2016.⁴³

³⁹ U.S. Census Bureau, <<http://www.census.gov/retail/>>. See also <<http://dstevenwhite.com/2010/08/20/u-s-e-commerce-growth-2000-2009/>>.

⁴⁰ Forrester research, see also <<http://www.internetretailer.com/trends/sales/>>.

⁴¹ E-commerce European Press Release, <<http://www.ecommerce-europe.eu/press/2013/05/press-release-european-e-commerce-to-reach-312-billion-in-2012-19-growth>>.

⁴² eMarketer, <<http://www.emarketer.com/Article/Ecommerce-Sales-Topped-1-Trillion-First-Time-2012/1009649>>.

⁴³ Ibid.

2.5 Difference from Conventional Transactions

E-commerce relies on so called intelligent software to run the business from advertises, take orders, payment, to buyer care⁴⁴ by using “internet”. The internet makes it possible to use “world wide web” which information including “color, graphics, audio and video” can be accessed through the websites.⁴⁵ On the other hand, traditionally business conducts as regard to “physical exchanges, face-to face meetings, and payment with a check, cash or barter.”, “physical events” is required to complete the traditional business.⁴⁶ On the contrary, E-commerce differs from traditional business in that it enables all kinds of business to reach millions of people around the world without any physical presence in other countries or territories connected.⁴⁷ Along with the new development of technology, a manner to conduct business has changed. The question arising here is how to tax the transaction using new technology, according to existing tax treaties, and what modification is necessary.⁴⁸

As E-commerce is a very new type of business⁴⁹ conducted over the internet which changes the traditional way of conducting business, it is important to review the current tax rule whether or not it is possible to apply to income generated in the new way both theoretically and administratively.⁵⁰ With the purpose to evaluate the existing tax rules conceivably and carefully, it is significant to understand how the technology makes E-commerce operate. It is believed that without the accurate understanding of how those incomes generated, it’s impossible for the tax authorities to make a new international taxing system effectively implemented.⁵¹

⁴⁴ Richard Doernberg, Luc Hinnekens, Walter Hellerstein & Jinyan Li, *supra* note 7, at 9.

⁴⁵ Richard Doernberg, Luc Hinnekens, Walter Hellerstein & Jinyan Li, *supra* note 7, at 11.

⁴⁶ *Id.*, at 12.

⁴⁷ Azam Rifat, *supra* note 6, at 646.

<<http://ssrn.com/abstract=2117022>>.

⁴⁸ OECD, *Are the current treaty rules for taxing business profits appropriate for E-commerce? Final Report* 6 (2002).

⁴⁹ Richard Doernberg & Luc Hinnekens, *Electronic Commerce and International Taxation*, 45 (1999).

⁵⁰ *Id.*, at 46.

⁵¹ *Ibid.*

2.5.1 An application of Internet

As, the internet is connected by so called “physical and logical infrastructure”, internet application benefits internet for E-commerce. Internet application is divided into several categories such as communications, databases, information processing services, and resource-sharing services. Electronic mail (email) is perhaps the most essential communication tool because it has an ability to send messages to anywhere in the world ⁵² within a second. It is an example in understanding the whole he system of internet. It is also possible to use the internet as a tool for communication with other countries as a group, by sending messages or video, or even for video conferences. Beside, the internet has offered a variety of databases consisting of texts such as articles, newspaper, magazines, reports, multimedia like video and audio, and computer software free and payable. There are still numerous kinds of information procession and programs online, in addition to the above noted.⁵³

2.5.2 World Wide Web (www)

According to a business dictionary, www is “a collection of internet resources such as FTF, Telnet, Usenet), hyperlinked text, audio, and video files, and remote sites that can be accessed and searched by browsers based on the standards such as HTTP and TCP/IF. It is also called as “web”, which was created in 1989 by the UK physicist Tim Berners-Lee.”⁵⁴ The World Wide Web is simply a system that makes the network functioning and allows users to broadcast information. Structurally, there is a user that runs a web browser for a client like Microsoft Internet Explorer and there is a server which manipulates information retrieval and transactions for safe message delivery. By browsing the web, one can view documents and webpages anywhere in the world to obtain information desired. At present,

⁵² Id, at 67.

⁵³ Id. at 68.

⁵⁴ <<http://www.businessdictionary.com/definition/World-Wide-Web-WWW.html>>

there are many web browsers and search engines available⁵⁵ such as Google, Yahoo, Bing, and so on. The search handling is so simple that the users only need to type keywords of the information which they like to view, thereby all the listed information will show up on a web.⁵⁶

The HyperText Transfer Protocol (HTTP) is a protocol that is used to transfer data on the World Wide Web. It transfers the information between a server and a client when the computer is connected to the internet. Accessing to the HTTP is easy. Users only start a computer, open the browser such as Internet Explorer, and then type in a web address the user wishes to open or just simply click on a⁵⁷ hyperlink.⁵⁸

2.5.3 Internet Server

Server is a necessary tool for operating a business on the internet. There needs at least one server to access to. The server can be owned by an enterprise⁵⁹ or a space can be rented on the servers of others. Typically, server is a computer appliance that is connected to the internet and holds a lot of space for storage and for operation. The server does not choose a specific location to operate. It can basically function in any places in the world. The data of enterprises doing business over the internet is kept in the server. Enterprises, which sell and deliver digital products over the internet may have many servers in different places all over the world for speedy service to their buyers. The same information is automatically copied onto the servers, and if necessary to store different information on different servers, it is also achievable. For example,⁶⁰ “the product description and buyer information on one server and

⁵⁵ Richard Doernberg & Luc Hinnekens, supra note 49.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ A hyperlink is a word, phrase, or image that you can click on to jump to a new document or a new section within the current document. Hyperlinks are found in nearly all Web pages, allowing users to click their way from page to page.

⁵⁹ Ertugrul Akcaoglu, *International Taxation of Electronic Commerce: A focus on the permanent establishment concept*, C.51 Sa.1, 120 Yale (2002).

⁶⁰ Ertugrul Akcaoglu, supra note, at 121.

digitalized products on another server.” In this way, the system can easily direct buyers from one server to another in a short time.⁶¹

2.5.4 E-commerce Transaction

Generally, E-commerce simply means a modern way of doing business by using computers in order to satisfy needs of buyers in an effective way. Typically, E-commerce consists of activities of exchanging information between business, between business and buyers as a tool to communicate with buyers.⁶² However, there is no single definition of E-commerce “universally agreed” yet.⁶³ A sale on the internet has been increasing due to global reach easiness, convenience, and low cost. Retailers online become popular for buyers with no time to visit shops, because it is very convenient as it operates 24 hours a day all the year round.⁶⁴

Unique characteristics of E-commerce that is different from conventional commerce are as follows. Firstly, there are no national boundaries in E-commerce, making the concept of territory meaningless. Secondly, it does neglect the distance, so that distance is no longer a problem anymore. Business can be done from anywhere with internet, regardless of the physical presence, whereby the physical presence in the operating countries becomes insignificant. Thirdly, enterprises need no physical locations such as branch, shop, or outlet in a buyers’ country to do a business. Apparently, this characteristic is the most significant difference between the conventional commerce and E-commerce. Further, sellers can directly contact with buyers, hence it can skip intermediaries like distributors, sales representatives, brokers and lawyers or other professionals, in delivery of products, services and information from a producer to consumers. The intermediaries are removable, especially in business of digital products because it is possible to download products without distributors in case of the digital

⁶¹ Ibid.

⁶² Richard Doernberg & Luc Hinnekens, *supra* note 49, at 72.

⁶³ Jinyan Li, *supra* note 20.

⁶⁴ Ibid.

product business. For an example, when one purchases a book, the seller need to send the book to the buyer whereas eBooks or digital form of books only need to be downloaded and read digitally.⁶⁵

According to Professor Avi-Yonah,⁶⁶ the fundamental characteristic of E-commerce is that it enables sellers and buyers to contact with each other in an electronic way. This characteristic launched when telegraphs started in 1830 and continued growing with the invention of the telephone in 1890. Therefore, E-commerce is not a completely new experience for anyone who had experienced order by telephone. A question is: what are the new challenges in current E-commerce transactions? He stated that the difference between traditional mail order and E-commerce is “interactivity, speed, and electronic payment.” In the old days, sellers needed to send a catalog of goods to buyers, and then have a conversation over the telephone, take orders, ship goods, and lastly receive payments. E-commerce makes all these actions online.⁶⁷

The main feature of E-commerce noted by Professor Avi-Yonah is similar to the above noted with no physical location and disintermediation, and possibility of operating an Internet site from a remote place. These features of E-commerce have given a new challenge to the current international tax rules because, under the current tax system, business profits become taxable only when there is a physical presence in a source country. On the other hand, by using E-commerce, it's possible for enterprises to do business abroad without a physical presence, such as a branch in a source country, and they can freely set up their residence in tax haven countries. As a result, the enterprise can easily avoid their taxes by E-commerce. Thus the rapid growth of E-commerce may undermine government's taxing right on incomes derived from its jurisdiction, under the current tax system.⁶⁸

As noted earlier, the traditional type of business of international taxation relies on the concept of residence of taxpayers and source of incomes. It is questionable to what extent the existing tax system can deal with the new situation caused by E-commerce.

⁶⁵ Jinyan Li, *supra* note 20, at 430-431.

⁶⁶ Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 *Tax L.Rev.* 507, 511-512 (1997).

CHAPTER 3

ISSUES IN INTERNATIONAL TAXATION ON INCOME DERIVED FROM E-COMMERCE

3.1 Source Rule

International tax principles are defined as “the taxation of cross-border transaction.”⁶⁹ It generally has two applications; resident taxation and source taxation. **Resident taxation** refers that a country has a right to tax its resident on their worldwide income. The second one is **Source taxation** in which a country has a primary right to tax on income that originates in their jurisdiction. These two types of taxation sometimes overlap jurisdictions and result in statutory double taxation. For an example, both a source country and a resident country may claim to tax on one income of one taxpayer at the same time based on the territorial jurisdiction and the resident jurisdiction.⁷⁰ As the OECD suggested, the double taxation “has harmful effects on the international exchange of goods and services and cross-border movements of capital, technology and persons.”⁷¹

According to the international principle, primary taxation is made in a country where business which generated the income is conducted, in other word, in a country of income source.

3.1.1 U.S. Source Rules for income of Non-resident

Source rules are rules that determine where incomes are generated. They are significant as to determine which income is subject to U.S. tax.⁷² Source rules for incomes derived from non-residents to the U.S. are provided under section 861-865 of the Internal Revenue Code. The government can tax an income of non-resident in accordance with the U.S. domestic tax laws if it is a U.S. source income based

⁶⁷ Id, at 512-513.

⁶⁸ Id, at 517.

⁶⁹ Michael Kobetsky, *International Taxation of Permanent Establishment: principles and Policy* 12-13 (2011).

⁷⁰ Brian J. Arnold Michael J. McIntyre, *International Tax Primer* 33 (1995).

⁷¹ OECD, an overview of available products,
<<http://www.oecd.org/tax/treaties/oecdmtcavailableproducts.htm>>.

on the territorial jurisdiction. Source rules differ by incomes, such as business profits, interests, dividends, personal services, rents or royalties.⁷³

An income effectively connected with a U.S. trade or business is subject to regular graduated income tax rates after the deductions and exemption provided.⁷⁴ The factors to be considered in determining whether or not the income has sources within the U.S. are (1) “the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or (2) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.”⁷⁵ This law applies whether or not there is a connection between the income and business carried on in the U.S.

Additional terms for tax on non-resident alien individuals are provided in section 871, which explains about passive income consisting of incomes other than capital gains, interest, gains described in section 631 (b).⁷⁶ An income generated in the U.S. but is not effectively connected with a trade or business within the United States is subject to withholding tax at a flat rate without allowance of deductions.⁷⁷

As a summarization, for a non-resident alien and foreign corporation’s taxable incomes on U.S. source income are classified into incomes effectively connected with the conduct of a trade or business within the United States and incomes not connected with United States business.

Summary of Source Rules for Income of Nonresident Aliens	
Item of Income	Factor Determining Source
Salaries, wages, other compensation	Where services performed

⁷² Richard A. Westin, *International Taxation of Electronic Commerce* 160 (2000).

⁷³ I.R.C. 861 (a).

⁷⁴ I.R.C.872, 873, 874.

⁷⁵ I.R.C. 864 (c) (2) (A) (B).

⁷⁶ I.R.C. 871.

⁷⁷ I.R.C. 871.

Summary of Source Rules for Income of Nonresident Aliens	
Item of Income	Factor Determining Source
Business income: Personal services	Where services performed
Business income: Sale of inventory - purchased	Where sold
Business income: Sale of inventory - produced	Where produced (Allocation may be necessary)
Interest	Residence of payer
Dividends	Whether a U.S. or foreign corporation*
Rents	Location of property
Royalties: Natural resources	Location of property
Royalties: Patents, copyrights, etc.	Where property is used
Sale of real property	Location of property
Sale of personal property	Seller's tax home (but see <i>Personal Property</i> , in Chapter 2 of Publication 519, for exceptions)

Summary of Source Rules for Income of Nonresident Aliens	
Item of Income	Factor Determining Source
Pensions	Where services were performed that earned the pension
Scholarships - Fellowships	Generally, the residence of the payer
Sale of natural resources	Allocation based on fair market value of product at export terminal. For more information, see IRC section 1.863-1(b) of the regulations.
<p>*Exceptions include:</p> <p>a) Dividends paid by a U.S. corporation are foreign source if the corporation elects the Puerto Rico economic activity credit or possessions tax credit.</p> <p>b) Part of a dividend paid by a foreign corporation is U.S. source if at least 25% of the corporation's gross income is effectively connected with a U.S. trade or business for the 3 tax years before the year in which the dividends are declared.</p>	

Source : from Summary of Source Rules for Income of Nonresident Aliens summarized by the Internal Revenue Service of U.S.⁷⁸

As shown in the above table 1 that source rule for non-resident is categorized in different kinds of income and tax accordingly.

⁷⁸ <http://www.irs.gov/Individuals/International-Taxpayers/Nonresident-Aliens---Source-of-Income>

3.1.2 Source rule of Japan

Domestic Source Income of Japan is provided in Article 138 Corporation Tax Law and Article 161 Income Tax Law.⁷⁹ Article 138 deals with the foreign corporations for Japanese corporate tax and Article 161 is applied to non-resident individuals for withholding tax purpose. These two articles provided rules for different type of income that generated in Japan.

Article 138 and 161 defines the “domestic source rules” as follows.

1. Incomes from a business conducted in Japan, having or using an asset which locates in Japan are considered to be Japanese source income.⁸⁰
2. Personal service provided in Japan is regarded as Japanese source income.⁸¹
3. Income from the rent, and any right on the real estate located in Japan.⁸²
4. Income of interest, including money trust and government bonds, from activities operated in Japan.⁸³
5. Dividend of surplus, dividend of profit, distribution of surplus received from domestic corporations.⁸⁴
6. Interest from a loan given to a person who carries operations in Japan and being a property of the said operation.⁸⁵
7. Royalties for the industrial property right, copyright, technology, machinery and any other tools received from a person who carried operation in Japan, which pertain to the said operation.⁸⁶

Whether a foreign corporation is obliged to Japanese taxation or not, depends on the kind of incomes and the nature of the corporation in Japan. A foreign corporation is taxable only if it establishes a permanent establishment in Japan in case of business profit. With regard to the other incomes, if the

⁷⁹ CITA, Article 138 and Article 161.

⁸⁰ CITA, Article 138 (i).

⁸¹ CITA, Article 138 (ii).

⁸² CITA, Article 138 (iii).

⁸³ CITA, Article 138 (iv).

⁸⁴ CITA, Article 138 (v).

⁸⁵ CITA, Article 138 (vi).

⁸⁶ CITA, Article 138 (vi1).

foreign corporation is considered to have Japanese source income, then it should be subject to withholding tax.⁸⁷

3.1.3 Problem in applying Source Rules

Most significant problems in applying source rules to income from E-commerce are probably that it is based on the territory. According to Azam,⁸⁸ the current source rules are based on two principles which are (1) “that territorial borders separate countries and define their legal jurisdiction and (2) that each income is produced in a territory of a single country.” Consequently, source rule system is created to determine the territory country income related to an economic commitment between the income and the country. Source rule is based on the concept of “physical concepts of territory and place.” However, this concept is weakened in E-commerce because business is conducted borderless where a territorial border between countries is not important. In addition, a fundamental characteristic of E-commerce is very hard to identify the location. Especially, E-commerce of intangibles and services is not related to physical place at all. This gives a new challenge to the traditional type of territory taxation concept both in “theoretical and conceptual.”⁸⁹

As noted above, since the state taxes incomes, according to type of incomes while E-commerce blurs the traditional source rules, it is crucial to define a type of income subject to tax. In case a state cannot completely define the type of income in accordance with the traditional source rules, it cannot assuredly decide whether it has a taxing right over that income.⁹⁰

⁸⁷ <http://japantax.org/?p=750>

⁸⁸ Rifat Azam, *E-Commerce Taxation and Cyberspace Law: The integrative Adaptation Model*, Vol.12 No.5, Va. J.L. & Tech.1, 8 (2007).

⁸⁹ Ibid.

⁹⁰ Subhajit Basu, *International taxation of E-Commerce: Persistent Problems ad Possible Developments*, JILT 10, 2008 (1).
<http://go.warwick.au.uk/jilt/2008_1/basu>

3.1.4 Role of Tax Treaty

To deal with double taxation, countries enter into a tax treaty, which prevents double taxation and allocates the taxing right between the contracting states.⁹¹ Currently, there are two tax treaty models. United Nations Model Tax Conventions deals with the tax matters between developed country and developing countries.⁹² OECD Model Tax Convention treats taxes on Income and on Capital between developed countries.⁹³ The primary aim of OECD Model tax Convention is “to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application of common solutions by all countries to identical cases of double taxation.”⁹⁴ The OECD Model plays an important role in international taxation set with many expertises while continuously developing rules and policy. Two tax conferences have been held to deal with tax issues related to E-commerce Taxation. “The Challenges to Tax Authorities and Taxpayers,” in Turku, Finland (1997) and “A Borderless World: Realizing the Potential of Global Electronic Commerce”, in Ottawa, Canada (1998).⁹⁵ Based on the OECD model, non-resident is taxable in a source country if the business profits are attributable to a permanent establishment situated in the source country; otherwise the income is not taxable in a source country.⁹⁶ When two countries enter into a treaty, it covers a clause of double residency to assure that the taxpayer will be considered of one country’s resident only. When the conflict of dual residency arrives, the resident country is decided by location of effective management.⁹⁷

⁹¹ Michael Kobetsky, *supra* note 69, at 13.

⁹² United Nations Model, *Double Taxation Convention between Developed and Developing Countries* (2011).

⁹³ OECD, *Model Tax Convention on Income and on Capital, Condensed Version* (2010). [hereinafter OECD Model].

⁹⁴ *Id.* at 7.

⁹⁵ AKCAOGLU Ertugrul, *International Taxation of Electronic Commerce: A focus on the permanent establishment concept C.51 Sa.1*, 131 (2002) <acikarsiv.ankara.edu.tr/browse/3906/1695.pdf>

⁹⁶ OECD Model Treaty, Art.5.

⁹⁷ *Ibid.*

3.2 Permanent Establishment

Article 7 of the OECD Model, on the business profit provides that “the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”⁹⁸ Furthermore, to be taxable in the other territorial state, the business profit should be attributable to that permanent establishment.⁹⁹

A permanent Establishment (hereinafter referred to as “PE”) concept is fundamental in a tax treaty by which the source country has a taxing right over the business profit of non-resident situated therein. The definition provided by the OECD Model, the term “permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”¹⁰⁰ It includes especially “a place of management, a branch, an office, a factory, a workshop and a mine, oil or gas, a quarry or any other place of extraction of natural resources.”¹⁰¹

The definition requires a geographical requirement such as a fixed place of physical location and time requirement.¹⁰² In addition, the place must be at a disposal of the enterprise to conduct the business.¹⁰³ The place should not be regarded as PE if the activity is merely for the purpose of a preparatory or auxiliary nature.¹⁰⁴ In case of an agent, only if the agent has an authority to conclude a contract on behalf of an enterprise, the PE can be regarded; otherwise there should not be PE.¹⁰⁵ Namely, general requirements for PE are; (1) a place of business (2) it must be fixed (3) business must be carried on through that fixed place.¹⁰⁶

⁹⁸ OECD Model Treaty, Art.7.

⁹⁹ Ibid.

¹⁰⁰ OECD Model Treaty, Art.5 (1).

¹⁰¹ OECD Model Treaty, Art.5 (2).

¹⁰² OECD Model Treaty, Art.5 (3).

¹⁰³ Commentary on Art.5 par 5.2.

¹⁰⁴ OECD Model Treaty, Art.5 (4).

¹⁰⁵ Ibid.

¹⁰⁶ Commentary on Art.5 Para 2.

3.2.1 Criteria to recognize Permanent Establishment under Current International Tax Rule

Currently, even under the OECD model, there is no article to deal with the E-commerce yet, only the commentary was added in 2003 for determining under what condition PE can be constituted related to E-commerce matters.¹⁰⁷ Nevertheless, there are many new tax challenges arising in respect to taxation of E-commerce. At the Ottawa conclusion, OECD emphasized that E-commerce should be taxed in the same manner as conventional business income. The same principle of “neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility” should be applied.¹⁰⁸ OECD mainly focuses on the four elements to enforce current tax rules to E-commerce:

- a) “Place of effective management”
- b) Concept of a Permanent Establishment (PE)
- c) Attribution of profit to a server PE
- d) Transfer pricing.”¹⁰⁹

Discussions have been made by OECD members and many experts about taxation of E-commerce, whether or not the common use of computer equipments in a country can constitute a PE. A lot of questions occur related to the Article.¹¹⁰

a. A server

A server may be regarded as a PE because it constitutes a “fixed place of business.” The data is stored in the computer server which can be regarded as a physical location.¹¹¹ Consequently, for a server to constitute a PE there must be a fixed place of business, and it must be wholly or partly carried on business through that equipment.¹¹²

¹⁰⁷ OECD, *Model Tax Convention on Income and on Capital, Condensed Version* (2003).

¹⁰⁸ OECD, *Taxation and Electronic Commerce: Implementing the Ottawa taxation framework conditions*, 10, (2001).

¹⁰⁹ OECD, *Are the Current Treaty rules for Taxing Business Profits Appropriate for E-commerce? Final Report 1* (2005) [hereinafter OECD report].

¹¹⁰ Commentary on Art.5 Para 42.1.

¹¹¹ Commentary on Art.5 Para 42.2.

¹¹² Id. at Para 42.5.

b. A Website

According to the OECD, an internet is seen as an intangible asset, “which is between software and electronic data,” thus it cannot be regarded as a PE. It lacks “location” as a “place of business.”¹¹³ As stated in the commentary, there is no “facility such as premise or, in certain instances, machinery or equipment” to constitute PE.

c. Hosting Arrangement

The important issue is to distinguish between an enterprise that provides a server and an enterprise that carries on business through the website hosted in the server. Commonly the hosted server provides Internet Service Provider (ISP) to an enterprise to carry on business for receiving fees according to the space used. The enterprise can request where the information should be located and the website should be hosted. Nonetheless, that enterprise cannot be regarded as having a PE because the website is intangible, lacking physical presence and control. Only if the enterprise operates stores and has its own server, then it can be regarded as having a PE required by the Article.¹¹⁴ If the core function of the enterprise is “in the business of hosting websites or other applications for other enterprises” then it should be considered that the activities cannot be seen as a preparatory or auxiliary stage therefore the PE should be regarded.¹¹⁵

Furthermore, it also states that to constitute a PE, the presence of personnel are not necessary if the nature of the business does not require personnel to operate.¹¹⁶ The ISP cannot be regarded as a dependent agent of an enterprise provided by paragraph 5 of the Article for the reason that it does not have an authority to conclude a contract on behalf of the enterprise.¹¹⁷ As commonly known, the ISP usually hosts the server website to other enterprises to store information on their server. In fact, the

¹¹³ Commentary on Art.5 Para 42.2.

¹¹⁴ Commentary on Art.5 Para 42.3.

¹¹⁵ Commentary on Art.5 Para 42.9.

¹¹⁶ Commentary on Art.5 Para 42.6.

¹¹⁷ Commentary on Art.5 Para 42.10.

server hosts and provides ISP for many services, so that it's impossible to conclude contracts on behalf of the other enterprise therefore the ISP cannot be regarded as an agent PE.¹¹⁸

Under the conventional concept, PE must be a place of business, fixed place and the requirement to have some permanency depend on the nature of the business.¹¹⁹ For example, building site or construction should last at least six months¹²⁰ or sometimes more than twelve months.¹²¹ Despite of that, the OECD does not mention about the time required in the commentary of E-commerce.

As a conclusion, to constitute a PE there must be a place of business, fixed place of business, and it must be wholly or partly carried on business through that equipment.

According to the Akcaoglu,¹²² a PE concept can be mainly divided into three categories which is 'objective conditions', 'subjective conditions', and 'functional conditions.' Some of these three tests are considerably important to the E-commerce.¹²³

3.2.2 Objective conditions

The first requirement of a PE is to have 'fixed place of business' in the source country where the business takes place. Theoretically, it requires two factors which are 'a place of business' and that business must be 'fixed' at the location of businesses. According to the Article 5 (1) of the OECD, place of business only includes tangible objects such as "a place of management, branch, office, factory, workshop, and a mine, oil gas well, quarry or other place of extraction of natural resources."¹²⁴ Nevertheless, E-commerce does not need any of those noted above to conduct a business in a buyer's residence. E-commerce only needs a server and a website to conduct a business. After adding a

¹¹⁸ Ibid.

¹¹⁹ Commentary on Art.5 Para 6.

¹²⁰ Ibid.

¹²¹ Commentary on Art.5 Para 16.

¹²² Ertugrul Akcaoglu, supra note 95.

¹²³ Ertugrul Akcaoglu, supra note 95, at 134.

¹²⁴ OECD Model Treaty, Art.5 (1).

commentary to Article 5, servers are qualified to be regarded as a PE and considered as a place of business.¹²⁵

As noted in the OECD commentary “the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a fixed place of business of the enterprise that operates that server.”¹²⁶ There is also a question whether website also should be regarded as a place of business and a PE because usually buyers access the website to buy goods and services. Considering that a website is an intangible object, whereas business test needs some kind of physical presence in the source country, therefore it’s crucial to regard as having a place of business and considered as a PE.¹²⁷

Nonetheless, Spain and Portugal argued that in some incident website can be considered as a place of business and treated as having a PE stating that “intangible or ‘digital’ existence should be virtually enough to determine a place of business in relation to electronic commerce, and term ‘place’ should be interpreted as including digital environments.”¹²⁸ Akcaoglu agreed on this view stating that “the country’s’ view is a realistic opinion, which aims to protect e link (nexus) between enterprises and source country’s taxation authority where physical presence requirement could allow many of enterprises that benefit economically from the country’s market through the Internet to avoid paying their fair share of taxes to that country.”¹²⁹ As for a ‘location test’, the requirement is that the business must be ‘fixed’, thus it must be attached to some of geographical location in a source country as a fixed place. Therefore, if a server is located in a particular place in the source country, it qualifies to the location test. Even though, there is a possibility that the location of the server may be moving around

¹²⁵ Ertugrul Akcaoglu, supra note 95, at 136.

¹²⁶ Commentary on Art.5 Para 42.2.

¹²⁷ Ertugrul Akcaoglu, supra note 95, at 138.

¹²⁸ Ertugrul Akcaoglu, supra note 95, at 139.

¹²⁹ Ibid.

from one place to another in a source country, it does not change the fact of a ‘fixed character’ as far as it’s in a certain place in the source country for a certain period of time.¹³⁰

3.2.3 Subjective conditions

In the objective condition, the requirement for a PE to exist is the fixed place of business. But it is also required that the business place needs to be in a source country for a certain period of time. Two conditions for this subjective test are ‘right of use test’ and the ‘permanence test’.¹³¹

In the commentary, it says that the difference between server and website is significant because it is very frequent that enterprises which take care of the server and enterprises which do business on website are different. The enterprise pays monthly fees for hosting a server of ISP, uses the space to store information there and apparently the enterprise can order how to host the website. Besides, the enterprise does not have control over the server as the website is intangible and does not have any physical presence at the location. Accordingly, it cannot be considered to have a place of business just to have an arrangement of hosting. Nevertheless, in case the enterprise operates a business on its own servers, then it can be considered as having a business place. The nature of the business must be investigated case by case.¹³²

Additionally, the computer equipment needs a ‘permanence test’ to be considered as having a PE.¹³³ Commentary commends that the equipment needs to be in a ‘certain place for a sufficient period of time’ to constitute a fixed place of business.¹³⁴ The word ‘permanence’ does not imply to have using right over the place of business forever, but it means to use that place for the time being. So, there must be a place of business, fixed and at least at some disposal. However, it must be decided case by case

¹³⁰ Ertugrul Akcaoglu, supra note 95, at 139-140.

¹³¹ Ertugrul Akcaoglu, supra note 95, at 140.

¹³² Commentary on Art.5 Para 42.3.

¹³³ Ertugrul Akcaoglu, supra note 95, at 141.

¹³⁴ Commentary on Art.5 Para 42.4.

basis depending on the nature of the business as the server can be relocated easily from one country to another.¹³⁵

3.2.4 Functional conditions

This part explains about the term of ‘business’ in the domestic law of a source country as well as in a tax treaty. The taxpayer may have a fixed place of business in the source country for a certain period of time with a disposal right, but still there is a case the source country has no right to tax on those incomes.¹³⁶ As provided in the OECD model, the term business to be applied must be dependent on the domestic source rule determined by each country. As a result, the decision to define the PE of business activities depends on the source country.¹³⁷ Thus, if the domestic source country defines the term business with limited scope, and when the server activity did not fall under the business scope, there is no PE in the source country.¹³⁸ In addition, even when the business activity may fall under the term of business, if the business is not a main business of preparatory or auxiliary nature, then the server cannot be regarded as a PE based on the OECD provision.¹³⁹ Hence, if the server is only used for storage or display purpose, it cannot be determined that the enterprise has a PE in a source country. Another example of a preparatory or auxiliary activities are “providing a communications link much like a telephone line between suppliers and buyers, advertising of goods and services, relaying information through a mirror server for security and efficiency purposes, gathering market data for the enterprises, and supplying information.”¹⁴⁰

The core function of the business depends on the nature of the business. For example, if the main business of the enterprise is providing a ISPs server to host the website and other application to the buyer then it cannot be said that their business activity is at preparatory or auxiliary stages.¹⁴¹ The final

¹³⁵ Ibid.

¹³⁶ Ertugrul Akcaoglu, supra note 95, at 141.

¹³⁷ OECD Model, Art. 3.1-3.2.

¹³⁸ Ertugrul Akcaoglu, supra note 95, at 142.

¹³⁹ OECD Model, Art. 5.4.

¹⁴⁰ Commentary on Art.5 Para 42.7.

¹⁴¹ Commentary on Art.5 Para 42.9.

requirement is to conduct the business ‘through’ a place of business. The business activity must be conducted through that business place for a regular basis for a certain time.

3.3 Problem of Current Criteria to recognize Permanent Establishment

3.3.1 General

As noted above, the traditional concept of PE was drafted in the old days when the physical presence was significant to conduct a business in another state.¹⁴² Under current treaty rules, the taxing right on non-resident business income is all dependent on the concept of “permanent establishment” and “attribution rule.”¹⁴³ The main issue that E-commerce brings to the tax system is its borderless characteristic because traditionally people are subjected to taxation in a country where they live and have a business place in another country.

In the conventional type of business, the PE concept provided by OECD can easily be applied, but not in the case of E-commerce where the function of E-commerce as explained earlier according to the application like web page, server, computers and cable.¹⁴⁴ In digital age, business can be conducted from any part of the world without a physical presence or establishing a PE in other states.¹⁴⁵ Therefore E-commerce raises many fundamental issues and causes a number of problems to the tax authorities on how to apply existing tax rules to E-commerce, how to identify the fixed place of business, and the source of business.¹⁴⁶

¹⁴² Cristian Garate, *The fixed place of business in the context of electronic commerce*, 2
<<https://www.u-cursos.cl/derecho/2010/1/D126T07161/24/.../284741>>

¹⁴³ OECD report, supra note 63, at 2. See also OECD, Art.7.

¹⁴⁴ Barrett Schaefer, *International Taxation of Electronic Commerce Income: A proposal to Utilize Software Agents for Source-Based Taxation*, 16 Santa Clara Computer & High Tech. L.J 111, 127 (1999)

¹⁴⁵ Benjamin Hoffart, *Permanent Establishment in the Digital Age: Improving and Stimulating Debate through an Access to Markets Proxy Approach*, 6 Nw. J. Tech. & Intell. Prop. 106, 107 (2007).

<<http://scholarlycommons.law.northwestern.edu/njtip/vol6/iss1/6>>.

¹⁴⁶ Barrett Schaefer, supra note 144, at 124.

The problem of **geographic issue** exists previously even before E-commerce arose because it's not easy to recognize the places of the income generated.¹⁴⁷ As explained earlier, conventional type of business has created different tax rules for different types of income. For example, services income is taxed where the service was rendered while taxing right of royalty is in accordance with territorial right.¹⁴⁸ Simon Woodside¹⁴⁹ states that “for direct tax purposes, we're clarifying how such concepts as ‘permanent establishment’ - that's the rule which determines the right of a state to tax the profits of an enterprise of another state - should operate in the electronic world. Elsewhere, for indirect taxes (such as value-added tax, or VAT) we're confirming how international transactions should be treated, and tackling such tricky issues as how you collect the tax on a product delivered online. E-commerce can and will be taxed – the important thing is that it be taxed fairly and efficiently (just like conventional commerce).”¹⁵⁰

Classification issue is also a problem in digital products as it is necessary to determine the items of incomes as incomes are taxed differently in accordance with items of incomes. For example, sales of inventories, services, royalties are taxed differently. To be concrete, there must be a clear classification on whether selling information on the CD and downloading it from the website is a sale of a product or a royalty payment. If the information is sold in a form of CD then it's a physical, tangible product while downloading is an intangible product. Based on the current existing tax law, these incomes will be taxed differently based on how the product is being delivered.¹⁵¹ In case that the state cannot identify the type of income as stated in the traditional source rules, then it cannot efficiently decide if it has a taxing right over that income. As a result, if the income is unable to be categorized, it is possible that the income can cause double taxation or under taxation and finally it will hinder the growth of E-commerce.¹⁵²

¹⁴⁷ Richard Doerberg and Luc Hinnekens, *Electronic commerce and International Taxation* 104 (1999).

¹⁴⁸ *Id.* at 105.

¹⁴⁹ Simon Woodside, Fiscal Affairs at OECD.

¹⁵⁰ Interview with Simon Woodside, Fiscal Affairs at OECD, *E-commerce and taxation: a virtual reality*, <http://oecdobserver.org/news/archivestory.php/aid/416/E-commerce_and_taxation:_a_virtual_reality.html>.

¹⁵¹ Subhajt Basu, *supra* note 90, at 7.

¹⁵² Subhajt Basu, *supra* note 90, at 10.

Some scholars also argue that current ‘permanent establishment’ rule is ‘no longer viable’ because that rule was created in pre-digital age when physical presence is inevitable to conduct a business in another state. Technology like the internet makes it possible to run a business in a non-resident state, even without the physical presence or establish a PE.¹⁵³ It has several issues to be addressed in E-commerce, for instance principle, enforcement and application issues.

This chapter explains how traditional business defined the source rule and a PE with the background of how it has been applied. The characteristic of the E-commerce weakens the need for business to maintain the physical presence in the source country conducting a business, as well as requirement for intermediaries. Another new characteristic is that it can provide intangible products and service over the internet. Recharacterization of the income is indispensable because business income is taxed where it has source to the extent that the income is attributable to a PE.

¹⁵³ Benjamin Hoffart, *supra* note 73, at 107.

CHAPTER 4

TAX ISSUES ON VAT OR CONSUMPTION TAX

Nowadays, one can purchase goods and products without going to stores at the cheapest price through internet. For this reason, consumers using online shopping have dramatically increased. For example, “**Amazon.com**”, an American book sales company is the biggest online retailer of books in the world at present.¹⁵⁴ In case of E-commerce, while it can expect a global market for potential buyers, no brick and mortar stores for sales are necessary. Hence it can provide buyers with inventories at much lower prices than those of traditional business by being more competitive at low operating costs.

On the other hand, current consumption tax of Japan is imposed only on domestic transactions and because of no physical presence or business bases in Japan, E-commerce business transactions of foreign enterprises are not treated as domestic transactions of Japan. As a result, sales by E-commerce in Japan are exempted from Consumption Tax. This causes unfair competition to Japanese enterprises selling similar inventories in Japan, which are subject to 5 % of Consumption Tax, whose tax rate will soon be raised to 8% in 2014 and then 10 % in 2016.

In Europe, tax measurements to secure both fair competitions in VAT and government revenue have already been introduced for E-commerce transactions such as “Distance Selling” and “VAT mini One Stop Shop”. In the U.S., Streamlined Sales Tax Project for sales and use tax is introduced in many States in order to deal with distance sales.

In reference to the VAT measurements and the Reverse Charge Tax, proper measurements should be explored that the Japanese government should introduce in order to cope with issues of E-commerce transactions by foreign enterprise. It should include exploration of new interpretation of the

¹⁵⁴ <http://www.amazon.com/>

current Consumption Tax Act and then possibility of new legislation if the issue cannot be resolved by changing of law interpretation.

4.1 Basic Structure of Japanese Consumption Tax

General

The consumption tax is one of indirect taxes imposed on goods and services, based on Consumption Tax Act (*Shohi Zei Ho*), together with Consumption Tax Enforcement Cabinet Order (*Shohi Zei Ho Sekorei*),¹⁵⁵ and Consumption Tax Ministry Order (*Shohi Zei Ho SekoKisoku*). According to the laws, all domestic transactions of individuals, corporations and import transactions are taxable when the annual sales amount exceeds threshold in the standard year.¹⁵⁶ The tax is usually paid at each level of business during the production and distribution process, and the total tax is finally to be borne by consumers since the paid tax is forwarded to the next stage of transactions. The tax rate is a single rate of 8%: total of 6.4% for national tax and 1.6% for a local tax. The tax is collected by the national government and then one fifth of the collected tax is distributed to local governments.¹⁵⁷

4.1.1 Transactions subjects to consumption tax

Transactions subjects to consumption tax are “(1) domestic transactions, (2) business activities, (3) transactions effected for compensation, and (4) transactions categorized as sales and leasing of assets or the provision of services” within Japan.¹⁵⁸

It is determined whether or not the transfer of property is made within Japan, as follows

- (a) If the transaction is alienation or lease of assets, it is taxable when the assets are located in Japan;
 - (i) If the assets are ships or aircrafts used for international transportation, the transfer is

¹⁵⁵ Masatami Otsuka, Ichiro Otsuka, and Eiichiro Nakatani. *Tax Law in Japan* 102 (2001).

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ MOF, *Comprehensive of Handbook of Japanese Tax, General Consumption Tax* 155 (2010). Retrieved from http://www.mof.go.jp/english/tax_policy/publication/taxes2010e/index.htm

- regarded in a country where the institution for registration is located ¹⁵⁹
- (ii) If the assets are mining rights or quarry rights, the transfer is regarded to take place in a country where the mine or quarry is located ¹⁶⁰
- (iii) If the assets are intangible properties such as patents, the transfer is regarded to take place in a country where the institution for registration of intangible properties is located ¹⁶¹
- (iv) If the assets are intangible properties such as copyrights, the transfer is regarded as taking place where the alien of assets is located ¹⁶²
- (b) If a transaction is the **provision of services**, then it is taxable when the place where the service is rendered is located in Japan.
- (i) In case of international transportation service, if a departure place or a destination place is Japan, the transaction is regarded as taking place in Japan ¹⁶³
- (ii) In case of international communication service, including international mailing service, if an origin place or a destination place is Japan, the transaction is regarded as taking place in Japan ¹⁶⁴
- (iii) In case of insurance service, if the permanent establishment for concluding a contract of insurance is located in Japan, it is regarded as taking place in Japan ¹⁶⁵
- (iv) In case of furnishing information or design, if an office used for furnishing service is located in Japan, it is regarded as taking place in Japan ¹⁶⁶
- (v) In case of providing services with special expertise for building capital assets such as buildings and plants, if most materials necessary for the building are procured in Japan,

¹⁵⁹ CTACO Sec.6-1 I& III.

¹⁶⁰ CTACO Sec.6-1 IV.

¹⁶¹ CTACO Sec.6-1 V.

¹⁶² CTACO Sec.6-1 VII.

¹⁶³ CTACO Sec.6-2 I.

¹⁶⁴ CTACO Sec.6-2 II&III.

¹⁶⁵ CTACO Sec.6-1 IV.

¹⁶⁶ CTACO Sec.6-2 V.

it is regarded as taking place in Japan.¹⁶⁷

Locations of assignment or lease of goods are the main criteria to decide whether it has physically taken place in Japan at the time when transactions occur or services are rendered.¹⁶⁸ Some transactions are excluded from taxation, such as “transfer and leasing of land, transfer of securities and means of payment, money lending and other financial transactions, sales of postal and other stamps, medical services, and social welfare services” and so on.¹⁶⁹ Export is excluded from consumption tax as they are to be taxed at the place where they are consumed.¹⁷⁰

4.1.2 Taxpayers

Corporation and individuals are subject to consumption tax when transactions take place.¹⁷¹ According to Consumption Tax Act of Japan, taxpayers subject to consumption tax are (1) business enterprises who transfer a taxable asset within Japan¹⁷² and (2) a person who takes foreign taxable goods from bonded areas. However, small and medium enterprises whose annual turnover or revenue in the base period is less than ¥10 million are exempted from consumption tax. This threshold used to be ¥30 million prior to 2003.¹⁷³ A person whose annual turnover or revenue is under the threshold opts to be a taxable person to pay consumption tax by filing a document in a taxation office in charge of his/her jurisdiction so that he or she can get input tax credits.

¹⁶⁷ CTACO Sec.6-1 VI.

¹⁶⁸ Masatami et al., *supra* note 155, at 103.

¹⁶⁹ MOF, *supra* note 158, at 160.

¹⁷⁰ MOF, *supra* note 158, at 162.

¹⁷¹ MOF, *supra* note 158, at 166.

4.2 Problems of Current Japanese Consumption Tax

According to the OECD report, under the pure definition of consumption, “tax should, in principle, accrue to a country in which the actual consumption takes place for all transactions, no matter whether it is a business -to- business or business -to –consumer transaction.”¹⁷⁴

The current Japanese Consumption Tax Law provides that only domestic transactions are taxable by a consumption tax. For example, when a Japanese consumer buys a product from domestic online retailers, the transaction is subject to consumption tax at 8%. On the other hand, when he purchases a similar product from foreign online retailers, consumption taxes is exempted since it is considered as a transaction outside of Japan. As a consequence, it results in a disadvantage to Japanese online retailers as they are charged at 8% of consumption tax while their foreign competitors can sell their products free of consumption tax, and hence the fairness and neutrality of the tax are violated.

4.3 European Value Added Tax and its measurement for E-commerce transactions

4.3.1 A brief history of VAT in the EU

First two VAT Directives known as Sixth Directive¹⁷⁵ were ratified on April 11 in 1967 which instructed to introduce “the general, multi-stage but non-cumulative turnover tax to replace all of the turnover taxes in the Member States.” These two VAT Directives provided only the basic structure of the system and let each Member States decide the coverage and the rate of the VAT by themselves. At

¹⁷² CTA Sec.4-1, Sec.5-1.

¹⁷³ MOF, *supra* note 158, at 167.

¹⁷⁴ Tax and Commerce OECD, Consumption tax aspects of Electronic Commerce, A report from working party No.9 on Consumption Taxes to the committee on fiscal affairs, (Draft for public comment) 7, 2000.

¹⁷⁵ Sixth Directive, 77/388/EC. (thereinafter mentioned as Sixth Directive).

this time, it was just the general term of taxation on the consumption of goods and services.¹⁷⁶ In May 1977, the Sixth VAT Directive was amended to instruct the VAT system with the same coverage which harmonized the general tax on consumption of goods and services in all the Member States. In addition, it specified what kinds of transactions were taxable within the EU regarding supply of goods, supply of services¹⁷⁷, and the importation of goods.¹⁷⁸ In 2000, the EU commission called for amending the Directive regarding the rules of some kinds of service supplied by electronic ways, such as a payable radio and television broadcasting.¹⁷⁹

Later, the Sixth VAT Directive was recasted to the VAT Directive (2006/112/EC) in January 2007. This time the new Directive instructed to integrate most of the provisions into one law to make it easier to understand the outline of the entire VAT system. The VAT Directive allowed each Member State to freely transform it to their national legislations and decide the rate respectively, so that the VAT rates became different from one Member State to another within the range of 15% to 25%. There were “temporary derogation” from it in some Member States, for example, the UK and Ireland. The coverage of VAT subject to the zero-rate was also different among Member States.¹⁸⁰ This VAT Directive is the primary legislation currently existing in the EU. In implementing the VAT in the Member State, a “binding implementing” measure is provided in the VAT Implementing Regulation (Council Regulation (EU) No 282/2011) in order to ensure the “uniform application” of the VAT Directive. This measure can be applied directly without transposition to the national laws. Moreover, if a Member State wants derogation from the rules provided by the Directives by adopting distinctive measures in order to deal with the tax avoidance or tax evasion, it must take special procedures to authorize.¹⁸¹ The following are the special procedures taken in the past:

¹⁷⁶ Sixth Directive, Article 2-3.

¹⁷⁷ Sixth Directive, Article 6.

¹⁷⁸ Sixth Directive, Article 7.

¹⁷⁹ Andreas Krmel, VAT Taxation of E-Commerce-under special consideration of the 6th EU VAT Directive, University of Cape Town, 26.

¹⁸⁰ http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_history_en.htm

¹⁸¹ http://ec.europa.eu/taxation_customs/taxation/vat/key_documents/legal_framework/index_en.htm

- Decisions authorized by the Council under the procedure provided for in Article 395;
- Council Decisions tacitly approved under the former Article 27(4) of Directive 77/388/EEC;
- Special measures that were applied by the Member States before 1st January 1977 and that were notified to the Commission before 1st January 1978, under Article 394.¹⁸²

The application of the Directive to their national legislation can be done basically on their own as far as the implementation meets the standard of EU level. The “interpretation and application of these provisions” are also free to do by the Member States as far as the application of the VAT provisions is made by the Member States along with the guidance discussed in the VAT Committee.¹⁸³

4.3.2 Features of European VAT

The European Union (hereinafter referred to as the EU) established a new ‘**internal market**’ as a single market in 1992 with the aim of freeing movement of goods, service, and capital (initially created as “European Community”). This internal market is fundamental for EU to accomplish “prosperity, growth, and employment.” The EU intends every EU member state to take full advantage of this single market.¹⁸⁴

In the EU, Value Added Tax (or VAT) is a commonly adopted consumption tax imposed on commercial transactions of goods and services. The tax at each stage of production and distribution is shifted and finally born by consumers.¹⁸⁵ The basic rule of VAT is directed by EU in a form of VAT Directives which bind legislation of VAT of every EU member state.¹⁸⁶ The VAT rate of each member state can vary, but it must be in a range from 15% up to 25%¹⁸⁷ according to the VAT Directives.¹⁸⁸ The

¹⁸² http://ec.europa.eu/taxation_customs/taxation/vat/key_documents/table_derogations/index_en.htm

¹⁸³ http://ec.europa.eu/taxation_customs/taxation/vat/key_documents/legal_framework/index_en.htm

¹⁸⁴ Internal market, general framework, Europa: Summaries of EU legislation. Retrieved from <http://europa.eu/legislation_summaries/internal_market/internal_market_general_framework/index_en.htm>

¹⁸⁵ Article 2, VAT Directive 2006/112/EC.

¹⁸⁶ VAT Directive 2006/112/EC.

¹⁸⁷ 2013, European Union EU VAT rates. Retrieved from <<http://www.vatlive.com/vat-rates/european-vat-rates/eu-vat-rates/>>

¹⁸⁸ Article 93 to130, VAT Directive 2006/112/EC. See also VAT Rates Applied in the Member States of the European Union, July 2013.

imported goods to the EU are generally subject to VAT at the time of goods entering into the EU for the fair competition in the European market.¹⁸⁹ The definitions of VAT provided by the EU are as follows;

- A **general tax** that is applied, in principle, to all commercial activities involving the production and distribution of goods and the provision of services.
- Consumption **tax** because it is borne ultimately by the final consumer. It is not a charge on business.
- Charged as a percentage of prices, which means that the actual tax burden is visible at each stage in the production and distribution chain.
- Collected fractionally, via a system of partial payments whereby taxable persons (i.e., VAT-registered businesses) deduct, from the VAT they have collected the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is **neutral** regardless of how many transactions are involved.
- Paid to the revenue authorities by the seller of the goods, who is a "taxable person", but it is actually paid by the buyer as part of the price paid to the seller. It is thus an indirect tax.¹⁹⁰

Taxable transactions include the supply of goods, intra-Community acquisitions of goods, supply of services,¹⁹¹ and importation of goods. According to the current law, trades among member states have no barriers, so no tax is collected. For taxable persons with VAT registered, the input VAT is deductible if they can provide the VAT number of other state Members.¹⁹²

4.3.3 Intra-Community acquisition of goods

The place of taxation is the final destination of the member state. Taxable person and non-taxable legal person is subject to VAT when they buy goods from another member state. However, some Small and Medium Enterprises, farmers under the flat-rate scheme and non-taxable legal persons are exempted from VAT in case the annual purchase is under the turnover threshold set by their Member

¹⁸⁹ Article 2, VAT Directive 2006/112/EC.

¹⁹⁰ Taxation and Customs Union of European Commission, How Vat works. Retrieved from <http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm>

¹⁹¹ Chapter 3, Title IV, VAT Directive 2006/112/EC.

¹⁹² VAT on goods moving between Member States. Retrieved from <http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/>

State. The tax rate of the destination member state is applicable. As provided “The acquisition of goods is taxed in the **Member State issuing the VAT number (Member State of identification)** under which the acquisition is made. Should the goods be **transported to another Member State (Member State of arrival)** tax must be paid there. This will be followed by an adjustment of the VAT paid in the Member State of registration.”¹⁹³ For example, in case of the Member State of identification,¹⁹⁴ when French company buy a good from another Member State by a French number then the French VAT must be paid. Another example is when Slovakia purchases a good from Spain by providing the VAT registration number in Slovakia then the tax should be paid at Slovakia.¹⁹⁵ For taxation in the Member State of arrival of the goods,¹⁹⁶ in case when the good is bought by using a Slovakian VAT registration number, but in fact the good is sent from Spain to Germany, then VAT must be paid in Germany as acquisition and Slovakia tax due will be exempted respectively.¹⁹⁷

4.3.4 Supply of goods and services

According to the current law, a jurisdiction to tax **supply of goods** is at a place where the supplier is located.¹⁹⁸ On the other hand, a jurisdiction to tax **supply of services** is generally at a place where the supplier has his permanent establishment or if no permanent establishment exists, then at the place of his permanent address where he usually lives.¹⁹⁹ However, in 2010, new rules of VAT packet that “a place of supply of service is where the services are supplied” was introduced, thereby VAT on services is better accumulated to the country of consumption.²⁰⁰ This rule concerns the nature of service

¹⁹³ Intra-Community acquisition of goods. Retrieved from <http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/index_en.htm>

¹⁹⁴ Article 41, VAT Directive 2006/112/EC.

¹⁹⁵ Intra-Community acquisition of goods, *supra* note 31.

¹⁹⁶ Article 40, VAT Directive 2006/112/EC.

¹⁹⁷ Intra-Community acquisition of goods, *supra* note 31.

¹⁹⁸ Article 31, VAT Directive 2006/112/EC.

¹⁹⁹ Article 43, VAT Directive 2006/112/EC.

²⁰⁰ COUNCIL DIRECTIVE 2008/8/EC, Amending Directive 2006/112/EC as regards the place of supply of services, L44/11, Official Journal of the European Union, 2008.

supplied as well as the status of buyer who receives service. A clear classification must be made between a taxable person and a non-taxable person (a final consumer).²⁰¹

4.3.5 B2B service

For business to business (B2B) service, “a buyer’s place of establishment” should be regarded as a place of supply of service.²⁰² It means VAT due is in the country where the recipient of the services is established. As an example of B2B business, Polish company gave legal service to a buyer with a place of business in Sweden, but the service was given at the buyer’s fixed establishment located in Finland. In this case, the service charge is subject to Finnish VAT according to the new rule.²⁰³

4.3.6 B2C service

On the other hand, for business to buyer (B2C) service, VAT should be imposed at the place of ‘supplier’s place of establishment’.²⁰⁴ For an example of B2C business, A Greek supplier with a fixed establishment in Greece is to be taxed by Greek tax when he gives legal services to Romania buyers for private purposes.²⁰⁵

4.3.7 Electronically Supplied Services

For examples, according to the EU, Electronically Supplied Services provided consists of:

- The supply of digitized products, generally including software and changes to or upgrades of software;
- Services providing or supporting a business or personal presence on an electronic network such as a website or a webpage;
- Services automatically generated from a computer via the Internet or an electronic network, in response to specific data input by the recipient

²⁰¹ Supply of services. Retrieved from <http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/index_en.htm>

²⁰² Article 44, VAT Directive 2006/112/EC.

²⁰³ Supply of services, supra note 37.

²⁰⁴ Article 45, VAT Directive 2006/112/EC.

²⁰⁵ Id.

- Website hosting and webpage hosting
- Remote systems administration.

It also includes other activities such as accessing and downloading music, game, online teaching and so on from the webpages.²⁰⁶ However, it does not include the offline activities like “radio and television broadcasting services, telecommunications services, CD-ROMs, floppy disks and similar tangible media, printed matter, such as books, newsletters, newspapers or journals.”

According to the guidelines, there are two ways to evaluate whether the service is under the categories of “electronically supplied service.” First one is to evaluate if the service is “delivery over the internet or an electronic network” and the second one is to evaluate if “the nature of the service is heavily dependent on information technology for its supply.” Only using the internet or electronic tools to conduct a business and connect with the customer does not change the nature of the transaction and it is nothing more than just using a communication tool, like a telephone. Similarly, receiving auction bids by email does not change the nature of a transaction. Probably the only changes are delivery and payment made over the internet in an electronic way.²⁰⁷ Currently, when a customer purchases electronically supplied services online from a seller who has a PE in the EU, VAT is chargeable in the EU where the seller has a PE.²⁰⁸

Prior to then, the supply of services was taxable at the place of establishment of business unless the service is under the section of immovable property, or the service is one such as entertainment, artistic, sport, and financial services.²⁰⁹ Obviously, when suppliers outside the EU provide services to the EU buyers, then EU VAT is not applicable because the VAT on service is to be charged at the place of establishment.²¹⁰ Contrary to this, when a service is provided from the EU to non-EU member countries,

²⁰⁶ <http://ec.europa.eu/taxation_customs/common/buying_online/buying_services/electronically_en.htm>

Available in Pdf (thereinafter mentioned as Europa)

²⁰⁷ Stephen Bill, *Practical application of European value added tax to E-commerce*, 38Ga.L.Rev.71, 76 (2003).

²⁰⁸ Europa, supra note 206.

²⁰⁹ Supply of services, <http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/index_en.htm>.

²¹⁰ Article 44 and 59, VAT Directive 2006/112/EC.

the EU suppliers are subject to VAT. This definitely gives EU disadvantage when digital products or online service are sold to consumers outside the EU.²¹¹ Therefore, it contradicts the principle of fairness and competitive neutrality in taxation.²¹²

An online business like the E-service is usually conducted in multiple countries and often it causes uncertainty in taxation regarding whether or not it should be subject to taxation in the destination country. To deal with this problem, the EU has proposed to amend the regulation of VAT on E-commerce service in 2002,²¹³ whereby ensuring legal certainty of taxation on E-services business. The law was enforced in July, 2003 with the aim of eliminating the disadvantage of suppliers doing E-services in the EU. This amended regulation covers the digital delivery by the electronic networks, such as “software and computer services”. In addition, it also includes cultural, artistic, sporting, scientific, educational, entertainment or similar services as well as information. Accordingly, these services shall be taxed at a place where a buyer resides, different from a supplier’s place. The purpose of the Directive is focused on “electronic services” or “electronically supplied services”. This change will erase the disadvantage faced by EU suppliers which will assure the same VAT treatments for both non-EU suppliers and EU suppliers when providing electronic services to the EU buyers. EU suppliers are in no need to charge European VAT when they make a sale to buyers outside the EU²¹⁴ unless the service is effectively used and enjoyed in one of the EU member countries.²¹⁵

In case of B2B where a non-EU business person supplies services to a business person in the EU with no VAT charged, VAT must be paid by a buyer (a taxable person) under the reverse-charge mechanism (self-assessment).²¹⁶ The commission has already set up measurements of the “VAT Information Exchange System”⁶ (VIES) “network for real time confirmation of the VAT status. This system will provide the information to the traders to identify the status of their buyers on whether the

²¹¹ Dr. Reimar Pinkernell, *Application of the EU Value Added Tax to E-Commerce Transactions*. Retrieved from <http://www.pinkernell.de/euvat.htm>

²¹² *Id.*

²¹³ COUNCIL DIRECTIVE, 2002/38/EC.

²¹⁴ http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm

²¹⁵ Article 59a, VAT Directive 2006/112/EC.

buyer is VAT-registered business or not, in order for them to decide whether or not the tax should be charged.²¹⁷

As for B2C from non-EU business suppliers to consumers in the EU by telecoms or broadcasting services, the VAT is charged in the EU where the service is used and enjoyed.²¹⁸ The new change is applied to electronic services to consumers in the EU, so the VAT must be paid to a State where the consumer belongs.²¹⁹ The business is required to register for VAT purpose when they make sales to final consumers in the EU. They are obliged to register in one of the EU member States and charge VAT at the rate of the state where the buyer is located. The tax is due in every three months and shall be paid to the administration of the State where they have registered for VAT purpose, together with the details of total sales they made in each EU member States, in a form of electronic return.²²⁰

However the rules for supply between EU countries remain the same. Service transactions within the EU shall be taxed in the Member State where the buyer belongs, in case of B2B business. B2C business within EU countries is taxed in the Member State where the supplier belongs.

It is expected that this new rule will have a great effect on U.S. based businesses because the U.S. is a main exporter of digital products and services to consumers in the EU.²²¹

4.4 Taxpayers

The taxpayer is an individual person or an enterprise that carries out an “economic activity”.²²² Economic activity means any activity of supplying goods and services including mining and agricultural activities, and activities of the professions, exploitation of tangible or intangible property.²²³ In addition, a person who carries out a business occasionally to sellers or buyers outside the member states but

²¹⁶ Article 44, VAT Directive 2006/112/EC.

²¹⁷ http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm

²¹⁸ Article 59b, VAT Directive 2006/112/EC.

²¹⁹ Article 58, VAT Directive 2006/112/EC.

²²⁰ http://europa.eu/legislation_summaries/taxation/131044_en.htm#AMENDINGACT

²²¹ Beth Cox, EU VAT: a New Tax Headache for E-Commerce, April 21, 2003. Retrieved from <<http://www.internetnews.com/ec-news/article.php/2194111.>>

²²² Article 9.1, VAT Directive 2006/112/EC.

²²³ *Ibid.*

within the EU community should also be regarded as a taxable person, relating to the economic activity.²²⁴

The taxpayers are allowed to deduct their VAT by the amount taxed at the previous stage of transactions.²²⁵ The VAT added to the goods and services is ultimately to be borne by the final consumer. The taxpayers pay VAT on behalf of the consumers to the national tax administration after the deduction of VAT they paid at the previous stage.²²⁶

4.5 Measurement to deal with E-Commerce as Distance selling

4.5.1 Distance Selling

The principle rule for distance selling is when a VAT-registered seller sells goods to buyers in other Member States of EU who is not registered for VAT. According to the distance selling rule, if the annual amount of sales to buyers is below the threshold of the Member State of buyers, then the seller applies the VAT tax rate of the seller's State.²²⁷ For an example, an Italy retailer sells handbag to French buyers, under the situation of an Italy VAT tax rate at 21% and French VAT tax rate at 19.6%.²²⁸ If the retailer's annual sales to France are below the threshold of French VAT, the retailer charges 21% VAT from his French buyers.

In case the annual sales amount exceeds the annual threshold of the buyer's country, the seller must register as a non-resident VAT trader in a country of buyers.²²⁹ For an example, if an Italian retailer exceeds the annual sale of €100,000 to France, then it must register in France.²³⁰ Then, the sale of Italian

²²⁴ Article 9.2, VAT Directive 2006/112/EC.

²²⁵ Article 168, VAT Directive 2006/112/EC.

²²⁶ Ibid.

²²⁷ <http://www.revenue.ie/en/tax/vat/leaflets/distance-sales-eu.html>

²²⁸ VAT live, Selling over the Internet- Should you think about VAT? Retrieved from

<http://www.vatlive.com/eu-vat-rules/internet-and-ecommerce-vat/>

²²⁹ Ibid.

²³⁰ Ibid.

retailer is subject to French VAT at a tax rate of 19.6%, and the seller must pay the French VAT to French tax authorities by using a French VAT return.²³¹

“Distance Selling” is applied only when goods are sold from Business in one of EU Members State to “a private individual” or a buyer residing in another EU Member State who is not registered for VAT.²³² The aim of EU legislation is to put in a similar position in terms of VAT both consumers using distance communication and consumers using conventional face-to-face shops, throughout the EU.²³³

Distance selling includes “catalogue sales, teleshopping, mobile phone commerce (m-commerce), and the use of the internet (E-commerce).”²³⁴ However, some contracts are excluded such as “financial services, contracts by automatic vending machines or automated commercial premises, contracts with telecommunications operators through the use of public payphones, contracts for the construction, and sale of immovable property or relating to other immovable property rights except for rental, contracts at auction.”²³⁵ Additionally, the directive does not cover the delivery of foods and drinks to the consumer’s residence or workplace by regular rounds men. Furthermore, a contract to perform service on a specific date like accommodation, transport, catering or leisure services is also excluded from the distance selling rule.²³⁶

Distance selling deals only with goods but not services. Moreover, it’s effective only when an EU Member of VAT registered sells and delivers goods to a buyer in another EU country who is not necessary to be registered and not registered.²³⁷

²³¹ Ibid.

²³² Article 1, Distance Selling Directive (EU Directive 97/7/EC).

²³³ Distance selling. Retrieved from
<http://ec.europa.eu/justice/consumer-marketing/rights-contracts/distance/index_en.htm>

²³⁴ Ibid.

²³⁵ Article 3.1, Distance Selling Directive (EU Directive 97/7/EC).

²³⁶ Article 3.2, Distance Selling Directive (EU Directive 97/7/EC).

²³⁷ Distance selling, the basic. Retrieved from
<<http://www.hmrc.gov.uk/vat/managing/international/distance-selling.htm#5>>

4.5.2 VAT mini One Stop Shop

From 2015, electronic service business like telecommunication services, television and radio broadcasting services and electronically supplied services from non-EU supplier (taxable person) providing service to a consumer in the EU with no fixed establishment²³⁸ and with a fixed establishment will always be taxable by VAT at the place where buyers are located. The suppliers have to register “VAT mini One Stop Shop”, by which the suppliers are exempted to register in every Member State in which they supply services to their buyers.²³⁹ In other words, if a non-EU supplier registers VAT mini One Stop Shop in one of the EU member countries according to their choice, then they do not need to register in every country like before. This mini One Stop Shop scheme is optional for taxable persons. A taxable person can register as a VAT taxpayer in every country as previously if he so prefers.

The VAT due is to be submitted quarterly to a tax office in an electronic form of VAT return, and the information will be transmitted to the Member State. After that, the tax office will allocate the VAT payment to share with a corresponding country at the national rate charged.²⁴⁰

Whether this system is effective or not, it will be enforced in 2015 onwards. The importing VAT tax on the Electronic-service is the first time to be introduced in the EU. The table below shows how the VAT will be taxed from January 2015.

For EU BUSINESSES

1. Business in another EU country	No VAT charged. Customer must account for the tax (reverse-charge mechanism).
2. Consumer in another EU country	Must charge VAT in the EU country where the customer belongs (not where the business is based). Example A Polish customer downloading an App on his mobile phone from a Finnish supplier. The Finnish company must charge the customer Polish VAT. MOSS available

²³⁸ European Commission, Guide to mini One Stop Shop 2 (2013)

²³⁹ European Commission, supra note 36, at 3.

²⁴⁰ European Commission, supra note 36.

3. Business or consumer outside the EU	No EU VAT charged. Example A Hungarian company sells an anti-virus program to be downloaded through its website to businesses or private individuals in Australia. NO VAT But if the service is effectively used & enjoyed in an EU country, that country can decide to levy VAT (option for Member States).
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Source: European Commission telecommunications, broadcasting and electronic services²⁴¹

For NON-EU BUSINESSES

1. Business in the EU	No VAT charged. Customer must account for the tax (reverse-charge mechanism).
2. Consumer in the EU (telecoms, broadcasting or electronic services)	Must charge VAT in the EU country where the customer belongs. Example A person living in Barcelona pays a US company for access to American TV channels. The US company must charge the customer Spanish VAT. MOSS available

Source: European Commission telecommunications, broadcasting and electronic services²⁴²

4.6 U.S. Sales Tax for E-commerce transactions

4.6.1 Brief History of E-commerce

An internet was mainly used by people belonging to academics, government, or military before 1992 in the U.S.²⁴³ Then, the use of the internet by individuals for business started in 1994 with the social and scientific phenomenon created for more than decades till then. E-commerce is better than traditional business providing broader choices by catalog, easy ordering at lower cost, and easy reaches to buyers around the world.²⁴⁴ Traditional business using physical retail stores known as brick-and-

²⁴¹ http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm#rulesapp2015

²⁴² http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm#rulesapp2015

²⁴³ Emily L. Patch, *Online Retailers Battle with Sales Tax: A Physical Rule Living in a Digital World*, 46 Suffolk U. L. Rev. 673,676 (2013).

²⁴⁴ Emily L. Patch, *supra* note 243, at 678.

mortar retailers has more than one million establishments and hold about 42% of personal-consumption expenditures of the U.S.. Nowadays, online shopping has already exceeded the catalog shopping with 5% of American retail spending even when the economy is not good. It is believed that the spending on the online shopping continues to grow because internet users are not only using internet for web surfing, but ²⁴⁵ they also do online shopping. Accordingly, the taxation of E-commerce transactions becomes a serious issue, especially regarding a sales tax. ²⁴⁶

In 1990, bookstores were growing in the U.S. along with many discount stores. Barnes & Noble and Borders made full use of this opportunity by opening huge superstores, warehouses, and movie theaters with a stock of 100,000 titles. They were five times bigger than local regular bookstores. As a consequence, Jeffery Bezos, a founder and CEO of Amazon rode this surf to open the online mega bookstore with greater inventories at cheaper prices. ²⁴⁷ Amazon was founded in 1994 in Seattle, Washington. It started first business operation in 1995 with a few employees. Amazon soon became known for relative advantages of broader choices, cheaper prices, easy to access and its convenience, in comparison with regular local bookstores. Only in one month, they could sell their books online to buyers in all fifty states and forty five countries. Since then, Amazon has grown continuously, ²⁴⁸ reaching an access of millions of Internet users everyday around the world. ²⁴⁹

4.6.2 General basic structure of U.S. Sales Tax

According to the definition of general sales tax provided by Internal Revenue Code of U.S., “General sales tax means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.”²⁵⁰ No general sales tax exists at a federal level in the U.S. Instead, each State or local government has a complete power to decide which goods and services are to be subject to sales and use

²⁴⁵ Ibid.

²⁴⁶ Ibid.

²⁴⁷ Ibid.

²⁴⁸ Id, at 679

²⁴⁹ Id, at 680.

²⁵⁰ 26 USC §164 Taxes, (5) (B).

tax.²⁵¹ Therefore the definition of retail sales and services subject to sales tax varies by State, which causes many problems for a taxpayer who operates business in more than one State. Not all types of goods and services are subject to sales tax. Most states exempt from the tax some kinds of business such as food, clothing, medical suppliers, and motor vehicles.²⁵² Although the tax incidence is on consumers, a seller is basically required to collect Sales tax and pay it on behalf of consumers.²⁵³ Sales tax is applicable only to retail sales, not for re-sale. The applicable sales tax rate varies from state to state,²⁵⁴ and the inter-state transactions are subject to the Commerce Clause of the Constitution Law of US.²⁵⁵ A taxpayer must meet this requirement of the Constitution to be subject to state and local tax law.²⁵⁶

The requirement to collect the sales tax is only on transactions within a state unless there is a minimum connection or ‘nexus’ with the other state.²⁵⁷ For nexus to exist, physical presence like a place of business must be established and maintained such as an office, employees, and individuals or an agent providing service.²⁵⁸ Almost all States levy the sales tax except Alaska, Delaware, Montana, New Hampshire, and Oregon. Even these five States charge specific sales taxes on certain products and services.²⁵⁹ At present, online retailers conducting E-commerce business are obliged to collect the sales tax from the sales in a state of retailer’s location.²⁶⁰

In order to deal with the internet taxation problem, the Congress set up a bipartisan Congressional Internet Caucus in 1996. Two years later, the Internet Tax Freedom Act was enacted to prohibit the imposing tax on state sales or use taxes on the Internet access or in online service including multiple or unfair taxes on the E-commerce. This tax moratorium had continued until November 1, 2014. While the federal government has applied this principle, state governments are always making an effort

²⁵¹ Emily L. Patch, *supra* note 243, at 681.

²⁵² 26 USC §164 Taxes, (5) (C).

²⁵³ Richard A. Westin, *International Taxation of electronic Commerce* 76, (2000).

²⁵⁴ 26 USC §164 Taxes, (5) (D).

²⁵⁵ The Commerce Clause refers to “regulate commerce with foreign nations, and among the several states, and with the Indian tribes.” U.S. Const. Art.I, §8, cl.3. <http://www.law.cornell.edu/wex/commerce_clause>.

²⁵⁶ Richard Doernberg & Luc Hinnekens, *Electronic Commerce and International Taxation* 283 (1999).

²⁵⁷ United States Sales Tax. Retrieved from

<http://www.usa-sales-use-tax-e-commerce.com/Intro_sales.asp>

²⁵⁸ *Ibid.*

²⁵⁹ *Ibid.*

²⁶⁰ Emily L. Patch, *supra* note 243, at 686.

to tax on E-commerce taxation because state and local taxes amount to more than \$700 billion or about 45% of all taxes collected in the U.S. Actually, one-third of tax revenue of state governments are from sales and use taxes, so that it is very significant for state governments to tax these taxes on E-commerce.

²⁶¹ Regardless of the Internet Tax freedom Act's passage, states continue to tax the business transaction conducted in the state through the internet as well as the transaction by out-of-state sellers. This is also applicable to brick-and-mortar retailers to request them to collect sales taxes.²⁶² Due to the insufficient budget and the decline of the tax base, states are unavoidably in need to find a new way of revenue by amendment of sales tax laws to be able to tax the sale of digital products, which is a very sophisticated issue in taxation.²⁶³

In 2008, New York State amended the tax law and expanded the definition of physical presence as a 'seller' for the purpose of local sales tax within the State. According to the New York State Law, "every seller of tangible personal properties" is required to collect the sales and use taxes on the sales of tangible personal property made to the New York State residents.²⁶⁴ A "seller" is defined as "a person who solicits business" within the State by using affiliates, agents or other representatives.²⁶⁵ The sellers need to register at the Department of Taxation and Finance (DTF) and then the certificate is granted to permit them to collect the sales tax.²⁶⁶ According to this amendment, presumption is given that if a "seller" made a contract with affiliates in New York to solicit business within the State, it can be presumed that the seller has physical presence, and therefore New York State can command the seller to collect the sales tax.²⁶⁷

This amendment is a reflection of reality that in fact there are many sales of goods to New York residents through the internet. There are two conditions for the amendment:

²⁶¹ Matthew Adam Susson, *Thinking Out Cloud' California State Sales and Use Taxability of Cloud Computing Transactions*, 17 Chap.L.Rev.295, 310 (2013).

²⁶² Id., at 311.

²⁶³ Id., at 295.

²⁶⁴ Tax Law § 1131 [1]; *see also* § 1101 [b] [8]; §§ 1105, 1110, 1132 [a].

²⁶⁵ Tax Law § 1101 [b] [8] [i] [C] [I].

²⁶⁶ Tax Law § 1134 [a].

²⁶⁷ Tax Law § 1101 [b] [8] [i] [C] [I], 1101 [b] (8)(iv).

1. An out-of state seller was : Soliciting business [in New York] through an independent contractor or other representatives if the seller enters into an agreement with a resident of this State under which the resident, for a commission or other consideration, directly or indirectly refers potential buyers, whether by a link on an internet website or otherwise, to the seller,
2. If the cumulative gross receipts from sales by the seller to buyers in the State who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods ending on the last day of February, May, August, and November.²⁶⁸

By this amendment, out-of-state sellers become responsible to collect sales or use taxes when they have a contract with an in-state resident to solicit business through the internet or website with New York residents.²⁶⁹ However, the law also provides that the presumption can be denied if the seller can prove that the resident “did not engage in any solicitation in the State on behalf of the seller that would satisfy the nexus requirement of the United States Constitution during the four quarterly periods in question.”²⁷⁰

4.7 Current Standard of Taxation for Case Law in Sales tax

4.7.1 National Bellas Hess, Inc v. Department of Revenue of Illinois

This case was held at the Supreme Court in 1967 where Department of Revenue of Illinois collected the tax from National Bellas Hess, Inc.²⁷¹ National Bellas Hess was a mail order corporation situated in Missouri, Delaware. It has “no tangible property in Illinois, has no sales outlets, representatives, telephone listing, or solicitors in that State, and does not advertise there by radio, television, billboards, or newspapers.”²⁷² They only sent catalogues by mail twice a year to the buyers all over the U.S. including Illinois states, periodically by “flyers.” Illinois claimed these advertisement

²⁶⁸ Tax Law § 1101 [b] [8] [vi].

²⁶⁹ <http://www.leagle.com/decision/In%20NYCO%2020101104278>

²⁷⁰ Tax Law § 1101 [b] [8] [vi].

²⁷¹ National Bellas Hess v. Department of Revenue of Illinois 386 U.S. 753 (1967).
<<https://supreme.justia.com/cases/federal/us/386/753/case.html>>

activities subject to collect the use taxes from out of state retailers in accordance with the Illinois state statutes.²⁷³ National insisted that attempting to collect the tax from out of state retailers was against the Due Process Clause and to impose unconstitutional burden on inter-state Commerce. Responding to this, the Supreme Court ruled that the collection of tax could be done only if National has a “physical presence” in Illinois. Moreover, the court opinion was cited that “The Commerce Clause prohibits a State from imposing the duty of use tax collection and payment upon a seller whose only connection with buyers in the State is by common carrier or by mail” and “the Court has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with buyers in the State is by common carrier or the United States mail.”²⁷⁴ Therefore, the court decided that only mail order activity was not sufficient to collect the tax unless there was some physical presence in the state.

4.7.2 Quill Corp v. North Dakota

While the internet has expanded over the years, this Quill case²⁷⁵ has been a controlling case regardless of technology improved.²⁷⁶ As explained above, in the U.S. the sales tax is imposed on transactions that take place within a state. The U.S. Supreme Court held in many cases that physical presence or nexus is necessary in order to tax sales tax of other states.²⁷⁷ In 1992, the Supreme Court heard a case of Quill Corp v. North Dakota²⁷⁸ in which the state cannot impose sales tax on out-of-state transactions without physical presence.

The Quill Corporation of Delaware sold an office supplier in North Dakota State where they had no office and no employees were hired. The business was to send catalogues to buyers, take orders by telephone and then deliver by mail or common carrier. According to North Dakota’s 1987 Statue, it requires a “retailer” engaging in “regular or systematic solicitation” with North Dakota residents must

²⁷² Ibid.

²⁷³ Ill. 2d 164, 214 N. E. 2d 755

²⁷⁴ National Bellas Hess v. Department of Revenue of Illinois, supra note 30.

²⁷⁵ Quill Corp. vs. North Dakota, 504 U.S. 298 (1992).

²⁷⁶ Ibid.

²⁷⁷ Richard Doernberg & Luc Hinnekens, supra note 49.

²⁷⁸ Quill Corp. vs. North Dakota, supra note 275.

collect the sales taxes from the buyers and pay those taxes to the states.²⁷⁹ Therefore North Dakota filed a lawsuit to Quill Corp to pay the sales tax on the transactions made to their residents. However, Quill denied to pay the tax and appealed to a higher court and the ruling was favored to the Quill with the reason that Quill had no physical presence or lack of nexus with the State, so that the sales tax should not be collected.²⁸⁰

In this Quill case, it developed two distinctive of “nexus” tests depending on the U.S. Constitution’s Due Process Clauses and Commerce Clause. In deciding the case, the court relied on these two tests to decide if the remote sellers have sufficient connection with the states to collect the sales tax on the transactions. To impose taxes on those incomes constitutionally on the remote sellers, the states must meet with these two tests.²⁸¹

The Due process nexus test is recognized as “flexible standard” which is not counting on a physical presence of the seller within the state, but rather the remote seller would be accounted with the requirement for Due Process nexus requirement through “purposeful direction” of its efforts toward a state to solicit business. This flexibility of standard comes from the objective of the Due Process Clause, principally concerned with “**the fundamental fairness of government activity.**” Therefore, under the Quill case, it is impossible for a remote seller to win the case regarding to the Due Process nexus requirement because a remote seller has a “purposefully availed” itself to conduct a business in the state.²⁸²

The other Commerce Clause nexus test found in the Quill case is considered to be “**a bright-line test**” which demands a physical presence of a seller in a state in order to levy use taxes. Regardless of Quill conducted business in mail-order sales, their holding should generally be applied to the Internet

²⁷⁹ Emily L. Patch, *supra* note 243, at 684.

²⁸⁰ <http://cases.laws.com/quill-corp-v-north-dakota>

²⁸¹ Steven M. Hogan, *Internet Taxes on Trial: New strategies for litigating remote-seller sales and use tax cases*, 88 Fla.Bar J. 31, 5 (2014).

²⁸² *Id.*, at 6.

retailers too. A state could not levy a sales tax on a seller or shop without having a physical presence in a state because of the unjustified burden in the statute of inter-state commerce.²⁸³

The two cases of *National* and *Quill* were undeniably very similar. Before the *Quill* case, the court had never considered the different meaning of a nexus requirement in both constitutional clauses. Nonetheless, in the *Quill* case, the Supreme Court had a different opinion to analyze the Due Process and Commerce Clauses. It stated that these clauses were very closely related in deciding taxing jurisdiction power.²⁸⁴ Due Process Clause depends on the taxpayer connection to the state with the requirement of “some definite link, some minimum connection, between the state and the person, property or transaction it seeks to tax.”²⁸⁵ Accordingly, the *Quill* case meets with the requirement if “(a) there is a sufficient and purposeful direction of the taxpayer’s activities aimed at the state’s residents; and (b) there is a rational relationship between the tax imposed and the benefits the taxpayer received through access to the taxing state’s market. Physical presence is not necessary.”²⁸⁶

4.7.3 New York Amazon Tax

Amazon,²⁸⁷ the biggest E-commerce in the U.S., has taken full advantage of physical presence by avoiding the sales tax while having business in all the fifty States of U.S. By using ‘entity isolation’ which setting the subsidiaries to function business like order taking, research and development on behalf of them on the contract basis. As a subsidiary is a legally separated entity, there is no way to impose sales tax on Amazon in this case.²⁸⁸ Obviously the subsidiary benefits public service from N.Y. State but Amazon alleged that they should not be enforced to pay the sales tax because it doesn’t directly benefit the public service from N.Y. State. The State argued that Amazon should be subject to the sales tax

²⁸³ *Id.*, at 7.

²⁸⁴ Richard Doernberg & Luc Hinnekens, *supra* note 49, at 284.

²⁸⁵ *Quill Corp. vs. North Dakota*, *supra* note 275.

²⁸⁶ Richard Doernberg & Luc Hinnekens, *supra* note 49, at 284.

²⁸⁷ <http://www.amazon.com>

²⁸⁸ Emily L. Patch, *supra* note 243, at 687.

because without the help of the subsidiary to fulfill the buyer's order, their business would not function that well.²⁸⁹

Soon after the New York amendment became effective, Amazon filed a lawsuit against New York State. In the remarkable *Amazon vs. New York*²⁹⁰ case, the plaintiff was Amazon.Com that situated in Delaware State and has no office, employees or any kind of properties in New York. The sale is made through internet to New York residents and the products are directly sent to buyers from outside of New York. Amazon offered a facial challenge to the statute as unconstitutional by raising three issues on the statute. Firstly, they argued that the statute was against the Commerce Clause of the Constitution by lacking "substantial nexus" within the state. Secondly, Amazon stated that the statute violates the Due Process of Law because the presumption is vague, ridiculous, and ineffective. Thirdly, it argued that the statute breached the Equal Protection Clause of the Constitution because this statute is mainly targeted to Amazon which is the world's biggest internet retailer. Nevertheless, the Supreme Court of New York dismissed the claim and declared that the statute is constitutional on its face, and it doesn't violate the Equal Protection Clause as well as the Commerce and Due Process Clauses and therefore affirmed that Amazon should pay the sales tax to the State.²⁹¹ As of now, Amazon has collected sales taxes in 19 states and remits them to relevant states.²⁹²

4.7.4 Performance Marketing Association, Inc. v. Hamer

In 2011, Illinois enacted "Amazon Law" or "Click-through Nexus Law"²⁹³ which requires out-of-state retailers to collect the sales tax and the use tax when they engage in "*performance marketing*" with certain in-state persons for a commission or others.²⁹⁴ The law is similar to "New York Amazon Tax Law". "Performance marketing" is that retailers pay for advertisements when a sale is made. For example, in case of internet advertisements, an out-of-state retailer requests local website administrators

²⁸⁹ Id.

²⁹⁰ *Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y. S/ 2d 129 (N.Y. App. Div.2010)

²⁹¹ *Quill Corp. vs. North Dakota*, supra note 275.

²⁹² <http://www.amazon.com/gp/help/customer/display.html?nodeId=468512>

to put a link on their websites for advertisement. If a consumer clicks on the link and the sale is made through this link, the local website administrator will get paid. The threshold under the click-through nexus statute is over \$10,000 sales per year.²⁹⁵

The case of Performance Marketing Association, Inc. v. Hamer²⁹⁶ was that the plaintiff brought a lawsuit against the representative for Illinois Department of Revenue to challenge the Click-through Nexus Law, commonly known as “Amazon Tax”. The Illinois Circuit Court held that the Illinois Act, which includes “Click-through Nexus Provision”, violated the Commerce Clause of the U.S. Constitution and was preempted by the Internet Tax Freedom Act (ITFA)²⁹⁷ which bans “multiple discriminatory taxes on electronic commerce”. Then Illinois appealed the case to the Supreme Court of Illinois.

The Supreme Court of Illinois also affirmed in favor of the taxpayer. In rendering this case, the Supreme Court of Illinois viewed that “performance marketing ” is not only limited to internet marketing, but it also exists in print media which is not subject to the tax under the Illinois statute. In addition, the Supreme Court of Illinois also referred to the Internet Tax Freedom Act (ITFA) and found that the Click-through Nexus Law discriminated electronic commerce against the ITFA, and therefore it is invalid. The court did not reach the issue of the Commerce Clause of the Constitution.²⁹⁸

Until now, the concept of ‘nexus’ has been used on the E-commerce transaction, which prevents the state to tax the transaction made to the other states. Due to the huge annual budgetary deficit of over \$1 trillion, together with the debts exceeding \$10 trillion,²⁹⁹ taxing E-commerce transactions across the state becomes fascinating to the governments. As a consequence, Amazon, the world biggest online firm, becomes a target of the U.S. governments to tax them properly. It is a hot issue at present whether or not the U.S. state governments should introduce a new law similar to the EU distance selling

²⁹³ 35 ILCS 105/2 (1.1).

²⁹⁴ Id.

²⁹⁵ <http://www.state.il.us/court/Opinions/SupremeCourt/2013/Summaries/114496s.htmw>

²⁹⁶ Performance Marketing Ass’n v. Hamer, 2013 IL 114496

²⁹⁷ 47 U.S.C. Section 151 note (2000)

²⁹⁸ Supra note 293.

system.³⁰⁰ Current law definitely creates unfair competition with out-state retailers free of the sales tax, while sales by E-commerce by in-state retailers are subject to the sales tax while out-of-state are not.³⁰¹

4.7.5 Streamlined Sales and Use Tax Agreement

A retail and wholesale transaction over the internet accounted for \$ 4.1trillion dollars in 2010 according to the estimation by the U.S. Bureau of the Census. Another different data evaluated that E-commerce in 2011 worth almost \$3.9 trillion dollars and it expects to increase to \$ 4 trillion dollars. State and local governments are paying attention to this because incomes from those transactions are not easy to enforce. Based on the current law, the state cannot tax the out-of-state internet retailers when they do not have a nexus with the buyer's state. As a result of Quill case ruling in 1967, holding that requiring remote sellers to collect the use tax is a burden under interstate commerce, the states has lost tax revenue from around \$11.4 billion in 2012.³⁰²

Congress is related because interstate commerce is subject of the Commerce Clause of the Constitution. Supporters of remote seller sales and use tax want the Congress to revise the law to allow the states to tax out-of-state remote sellers without the nexus. Recognition is necessary that “simplification and harmonization of state tax systems” are mandatory, in order for the Congress to approve it. Many states have made an endeavor to harmonize the sales tax collection and set up the Streamlined Sales and Use Tax Agreement (hereinafter referred to as SSUTA with which Congress may agree so that they can collect out-of-state sales to buyers in the member) states. Finally, the 112th Congress, S.1452 and H.R. 2701 had approved the SSUTA member states to enforce sales and use tax on out-of-state retailers in other member states. Also S.336 and H.R.684 granted member states and non-

²⁹⁹ http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm

³⁰⁰ <http://www.vatlive.com/americas/time-for-a-us-amazon-tax-or-eu-vat-on-e-commerce/>

³⁰¹ Ibid.

³⁰² Steven Maguire, *State Taxation of Internet Transactions*, Congressional Research Service,1 (2013).

member states which satisfy the “less rigorous simplifications standards and the authority” to enforce the out-of-state sellers with more than \$ 1 million remote sales to collect sales and use tax.³⁰³

SSUTA established in 2000 by 43 states and the District of Columbia with purpose to simplify the individual sales tax and use tax in the U.S. The stated goal was to “create a simplified sales tax system” in order that all kinds of sellers from the traditional to the internet could collect the sales tax without difficulties with the same rules. However, the Sales and Use Tax Project were dissolved for a while and the agreement comes into force again in 2005.³⁰⁴

“This SSUTA Agreement is a result of the joint efforts of 44 states, the District of Columbia, local governments and the business community to simplify sales and use tax collection and administration by retailers and states. The Agreement minimizes costs and administrative burdens on retailers that collect sales tax, particularly for retailers operating in multiple states. It encourages "remote sellers" selling over the Internet and by mail order to collect tax on sales from buyers living in the Streamlined states, so that local "brick-and-mortar" stores and remote sellers can operate under the same rules in a fair and competitive environment.”³⁰⁵

Secondly, as an alternative for non-member states, states must implement the minimum simplification requirements.³⁰⁶ In this case, the state must agree to some application:

- Notify retailers in advance of any rate changes within the state
- Designate a single state organization to handle sales tax registrations, filings, and audits
- Establish a uniform sales tax base for use throughout the state
- Use destination sourcing to determine sales tax rates for out-of-state purchases (for example, a purchase made by a consumer in California from a retailer in Ohio is taxed at the California rate, and the sales tax collected is remitted to California to fund projects and services there)

³⁰³ Ibid.

³⁰⁴ Id, at 9.

³⁰⁵ http://www.streamlinedsalestax.org/index.php?page=gen_1

³⁰⁶ S.743, sec. 2 (b)

- Provide free software for managing sales tax compliance, and hold retailers harmless for any errors that result from relying on state-provided systems and data.³⁰⁷

4.8 Marketplace Fairness Act 2013

In 2013, the Marketplace Fairness Act was approved by the Senate at 69 to 27 votes. The legislation is still pending under the House of Representative at the end of 2013. The Marketplace Fairness Act allows the states to collect sales and use Streamlined Sales and Use Tax Agreement taxes on “remote sellers” which includes online and catalog retailers when transactions are made, regardless of physical presence in the state or not.³⁰⁸ Under the current law, only if the retailers have a physical presence, property or employees in other state, they need to collect the sales taxes. However, the Marketplace Fairness Act requires some simplification of sales tax law. First, the state requires joining SSUTA.³⁰⁹ The states hope the measure on this provision will make it easier for them to collect the sales tax across the country. As of today, the retail world is very distinct; the controlling Quill case is no longer applicable to the sales tax. It is believed that the Marketplace Fairness Act will be a big help in collecting sales tax and use tax.³¹⁰

³⁰⁷ <http://www.marketplacefairness.org/what-is-the-marketplace-fairness-act/>
See more at S.743-Marketplace Fairness Act of 2013.

CHAPTER 5

BASE EROSION AND PROFIT SHIFTING

5.1 Introduction

Globalization means “the development of an increasingly integrated global economy market, especially by free trade, free flow of capital, and the tapping of cheaper foreign labor markets.”³¹¹ A concept of Globalization is not new but in the recent years national economy and market has significantly increased. Globalization gives many benefits and positive impacts on the domestic economy, which increases foreign direct investments, creates job opportunities, advances technological innovation, and reduces lots of poverty in many countries.³¹² At the same time, Globalization affects domestic policies, including tax policy.³¹³

Earlier, in 1920, the League of Nation observed that the influence of globalization could lead to double taxation as a result of growth of global prosperity. Many countries agreed to create clear and predictable international rules to eliminate the double taxation for both governments and businesses. Hence, bilateral tax treaties are a basis for the growth of the global economy.³¹⁴

However, current rules have some weakness of allowing opportunities for Base Erosion and Profit Shifting (hereinafter referred as BEPS). Interaction of different tax rules can result in a double non-taxation or less taxation as BEPS. Increase of digital economy gives a lot of challenges to international taxation.³¹⁵

³⁰⁸ S.743-Marketplace Fairness Act of 2013.

³⁰⁹ S.743, sec. 2 (a)

³¹⁰ *Ibid.*

³¹¹ Merriam-Webster Retrieved from <<http://www.merriam-webster.com/dictionary/globalization>>

³¹² OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 9 <http://dx.doi.org/10.1787/9789264202719-en>

³¹³ *Id.*, at 15.

³¹⁴ *Ibid.*

³¹⁵ *Id.*, at 10.

Along with globalization and innovation of technology, the digital economy has increased quickly, in which the digital products or service can easily be sent online to another countries without any physical presence there. This has led to reduction of tax incidence of the MNEs which raises an issue of fairness in taxation with critics as follows:

- It is harmful to the Government. Many governments must deal with the avoided revenue and must spend more cost to assure compliance.
- It harms businesses by individual taxpayers because only multi business can take an opportunity to shift their income easily to other countries with no or low taxes or manipulate their income.
- For corporations doing business only domestically such as a family owned business and newly founded companies, it becomes more difficult to compete with MNEs that can easily shift their income to abroad to reduce or avoid taxes.³¹⁶

In September 2013, the Task Force on the Digital Economy which is a subsidiary body of the Committee on Fiscal Affairs (CFA) was formed with the purpose to evolve the report, dealing with the digital economy issues and get the possible solutions by September 2014.³¹⁷

Recently, the OECD released a discussion draft of BEPS Action Plan 1 known as “Tax Challenges of the Digital Economy” to respond to the digital economy tax issue requested by G20 countries. This report includes the result of preceding work discussed by the Task Force on the Digital Economy. However, the BEPS actions discussion draft has not been agreed by the G20/OECD countries yet.

The BEPS action plan describes about the characteristics of the digital economy as follows;

The spread of the digital economy also poses challenges for international taxation. The digital economy is characterized by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free

³¹⁶ Ibid.

products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterization of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.³¹⁸

The first Meeting of the Task Force on the Digital Economy was held on October 2013 by representative and experts on the digital economy.³¹⁹ The discussion draft classified the administration challenges to tax both remote places of service as well as virtual presence of service.³²⁰ The proposal is to have various measurement options for the tax challenges occurred by the digital economy, mainly based on the previous work of 1998 Ottawa Taxation Framework Conditions. The principles are “neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.”³²¹ These principles are still fundamental in addressing the tax challenges regarding the digital economy. Furthermore, the discussion also considered about the post-Ottawa body of work relevant to the concept of “the attribution of profits to permanent establishments, the place of effective management concept and treaty rule in the context of e-commerce.”³²²

BEPS Action 1 is mainly focused on the digital economy.

Four main policy challenges are discussed regarding the digital economy. They are a nexus, data collection, characterization of income, and collection of VAT/GST.

The challenge of the digital economy explained in Action 1 is as follows;

³¹⁷ OECD, BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY, Public Discussion Draft, 6, 24 March 2014 – 14 April 2014. Retrieved from <http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf>

³¹⁸ OECD (2013), *supra* note, at 312.

³¹⁹ *Ibid.*

³²⁰ OECD BEPS Action 1, Address the tax challenges of the digital economy, 1 World Tax Advisor, 28 March 2014.

Issues to be examined include, but are not limited to,

- the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules,
- the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services,
- the characterization of income derived from new business models, the application of related source rules, and
- how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services.³²³

In order for the Action Plan to work effectively, it needs fundamental change to the current rules, plans new standard rules at an international level, and most importantly, the government must keep up working together to prevent double non-taxation and low taxation practices.³²⁴ BEPS issues occur as a result of imbalance in the interaction of country's domestic tax laws, the loophole of laws, and gaps among laws. Typically, these issues are not covered by OECD bilateral treaty, thus it needs a supplementary standard to prevent double taxation that is not currently included. Bilateral tax treaties are effective to some degree to prevent double taxation, but they are often lacking to prevent double non taxation in more than two countries.³²⁵

To deal with the changing international tax environment, a number of countries have shown their worry about how the international standard like bilateral tax treaties should allocate the taxing rights between source and residence States. BEPS is hoping to restore those problems about how to allocate taxing rights on cross-border income between source and residence States, without changing the

³²¹ Supra Note 5 at 6

³²² Ibid. See more at Annex 1 Ottawa taxation Framework Condition.

³²³ OECD (2013), supra note, at 16-17.

³²⁴ OECD (2013), supra note, at 13.

³²⁵ Ibid.

entire current system. This BEPS Action Plan aims at coordination of taxing right to better deal with economic activities.

Currently, BEPS report covers “(i) identifies action needed to address BEPS, (ii) sets deadline to implement these actions and (iii) identifies the resources needed and the methodology to implement these actions.”³²⁶

5.2 Tax Challenges

The BEPS report defines the main challenges brought by the digital economy as four categories as follows:

- **Nexus.** The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business raise questions as to whether the current rules are appropriate which requires “Nexus” as basis for taxation.
- **Data.** The information technologies have enabled companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterize a supply of data in a transaction for tax purposes.
- **Characterization.** The development of new digital products or means of delivering services creates uncertainties with regard to the proper characterization of payments made by new business models such as cloud computing.
- **VAT Collection.** Cross-border trade in both goods and services creates challenges for VAT systems, particularly where such goods and services are purchased by private consumers from suppliers abroad. This is partly due to the absence of an effective international framework in which small and medium enterprises with many low value transactions and low tax liabilities,

register and pay VAT to many tax authorities related to their transactions, which may be a significant administrative burden but marginal revenues for tax authorities.³²⁷

In order to deal with the tax challenges above, there are several options, which include “modification of the permanent establishment threshold, the potential imposition of a withholding tax on certain types of digital transactions and the imposition of an indirect tax on digital transactions”.

5.2.1 Potential Options proposed by the Task Force for the BEPS

There are many discussions has been talked and potential options are proposed to the Task Force from many kinds of sources and working groups.³²⁸

Modifications of the Exceptions from Permanent Establishment of Paragraph 4 of Article 5 of OECD Model are one potential option. For some business, it is possible to do the business activities without a PE, namely only with activities of a preparatory or auxiliary nature described in the subparagraphs (a) to (d) of Paragraph 4 of Article 5, such as facilities for the purpose of storage, maintenance, display, and so on. As a concrete option, one proposal is to get rid of all the subparagraphs. Another option is to eliminate (a) to (d) and keep only general conditions of preparatory or auxiliary in nature different from the core functions of business.³²⁹

Another potential option proposed by the Task Force is to establish an alternative nexus for “fully dematerialized digital activities”. It would consider a business as having a PE if the enterprise keeps a “significant digital presence” in the economy of another country.

A fully dematerialized digital activity has following features:

³²⁶ OECD (2013), supra note, at 11.

³²⁷ OECD, BEPS ACTION 1, supra note 320, at 56.

³²⁸ OECD, BEPS ACTION1, supra note 320, at 64.

³²⁹ Ibid, at 65.

- The core business of the enterprise is entirely or significantly dependent on digital goods or digital services.
- There are no physical elements or any activities other than ‘existence, use or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data.’
- Contracts are concluded in the distance, via internet or by telephone.
- Payments are made online using credit cards or other electronic payments using online forms or platforms linked or integrated to the relative websites.
- Website is the only tool to get into communication with the enterprise and it has ‘no physical stores or agencies existing for the core activities other than physical offices in countries where the parent company or operating companies are located.
- Entire or most profits are derived from provisions of digital goods or services.
- ‘The legal or tax residence and the physical location of the seller are disregarded by the buyer and do not influence its choices.’
- ‘The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.’³³⁰

5.2.2 Virtual Permanent Establishment

Some potential options have been proposed for the alternative of PE thresholds. Part of them has already explained in the previous work of the Business Profit Tax Advisory Group (hereinafter referred to as “TAG”). The three broad alternatives considered by the Business Profits TAG are as follows.

- A “**virtual fixed place of business PE**”: When a foreign enterprise maintains a website on a server of another enterprise located in a jurisdiction of State and carries on business through that website, the website should be considered as PE;
- A “**virtual agency PE**”: This is the extension of the existing concept of dependent agent PE when contracts are habitually concluded on behalf of a foreign enterprise through technological means located in the jurisdiction, rather than through a person; and
- An “**on-site business presence PE**”: The economic presence of a foreign enterprise within a jurisdiction should be recognized if it provides on-site services or other business interface at the buyer’s location.³³¹

5.2.3 Introduction of Withholding Tax on Digital Transactions

This option is to deal with difficulties of collecting taxes from foreign enterprises when they are not cooperating in compliance with tax laws when it becomes due for them to pay taxes. To make this option practical, possibility of obliging financial institution to be a withholding agent because most of payment of digital transactions is made by credit cards.

5.2.4 Consumption Tax Options

There is an issue of neutrality of consumption taxes between international B2C transactions online made by foreign enterprises at no or inappropriately low amount of VAT and domestic B2C transactions made by domestic enterprises taxable at regular amount of VAT. In order to cope with this issue, harmonization of thresholds should be explored that are currently different by jurisdictions. It is hoped to be a low threshold, if the tax authorities of all jurisdictions can administer it in a fair and proper manner, so that it obliges non-resident sellers to charge, collect and remit consumption taxes on the imports of even low value parcels for the importing jurisdictions. It

³³⁰ Ibid.

may be required to introduce a new system such as online registration and filing, electronic filing to realize simplified registration and compliance mechanisms for taxpayers.

³³¹ Ibid.

CHAPTER 6

GUIDELINE BY OECD

According to the OECD Subgroup on Electronic Commerce, there is a guideline on the definition of the place of consumption and recommended approaches to the practical application. The main purpose of this guideline is:

1. “To prevent double taxation, or unintentional non-taxation, taxation rules for the consumption tax on cross-border trades should be based on taxation in a jurisdiction where the consumption takes place (destination principle).
2. For the purpose of consumption taxes, the supply of digitized products should not be treated as a supply of goods.
3. Where businesses acquire services and intangible property from a non-resident seller, the use of reverse charge should be considered³³² by self assessment or other equivalent mechanisms.”³³³

6.1 B2B transactions

For cross-border supplies of services and intangible property, delivery from “remote location” to a non-resident business recipient should be regarded to be made in “the jurisdiction in which the

³³² A reverse-charge mechanism allows the liability to pay for the VAT to switch *from the* supplier to the customer. The customer is entitled to offset the output VAT that he reverse-charged against the same amount of deductible input VAT as if the VAT had been charged by the supplier. Alain Charlet and Stéphane Buydens, The OECD International VAT/GST Guidelines: past and future developments, DOI: 10.5235/WJOVL.1.2.175, 176 (2012).

³³³ OECD, *Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-commerce, A. Guidelines on the Definition of the Place of Consumption* (2001). [Hereinafter OECD guidelines]

recipient has located its business presence.”³³⁴ However, in some situation, different criterion should decide where should be the place of consumption.³³⁵

6.2 B2C transactions

The place of consumption for B2C business “should be the jurisdiction in which the recipient has their usual residence.”³³⁶

Anyhow, application of this guideline is limited to the cross-border supply of services and intangible property delivered from a remote location. This guideline excludes the service which is unable to deliver directly from a remote location, such as hotel accommodation, transportation and vehicle rental.³³⁷

6.3 Practical Approaches

There are three possible tax collection mechanisms to collect consumption tax, which are (a) registration and payment by sellers, (b) reverse charge/self-assessment by buyers, and collection of tax by customs authorities on importation of tangible goods.³³⁸

6.4 B2B transactions

As for cross-border B2B business, it's suggested that “in cases where the supplying business is not registered and is not required to register for consumption tax in the country of the recipient business, a self-assessment or reverse charge mechanism should be applied where this type of mechanism is consistent with the overall design of the national consumption tax system.”³³⁹

³³⁴ Ibid.

³³⁵ Ibid.

³³⁶ Ibid.

³³⁷ Ibid.

6.5 B2C transactions

As for B2C business, the OECD member countries admit that there is no single option and further exploration of this issue is necessary for better outcomes. Meanwhile, a registration system should be explored in order to collect tax on B2C transactions.

In case a State thinks the registration system is appropriate to apply to non-resident sellers of services and intangible property, which is not currently registered and not necessary to register in that country, it must consider the effective and efficient collections of tax, simplified registration requirements for non-resident suppliers, applicable thresholds for registration in a non-discriminatory manner, and enforcement measures to ensure compliance.³⁴⁰

³³⁸ OECD guidelines, *supra* note 333, at 26.

³³⁹ *Ibid.*

³⁴⁰ *Id.*, at 27.

CHAPTER 7

RESEARCHES IN THE PAST BY SCHOLARS

7.1 Bit Tax

An early response to the E-commerce was a “Bit Tax” proposed by Arthur J. Cordell.³⁴¹ The Bit Tax simply means to “tax each digital bit of information flowing in global networks.” Regardless of whether the digital bit is a part of a foreign exchange transaction, a business teleconference, an Internet e-mail or file transfer, or electronic check clearance or an ATM transaction, each bit is a physical manifestation of the new economy at work. No matter whether the tax is levied on the traffic carried by a fiber optic cable or on micro-wave or whether the tax is levied on interactive satellite traffic, the bit tax presents a way of accessing the new wealth created by the New Economy.³⁴²

7.2 Professor Avi-Yonah’s proposals

Professor Reuven Avi-Yonah³⁴³ has proposed three proposals applicable only to E-commerce transactions, to deal with the international tax issues.³⁴⁴ In the first proposal, he recommended to change the concept of “permanent establishment” that demands a physical presence in a taxing jurisdiction. As already explained, E-commerce needs no physical presence to conduct a business in a foreign country. He proposed that E-commerce income should be taxed as a withholding tax at the “demand side” jurisdiction where a consumer resides.³⁴⁵

³⁴¹ Arthur Cordell is Special Advisor in the Information Technology Policy Branch of the Canadian Department of Industry in Ottawa. This is the text of a speech delivered to the International Tax Program at the Harvard Law School on February 14, 1997.

³⁴² Arthur J. Cordell, Taxing the Internet: the Proposal for a Bit Tax (1997), <<http://www.arraydev.com/commerce/jibc/9702-05.htm>>.

³⁴³ Reuven S. Avi-Yonah, Professor of Law and director of the International Tax LL.M. Program, University of Michigan.

³⁴⁴ Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce* 52 Tax L. Rec. 507, 509 (1997).

³⁴⁵ *Id.* at 510.

His second proposal is to categorize “income from services, royalties, and sale of goods” into the same category of income because they are taxed differently under current rules. “For electronic commerce, royalties, income from services, and an income from sales all should be treated in the same category as “active business income”, without further distinctions.”³⁴⁶

The last proposal is about transfer pricing taxation to E-commerce. Transfer pricing taxation on the profits derived from E-commerce transactions should be made by Global Profit Split Method on the basis of a functional analysis of the related parties involved. At first stage, profits should be allocated in accordance with Arm’s Length Principle, and then any residual profit brought by synergy effect arising from transactions between related parties should be allocated to the demand- side jurisdiction.³⁴⁷

7.3 Proposal by Azam Rifat

A different proposal was made by Azam Rifat,³⁴⁸ which advocates founding a Global Tax Fund as an institution to levy taxes on global E-commerce tax, including the imposition of a global e-commerce tax on cross-border E-commerce income and designs the details of the tax system. This institution must be established in a form of new international multilateral tax treaty signed by multiple countries, as a supranational institution called the “Global Tax Fund” His proposal adds that global E-commerce tax revenues shall be spent for funding global public goods, such as climate change stability, global communication infrastructures, and so on.³⁴⁹

7.4 Proposal by Professor Scott

A basic proposal made by Professor Scott³⁵⁰ has 10 characteristics:

³⁴⁶ Ibid.

³⁴⁷ Ibid.

³⁴⁸ Azam Rifat, Radzyner School of Law, Interdisciplinary Center Herzliya.

³⁴⁹ Azam Rifat, supra note 6, at 639.

³⁵⁰ Scott A. Taylor, Professor of Law, University of New Mexico Law School. An Ideal E-commerce Consumption Tax in a Global Economy, 2000.

1. **Share Tax Base.** Consumption Tax should be shared by both the origin country and the destination country. To ensure that, the consumption tax should be collected and paid to the origin country by giving interest to the collecting country.
2. **Registration System for Business, Government, and Charities.** To avoid accumulation of consumption tax, business should be registered in a country where it has active business through one or more physical establishment. The sales made to registered business should be exempt from the consumption tax. Sales to governments and charities should be exempted from consumption tax.
- 3) **Universal product Coding System.** To determine what products are taxable at what taxable rate, a universal product coding system must be established.
- 4) **Third Party Collection and Payment.** Credit card companies or banking institutions should function as an agent to administer the system by receiving proper fees.
- 5) **Universal Software to Determine Taxability.** Universal software must be developed to determine the tax due on each sale, which can be used by third parties and the sellers.
- 6) **Audit Insurance.** Sellers are free from being audited as long as sold within the system.
- 7) **Audit Function.** Primary audit is to be made in the destination country.
- 8) **Privacy.** As many countries are involved, the use of privacy of businesses and consumers should be restricted.
- 9) **Adoption.** Universal adoption is necessary. The rule should be applied universally by state-to-state, country-to-country.
- 10) **Income Redistribution.** Higher share should be given to the lower income countries to promote public health, public education and infrastructure improvement.³⁵¹

³⁵¹ Id, at 12-13.

7.5 Proposal by Emily

Another proposal was made by Emily³⁵² “to enact federal legislation that is much narrower in scope than the Streamlined Sales and Use Tax Agreement (SSUTA), focusing solely on a state’s ability to collect sales tax from remote sellers.”³⁵³ The federal legislation should be similar to New York’s Amazon Law. While it may create an affiliate nexus definition of physical presence, it would not go to the extent to entirely change and attempt to simplify state sales tax definitions and rates.³⁵⁴

³⁵² Emily L. Patch, *supra* note 243.

³⁵³ Emily L. Patch, *supra* note 243, at 699.

³⁵⁴ Emily L. Patch, *supra* note 243, at 699-700.

CHAPTER 8

REVIEW 1: CONSUMPTION TAX ON E-COMMERCE TRANSACTIONS

Introduction

In my reviewing the desirable solutions for current international tax issues on E-commerce taxation, the income taxation on profits derived from E-commerce and the consumption tax on E-commerce transactions must be discussed separately. For whereas the international tax issue of income taxation on E-commerce is an issue of allocation of taxing rights between seller's country and consumer's country to avoid double taxation, the tax issue of consumption tax on E-commerce transactions are an issue of avoiding double non-taxation.

In case of the income taxation based on the personal jurisdiction and the territorial jurisdiction, even when there is no taxation on income derived from E-commerce in the consumer's state based on territorial jurisdiction, the income is subject to worldwide income taxation by the resident country (seller's country). Therefore the exemption of income taxation in the consumer's state will result in the increase of income tax in the seller's country under the current foreign tax credit method.

On the other hand, in the case of consumption tax such as VAT, the exportation of goods and services are subject to zero rated taxation so that there is no taxation in the seller's country as far as the goods and services are expected to be consumed in the other countries. Therefore if there is no consumption tax on E-commerce transactions in the consumer's country, it will inevitably result in double non taxation to cross border E-commerce transactions, that violates the neutrality of taxation between domestic sellers and foreign sellers using E-commerce transactions.

Hence, from a viewpoint of fair taxation among taxpayers, the consumption tax issue is more serious than the income tax issue.

Admittedly, both of the issues of income taxation and that of consumption tax have the common problems of proper enforcement of collection.

8.1 Change of Concept of Place of transactions in Consumption Tax

Consumption tax (or VAT) is charged on transactions by a government of a country when the transactions are conducted in the country. In case of cross border E-commerce transactions, transactions are deemed to be conducted in a country where the seller was at the time the transactions, under the current rules of most countries, as noted above. Since the cross border E-commerce transactions are exportation of goods and services for sellers, all the consumption taxes charged at previous stages of trades are to be refunded while zero rate taxation is imposed on the export transactions even when the transactions are deemed in the seller's country. As a result, no consumption tax is imposed neither of the seller's country or the consumer's country.

The only solution to this double non taxation of consumption tax over cross border E-commerce is to make it taxable in the consumer's country by changing the criterion of recognizing a place of transaction from current seller's place to consumer's place. Under this solution, enforcement of collection becomes an issue because the tax should be paid to a government of the consumer's country while the seller stays outside of vender's country.

8.2 Reverse charge

Reverse charge is a solution to the difficulties of collecting consumption taxes, in case the taxation rule is changed to the rule recognizing that cross border E-commerce transactions are conducted in a consumer's country so that they are subject to taxation by the consumer's country.

Reverse Charge is to make an importer of goods and services file a tax return by self assessment system and pay the consumption tax instead of the seller. In case where the E-commerce transaction is B2B transactions, it can be expected that the business importer of goods and services will comply the reverse

charge system as already implemented in many countries for VAT in EU and sales tax in States of U.S. If the importers fail to duly pay the consumption tax, their properties will be ultimately foreclosed to pay the delinquent taxes.

On the other hand, if the importer of goods and services are consumers, it cannot be expected that they will pay the consumption tax on E-commerce because they are not accustomed to pay the consumption tax to a taxation office, especially in a country like Japan where filing tax return for personal income tax is exempted in case of a taxpayer who earns only salary income from one company. Hence it is difficult to apply the reverse charge system to both B2B and B2C transactions.

8.3 Self-assessment as a Collection Agent

To deal with no expectation of compliance by consumers, it is explored to introduce a system of making sellers by cross border E-commerce a kind of collection agent for a government of the consumer's country. Namely the sellers collect consumption tax of the consumer's country from the consumers and remit it to the government of the consumer's country.

A question of this system is whether all the sellers will follow the new rule. If only good sellers follow the rule and bad sellers neglect it, the fairness and neutrality of consumption tax cannot be sustained between good sellers (including domestic sellers who are forced to pay the consumption tax) and bad sellers. Therefore, some kind of international cooperation among tax administrators is necessary for mutual assistance of tax administration such as exchange of information and collection of delinquent taxes.

As a form of international cooperation scheme among tax administrators, largely two means are conceivable: one is to conclude a new bilateral tax treaty for consumption taxes, and the other is to use current "Multilateral Convention on Mutual Administrative Assistance in tax Matters". In fact, it takes too long time to conclude a new bilateral tax treaty for consumption taxes from now while solving the

tax issue of E-commerce transactions is so urgent. Hence, the use of Multilateral Convention should be most practical and realistic way by amending it.

8.4 Enforcement: Is fair administration of new rules possible?

In case of cross border E-commerce transactions of tangible goods, a consumption tax is supposed to be imposed at the custom office when the goods pass it in countries including Japan, When transactions are carried on among EU member countries or among US States, however, it is impossible to charge consumption taxes at the same time with custom duties because no custom duties are imposed on these transactions, so that no custom offices are available.

Besides, even when the transactions are made directly from a foreign business person to domestic consumers even in countries like Japan, collecting the consumption tax at the custom office seems difficult to administer because of too many transactions at low price each are exempted from custom duties and custom examinations on these transactions are limited.

Furthermore, it is the recent trade policy of the Japanese government to conclude bilateral or regional Free Trade Agreements, so that it will be more difficult to collect consumption taxes for years to come. Hence another taxation scheme must be introduced even for cross border E-commerce transactions of tangible goods.

Cross border E-commerce transactions of intangible properties which can be downloaded through internet or telephone line are not taxed at all with a consumption tax, under the current Consumption Tax Act providing that those transactions take place in a country where a supplier resides. For fairness and neutrality of consumption tax between domestic business persons and foreign business persons, the Consumption Tax Act should be amended to make the E-commerce transactions taxable by defining them as taking place in a country where consumers are located.

Then an implementation issue arises: how to administer the new act under the situation where Japanese government has no means to inspect the transaction records of foreign business persons.

To deal with this issue, a proposal is the introduction of “Registration system of Consumption Tax Number” such as VAT number system adopted in the EU countries, which enforces foreign business persons whose annual transactional amounts in Japan exceed threshold to register and pay consumption tax in the same manner as domestic business persons.

As a base for the above method, certain numbering systems for identifying business persons and consumers are essential in Japan, otherwise it is impossible for Japanese government to manage huge volume of transaction records to be processed electronically within a server. Different from EU member countries with VAT registration numbers and the U.S. with Social Security Number for individuals and Employer Identification Numbers for companies, Japanese taxpayer numbering system (My Number System) has just introduced. It may take some time for the new numbering system to be accepted and common by all the Japanese taxpayers.

Based on the above consideration, I agree with EU VAT mini One Stop Shop for B2C transaction that the place of consumption should be taxed at the place where consumed, so that it becomes taxable in the consumed country. The registration requirement above the threshold for VAT should be provided by law. Since Japan has only one tax rate, the application should be simpler. For offline E-commerce, it's easier to track or collect consumption tax at customs when the time of importation. For online transaction such as downloading music and software, there is no way to track or very difficult. The registration system is a good choice for B2C transaction. By identifying the registration number, sellers can easily declare the consumption tax to a State of buyers.

For B2B transaction, the reverse charge/self assessment should be introduced as suggested in the OECD's guidelines. Thus, buyers can declare and pay the consumption tax to their government because they are familiar with tax payment through business activities.

CHAPTER 9

REVIEW 2: TAXES ON INCOME FROM E-COMMERCE

9.1 Introduction

There is no question in that a resident country of sellers of goods and services by cross border E-commerce has a right of income taxation on worldwide incomes of the sellers by its domestic laws based on its personal jurisdiction. Therefore the issue in direct taxation on incomes from E-commerce is a question of allocation of taxing rights between jurisdictions of sellers and buyers of goods and services: whether such incomes are also taxable in the market country of buyers. For if the market country imposes income taxation on the income derived from cross border E-commerce, it will reduce the tax revenue of seller's country through the foreign tax credit method.

As noted above, incomes of sellers of goods and services by cross border E-commerce is not subject to income taxation currently by the market country, in most cases because the incomes are not sourced in the market country according to source rules provided by its domestic tax laws, and because there is no nexus of physical presence in the market country such as PE when the income is considered as a business profit.

This is because current international tax rules were established at the time under the conventional business environments where it was necessary for non-resident companies to sending their staff and/or materials to render services in the market country or to establish a physical presence to regularly sell its goods and services in the market country

Now the business environment has completely changed along with development of "Information and Communication Technology (ICT)". Non-resident companies can regularly sell goods and provide services from remote places without any physical presence in the market country.

Accordingly, if the current international rules are applied as they are, it reduces and will reduce tax revenues of market countries for years to come as transactional amounts of E-commerce become greatly increased, so that the inappropriate tax sharing between jurisdictions of residence and “market” takes place.

In the below, I would like to review the new international tax rules on income taxation by answering following questions: whether (i) the rules of income taxation in general or the special rules applicable solely for E-commerce, (ii) the rules for E-commerce in general or the rules in accordance with types of E-commerce, and how to implement the new rules.

9.2 The rules of income taxation in general vs. the special rules of income taxation solely applicable to E-commerce?

In considering new rules for income taxation, a question is whether the rules should be the ones generally applicable to all incomes regardless of whether they are derived from E-commerce or not, or the special rules exclusively applicable to incomes derived from E-commerce.

Pros for the view that the new rules should be the general rules are:

(A). It is difficult to define incomes from E-commerce because ICT is used in various part of today’s business wholly or partially. So if different rules are determined for incomes from E-commerce, they will cause difficulties in judging which of conventional rules or new rules shall be applicable to each case at issue.

(B). E-commerce or Digital economy is under rapid evolution at present, so a new type of E-commerce will arise. Therefore if the new rules are applied solely to incomes from E-commerce, the definition of incomes from E-commerce will soon become obsolete and must be amended frequently for fairness, which is hard to catch up all the time.

On the other hand, Cons for the view are:

(C) It is too dramatic to change the current rules in general just to cope with problems arising from E-commerce income taxation. The new rules may inevitably affect taxation on the incomes from conventional type of transactions and new kind of unfairness may be caused wherefrom.

(D) When the new rules are extended to incomes other than those from E-commerce, it is more difficult to get consents from all the member countries, even if limited to G20 countries. Then incoherent tax rules may generate new double non taxation or double taxation which can be more serious problems than now.

With regard to the view that the new rules should be the special rules designed solely for incomes from E-commerce, pros and cons are opposite.

Realistically thinking, it seems impossible to create completely new rules fitting the era when the digital economy is common, applicable to all kinds of incomes that can be agreed even only by OECD member countries. Therefore, I think it practicable to think about the new rules specifically applicable to certain types of incomes from E-commerce to be emergently dealt with for the time being.

Then, in the following, I classify the E-commerce into three categories in reference to the OECD/G20 BEPS report.³⁵⁵

According to the BEPS report, the main policy challenges raised by the digital economy are classified into three categories of Nexus, Data and Characterization in the area of direct taxation. I rephrase these categories into three types of E-commerce business as follows and address issues in each category.

- (1) Sales of tangible goods through internet such as sales of books by Amazon and Rakuten
- (2) Sales of intangible properties through internet such as sales of software by Apple
- (3) Provision of service from a remote place through internet such as English lessons via Skype
- (4) Provision of information including know-how based on analysis using “Big data“ obtained through internet service, such as Google

³⁵⁵ OECD/G20 BEPS Report, “Addressing the Tax Challenges of the Digital Economy” September 2014 at 125

(5) Cloud computing that enables users to access a common pool of computing resources on demand

9.3 Sales of goods and services through internet/server

9.3.1 Income from sales of tangible properties by E-commerce

As explained above, under the current source rule of Japan,³⁵⁶ incomes from resale of tangible properties are regarded as sourced in a country where the contract of sales was concluded including the agreement and negotiation for the contract, or where the delivery was provided. If none of conclusion of contract or delivery is made in Japan, the incomes are not taxable by Japanese government as the ones outside of territorial jurisdiction.

Under the current tax treaty rule, incomes derived from sales of tangible properties are treated as business profits provided by Article 7, which are not taxable if there is any physical presence of non-resident such as PE in the buyer's country.

As a result, incomes of non-resident taxpayers who sell tangible properties by E-commerce are not taxable by the buyer's country because there is no server in which the virtual shopping malls open in the buyer's country, whereas incomes of resident taxpayers who sell the same kind of properties are always taxable by the buyer's country. A difference from consumption tax is that non-resident taxpayers who are not taxable by the buyer's country can be taxable by their resident country in accordance with their domestic tax laws based on the jurisdiction of residence.³⁵⁷ Therefore, if the transactions by E-commerce are two ways where E-commerce transactions from country A to country B are made to the same extent of E-commerce from country B to country A, there can be no problems as understood that such incomes are mutually exempted from income taxation on a reciprocal base. Unfortunately E-commerce transactions from the U.S. to the other countries, overwhelm the same kind of transactions with opposite direction. Thus, the current rules are too favorable to the U.S. It is also conceivable that

the U.S. companies may establish subsidiaries in no or extremely low tax countries or regions for deploying global E-commerce business in order to realize double non-taxation by avoiding resident taxation by the U.S. government.

As means to deal with this issue, amendments conceivable are as follows:

1. Introduction of special source rules regarding the transaction

In case of sales of tangible properties by E-commerce, contracts can be concluded anywhere in the world, so that a place of concluding contracts cannot be a criterion to determine where the source of income was located. Therefore “delivery” should be adopted as a core criterion to determine the source of income. In other words, if the tangible properties are delivered as goods sold to customers in a country (e.g. Japan), the income from the sales should be regarded as a domestic source income of the country (e.g. Japan).

The “delivery” is one of criteria in determining an income source of resale business even under current domestic income tax laws of Japan as well as many developing countries, so that it is relatively easy to be accepted even by the other OECD member countries currently with no such criterion.

2. Amendment of elements to recognize PE

Under the current OECD Model Tax Convention (OECD Model), the income from resale of tangible properties is considered as business profits provided by Article 7 and a rule that if there is no PE in a source country, no income taxation is made in that country, is adopted. According to Article 5 of OECD Treaty, PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on. In addition, in Article 5-4 of the same treaty, “delivery” is regarded as an activity of auxiliary character and a fixed place of business for purpose of delivery of goods are excluded from PE.

³⁵⁶ Personal Income Tax Act (PITA). Sec 161-1-1 and Personal Income Tax Order(PITO) Sec.279-1-1, Corporate Income Tax

However, in such incomes from E-commerce, “delivery” is a key element to measure “nexus” of the income with the country; hence a fixed place of business for delivery of goods on a regular base should be recognized as PE with regard to this type of incomes noted here.

For example, a company like Amazon, which regularly sells huge volume of books to Japanese market needs many delivery centers in Japan. If these delivery centers are considered as PE of Amazon, all the incomes from sales of books delivered through those centers are regarded as attributable profits to PE and therefore taxable by Japanese government.

Then a question arises. How about incomes from sales of tangible goods by E-commerce, directly shipped from a seller’s country without using delivery centers in the buyer’s country? I think such incomes can be exempted, in principle, from income taxation by the buyer’s country because a taxpayer doing E-commerce cannot have a large scale of business in the buyer’s country on a regular base without establishing delivery centers in the buyer’s country. As an exception, if the taxpayers have a delivery center and the same or similar goods are sold through the delivery centers, then the same goods shipped directly from the seller’s country to the buyer’s country should be regarded as delivered by the delivery center and taxable in the same manner as goods sold through the delivery center. This concept is an extension of “limited force of attraction” rule adopted by United Nations Model Tax Convention (UN Model).

In the new OECD Model, instead of deletion of “delivery” from Article 5-4, a new provision stipulating a rule regarding income from the sales of tangible properties by E-commerce should be added as a new Article 5-5.

9.3.2 Income from sales of intangible properties through internet

When intangible properties are sold through internet such as sales of music by iTunes Store and applications by Apple Store, two questions arise on the tax treatment on income derived from the

Act(CITA) Sec. 138-1-1 and Corporate Income Tax Order(CITO) Sec.176-1-1

transactions. The first question is which category of income the income should be classified: business profits or royalties. The second question is how the income should be treated in terms of taxation in the buyer's country.

In the sales of tangible properties, title to the property subject to the sales doesn't remain in the seller's side by being passed to the buyer. On the other hand, in the sales of intangible properties, the sellers still keep the right to resell the intangible properties to another prospective customers even after the sales were made. In other words, the sellers let the buyers use their intangible properties in exchange for fees under the contract of sales. Therefore the sales of intangible properties such as music, software and design are closer in substance to leasing intangible properties in exchange for payments of royalty.

When royalties are received as a business income of non-residents or foreign corporations, the Article of royalties shall be applied to the income under current tax treaties.³⁵⁷ Royalties paid to non-residents and foreign corporations are subject to withholding taxes regardless of whether the recipients have a PE in the payer's country or not.

Accordingly, the payments for the sales of intangible properties should be always subject to withholding tax by the buyer's country, regardless of whether or not the sellers have a PE in the buyers' country.

9.3.3 Income from rendering service from a remote place by modern communication tools including internet

As noted above, under the current source rules of many countries, the income derived from rendering services by a person via modern communication tools while staying in a foreign country is treated as sourced in the foreign country. It is because the current source regards that the service is considered to take place where the supplier stays rather than the customer stays.

³⁵⁷ If their resident country has no income tax, double no taxation occurs in the same situation as consumption tax

³⁵⁸ OECD Model 2010 Art.7-4, UN Model 2011 Art. 7-6

For example, if an American singer sings for a Japanese TV program at real time via Satellite channel while staying in New York, the guarantee she receives from a Japanese TV company is considered to be U.S. source income because the service is rendered in the U.S. On the other hand, if the same singer records her song into digital device and send it to Japan for broadcasting through Japanese TV program, the fee paid for her song is considered to be a royalty and it becomes subject to withholding tax of Japan as one of Japanese source incomes, according to the source rule provided by Japanese Personal Income Tax Act³⁵⁹.

The difference of tax treatment between an income for rendering services and a royalty seems due to a difference of nature of incomes that an income for rendering services is an active income whereas a royalty is more like a passive income. In case of a passive income, the source of the income shall a place of use in theory, while in case of an active income, the source of the income shall be a place where the economic activity takes place.

In the era where all the spots on the earth can be connected and a service can be performed in real time by using communication tools such as satellite channels and internet, new rules of taxation must be created, regarding incomes received for such services performed. Concretely speaking, the digital equipments used for sending performance of services shall be included into the category of PE for business profits and the incomes for rendering services via communication tools such as internet and satellite shall be taxable in the country where the services are enjoyed. For examples, if a medical doctor carries out surgery by the remote control system of robot hands of real time from a foreign country, the medical fee for the operation should be recognized as an income derived from the place where the patient is situated and the operation room with robot hands constitutes PE. In the same manner, if a song is delivered via TV networks with satellite from a singer in the U.S. to audiences in front of TV sets in Japan, the performance shall be recognized as performed in Japan and the TV network system including signal receiving equipments from satellite shall constitute PE.

³⁵⁹ PITA Sec. 161-7-2

9.3.4 Income Category

9.3.4.1 “Nexus” with Buyer’s country required for taxation on business profits: Should Concept of Permanent Establishment be maintained?

Under current international tax rules, business profits are taxable by the source country only when the taxpayer has a PE in the country. Namely “Nexus” with the source country is required for the source government to have the taxing rights on the business profits. According to OECD Model, this is due to “the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits”³⁶⁰

As discussed above, this international consensus no longer exists with regard to business profits earned by E-commerce. Then, how should the concept of PE be adjusted to the new situation?

Possible solutions are as follows:

1. Eliminate the requirement of PE as a condition for taxing business profits in a source jurisdiction;
2. Facilities for the purpose of “delivery” and maintenance of a stock of goods and merchandise belonging to the enterprise solely for the purpose of “delivery” should be regarded as PE in general or as a special rule applicable only for E-commerce;
3. Adoption of a special provision to the current OECD Model, applicable only to incomes by E-commerce

With regard to the solution 1, when considering that business profits are to be taxed on net income base, the presence of PE seems indispensable for calculation and verification of the net income of business profits attributable to the PE based on Arm’s Length Principle. Therefore, I think it necessary to keep the criterion of PE for business profits in general as far as the business profits should

be continued to be taxed on the net income based on Arm's Length Principle and this option should not be adopted.

In case of business profits derived from sales of tangible properties, "delivery" can be a nexus with source jurisdiction, as the current UN Model Article 5-4 where facilities for the purpose of delivery and the maintenance of a stock of good and merchandise belonging to the enterprise solely for the purpose of delivery are not regarded as activities of a preparatory or auxiliary character. Therefore the solution 2 seems plausible. However, in case of business profits derived from rendering services by internet, "delivery" cannot be taken to be "nexus" with the source jurisdiction because there are no needs of facilities for service provision in the country of demand. Therefore, if the facilities for delivery, etc. are included into PE, its application should be limited only to the business profits from sale of tangible properties. This change extends taxing rights based on the source jurisdiction over business profits derived from the conventional type of sales of tangible properties. At the same time, a new rule should be introduced into tax treaties that no PE threshold is applied on income from services rendered by internet.

In case OECD Member countries prefer adhering to the current character of "delivery" as auxiliary for conventional transactions under the OECD Model even in the business profits derived from sales of tangible properties, the solution 3 can be an option to introduce a special rule for incomes from E-commerce transactions as noted in the following 9.2.4.2.

When an enterprise receives royalties as a business income, the article of royalty is applied to the income rather than the article of business profits under tax treaties. Therefore royalties earned by enterprises through E-commerce are taxable in a source jurisdiction, regardless of whether or not there is a PE in the source jurisdiction. As noted above, if the source rule is changed to the one that incomes derived from sales of intangible properties deemed to be sourced in the country where the customer is located.

³⁶⁰ OECD Model Commentary 2010 at 132

9.3.4.2 Creation of new income category integrating the three income categories as “Active income by E-commerce” (Professor Avi-Yonah’s proposal)

Creation of a new category of income special for profits from E-commerce transactions seems an innovative solution to the problems on E-commerce taxation. It is a new income category combining “royalty”, “business income from rendering service”, and “business income from sales” through E-commerce. In this income category, there are two presumptions: Firstly the income is sourced in a country where a demand is, which is deviated from the conventional source rule principle. Secondly, there is no PE threshold in determining taxable or not, and all the incomes are taxable in a source country and are subject to a withholding tax when the transactions are B2B.

Royalties derived from E-commerce include incomes from sales of intangible properties by E-commerce. Therefore the business income from sales by E-commerce means the business income from sales of tangible properties by E-commerce.

The condition to introduce this solution 3 is that all the countries must agree to the solution. Otherwise, if only some countries adopt this solution while the other countries don’t, a risk of double taxation by dual source taxation becomes so high, and international tax disputes may take place so frequently that competent authorities cannot deal with them within their capacity.

In fact, it is not an easy task. Besides, it is difficult to draw a clear line between conventional transactions and E-commerce transactions when considering remote sales by using catalogues and fax, in its administration

9.4 Provision of information based on analysis of “Big data”

Earning income from use of big data obtained from internet users is a new kind of business recently emerged. The value is created by the collection of big data, the analysis of big data, and the sale of the information from the analysis.

If the big data are collected from Country A by an enterprise such as Google located in Country B, and the big data is sold to the other enterprises in Country C without any analysis by internet, I think it resembles the resale of goods. Then, issues are where the sales are made and the PE threshold should be applied in determining whether taxable or not.

OECD Report³⁶¹ suggests that the source country should be Country A where the big data was collected. Against the OECD approach, I think the source of the income should be Country C where the buyer of big data is located because the purchase price is deducted as business expenses from taxable income of Country C, so that taxation based on the jurisdiction of the source should be made by Country C in a form of withholding tax. A possible argument from OECD against my idea is that collecting big data needs a special know-how different from the mere purchase of regular inventories, so that some value should be allocated to the know-how used in Country A as a source jurisdiction. Although it is true that collecting big data needs a special know-how or special internet networks, I think that collecting big data cannot be a core activity for itself to generate profits

On the other hand, if the big data that is collected from Country A by an enterprise in Country B is analyzed by the enterprise and then the analyzed information is sold to an enterprise in Country C at a higher price than expected price of big data, it resembles the income from sales of products whose value is composed of the value from processing data and the value from the sales. In this case, if following the theory, the income derived from the sale of the information must be divided into the value from analysis of big data and the value from the sale by using Arm's Length Principle. However, if no PE threshold is applied to the income from E-commerce, there is no way to tax the net income and the withholding tax on the gross income by Country C is the only way of taxation. As a result, the presumption is necessary that the income from the sales of information based on analysis of big data is only sourced in the country C where the buyer is located.

³⁶¹ OECD/BEPS Addressing the Tax Challenges of the Digital Economy Action 1: 2014 Deliverable, September 2014

9.5 Cloud computing

Cloud computing is also a newly emerging business using internet networks. It is a kind of leasing service of computer servers for retention of data on internet networks. This service is also possible to be rendered without any PE in customers' countries.

Since there is no PE in a country of customers, after changing the source rules that the services are rendered in the country where the customers are located, the taxation method adoptable by the customers' country is a withholding tax or voluntary compliance by the enterprises.

With regard to VAT or Consumption Tax, the fees for the service should be subject to the reverse charge or use tax system in case of B2B transactions and subject to taxation by voluntary compliance in case of B2C transactions.

With regard to income taxation, such as Corporate Income Tax, the fees for the service should be subject to the withholding tax in case of B2B transactions and subject to taxation by voluntary compliance in case of B2C transactions.

9.6 Enforcement Issue: Is fair administration of new rules implementable?

9.6.1 Possibility of voluntary compliance

As noted above, if a country of demand attempts to tax the income arising from cross border E-commerce transactions, it is inevitable to depend on voluntary compliance of enterprises abroad in case of B2C transactions. Then a question is to what extent the government can rely upon the literally voluntary compliance of enterprises. In EU, the registration system of VAT number is introduced even for alien enterprises who conduct business over a certain threshold of annual transactional amounts in the EU regions.

In order for governments to find taxpayers who fail to register the number, international cooperation of tax administration among governments is indispensable because it is almost impossible

for the government of demand to verify inbound E-commerce records of foreign enterprises on an annual base.

If the international cooperation among governments for exchanging information on taxpayers is successfully established, the registration system of the VAT number can be used for verification of income taxation as well. In this case, the taxation on the income from B2C transactions should be based on the gross income on parity with B2B transactions subject to B2B transactions.

9.6.2 Creation of Global Tax Fund Institution

There are many questions on the idea of establishing a supranational institution which only deals with cross-border E-commerce tax. The first question is how the institution can obtain information on cross border commerce, which is a base of taxation. Does the institution obtain information from a taxpayer enterprise, a buyer, or governments? If a request to submit information is rejected, what kind of countermeasure can the institution have? If the countermeasure is voluntary, it cannot expect compliance to the request. If the countermeasure is compulsory, an issue may come out on how to deal with violation of sovereign taxing rights. Ultimately, it is extremely hard to reach an agreement on how to allocate the pooled fund to international organizations because of conflict of interests among member countries. On the whole, it is not a realistic solution to the E-commerce issues.

9.6.3 “BIT” Tax as an alternative: Is Introduction of “Bit Tax” effective in dealing with enforcement problem?

A “Bit Tax” is to replace income tax on profits from E-commerce transactions. It is good in that a state where an internet server is located, can administer taxation on E-commerce transactions in accordance with the volume of information exchanged denoted by digital bit, without knowing

transaction amounts. Thus a certain portion of profits from E-commerce can be allocated to a country that furnished public service for E-commerce other than a resident country of taxpayers.

On the other hand, it has some defects. Firstly, if a state introduces the bit tax when the other states don't have it, taxpayers will certainly avoid installing servers in such a country with the bit tax since taxpayer can easily find states or regions with no bit tax in the world. As a result, the state that introduced the bit tax cannot in fact collect taxes. Secondly, the bit tax is not based on profits generated by the exchange of information, so that it doesn't reflect an ability to pay tax by the taxpayers. It may be a harsh tax for taxpayers who earn slim margin profits, which hampers global trade by E-commerce. Thirdly internet networks can pass through various servers from taxpayers to buyers, so that multiple fold taxation cascaded on the same transactions can take place.

With the reasons above, I think the bit tax is not a good solution.

9.7 Conclusion

With the review above, I conclude that the proposal of Prof. Avi-Yonah should be explored furthermore to the direction to realize the international agreements. For that purpose, international organization such as United Nations should play a more important role because developing member countries are on the side of demand for E-commerce in most cases. Even for developed countries, these solutions become more important when considering E-commerce taxpayers may move their residence to tax haven countries with no or little income taxes in order to enjoy full exemption of income taxes.

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