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Current Problems of International Taxation of Electronic Commerce

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CURRENT PROBLEMS OF INTERNATIONAL TAXATION OF ELECTRONIC
COMMERCE

by

NURAN KERIMOV

(Under the direction of Professor Walter Hellerstein)

ABSTRACT

This Thesis discusses main Problems that face Tax Authorities of many countries in the process of Taxation of Electronic Commerce. It Analyzes examples of Problems Posed by the Growth of E-Commerce in the context International Direct and Indirect Taxation. Current International Policy Issues are subject of Discussion of the Thesis. The Thesis also analyzes some of the Proposals regarding Taxation of Electronic Commerce.

INDEX WORDS: The University of Georgia, Master of Laws, Current, Problem, International, Taxation, Electronic, Commerce, Thesis, Tax, Authority, Analyze, Posed, Growth, E-Commerce, Direct, Indirect, Discussion, Proposal.

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COMMERCE

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A Thesis Submitted to the Graduate Faculty of The University of Georgia in Partial
Fulfillment of the Requirement for the Degree

MASTER OF LAWS

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COMMERCE

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DEDICATION

To my wife Vusala.

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I. INTRODUCTION

“Electronic commerce¹ has the potential to be one of the great economic developments of the 21st Century. The information and communication technologies which underlie this new way of doing business open up opportunities to improve the global quality of life and economic well being. Electronic commerce had the potential to spur the growth and employment in industrialized, emerging and developing countries.”² “Most business-to-consumer transactions include numerous business-to-business transactions and result in the “transactions multiplier effect”-in which one business-to-consumer transaction spawns multiple business-to-business transactions.”³ “Recent estimates suggest that business-to-business e-commerce will reach \$1.3 trillion by the year 2003.”⁴ “Experts also believe that the dollar volume of business-to-business transactions will be several times that of consumer purchases.”⁵ Obviously governments throughout the world are concerned that they will not receive their fair share of the revenues associated with taxing e-commerce profits.⁶ “At the end of 19th century, the question was how to tax commerce via the telegraph; at the end of the 20th century, the

¹ Throughout this paper, the terms “ electronic commerce” and “e-commerce” are used interchangeably.

² *Electronic Commerce: Taxation Framework Conditions*, A Report by the Committee on Fiscal Affairs presented to Ministers at the OECD Ministerial Conference, A Borderless World: Realising the Potential of Electronic Commerce (October 8, 1998) at 3, at http://www.oecd.org/daf/fa/e_com/public_release.htm.

³ Brian Fagan, *Taxation of Electronic Commerce: Avoiding an Inroad Upon Federalism*, 49 Drake L. Rev. 465, 469 (2001).

⁴ See e-tax.org, Apr. 17, 2002 at <http://www.e-tax.org.uk/>

⁵ DAVID E. HARDESTY, *ELECTRONIC COMMERCE: TAXATION AND PLANNING* 1-1 (1999).

⁶ Arthur J. Cockfield, *Transforming the Internet Into a Taxable Forum: A Case Study in E-Commerce Taxation*, 85 MINN. L. REV. 1171, 1182 (2001).

question is how to tax commerce via the Internet.”⁷ Indeed taxation of electronic commerce is a hot topic of tax policy. The non-traceable nature of electronic commerce has created endless challenges to the existing tax laws of all countries. The borderless nature of electronic commerce has put under doubts the famous phrase of Benjamin Franklin: “In this world nothing is certain but death and taxes.”⁸

This thesis will focus on current problems related to international taxation of electronic commerce. It will discuss the tax issues surrounding e-commerce, where the issues stand, and major questions posed by e-commerce.

Part II of this thesis that follows the introductory Part I will lay foundation of the problems related to taxation of e-commerce. It will briefly explain the architecture of the World Wide Web and its main principles. It will also describe the main commercial activities conducted on the web that form electronic commerce. Part II will also discuss the historical development of the application of national tax laws to e-commerce.

Part III will discuss current problems of taxation of electronic commerce. It will particularly analyze e-commerce taxation issues in the context of income taxation and consumption taxes.

Part IV will underline the importance of international cooperation in developing internationally acceptable solutions to challenges created by electronic commerce and will provide the author’s views on the issues discussed.

Part V concludes the thesis and gives some thoughts of the author on the discussed issues.

⁷ e-tax.org, *supra* note 4.

⁸ Letter from Benjamin Franklin to Jean-Baptiste (1789), at <http://phrases.shu.ac.uk/meanings/261050.html>

II. BACKGROUND

A. World Wide Web

“Over the past decade, the world’s fastest growing commercial center has not been in any specific geographic location. Rather, this growth has occurred in the amorphous, nebulous region of computer communications topography known as Cyberspace – also commonly referred to as the Internet, or the ‘information highway’. Created in 1969 by the United States Department of Defense Advanced Research Projects Agency, the original Internet was quickly adapted for academic use in the 1980s. In the mid-1990s, the creation of the ‘World Wide Web’ and improvements in telecommunications technology spurred commercial application of Internet technology.”⁹

“The Internet is a worldwide network of computers, linked mainly by telephone lines.”¹⁰

“To most, the most familiar aspect of the Internet is the Web.”¹¹ “The Web combines graphics, sound, video, and text, to present a truly multimedia experience. The Web is accessed through a Web browser, a program resident on the user’s computer that reads and displays certain types of electronic files. The browser receives text, graphics, audio, and video files from the Internet that the browser assembles into a Web page on the user’s computer.”¹² “To make the web useful, there are a variety of ‘search engines’ that can provide a listing of the requested information. The user simply enters one or more

⁹ Clayton W. Chan, *Taxation of Global E-Commerce on the Internet: the Underlying Issues and Proposed Plans*, 9 MINN.J.GLOBAL TRADE 233, 234 (2000).

¹⁰ HARDESTY, *supra* note 5, at 2-3.

¹¹ *See id.* at 2-5.

¹² *See id.* at 2-5.

keywords and the search engine provides a listing of all the web sites (i.e. servers) that correspond to the requested information.”¹³

B. Electronic Commerce

"Electronic commerce is the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and techniques."¹⁴ "New information and communications technologies such as the Internet are creating exciting opportunities for workers, consumers, and businesses. Information, services, and money may now be instantaneously transferred anywhere in the world. Firms are increasing their imports and exports of goods, services, and information as the costs associated with participating in global markets plummet, and they are forming closer relationships with suppliers and customers around the world. New markets and market mechanisms are emerging. Consumers can choose from a much broader range of goods and services, and "intelligent agent" software will soon give consumers an unprecedented ability to hunt for bargains."¹⁵ Selling through electronic commerce is a rapidly growing channel for sales to both retail consumers and businesses. In these days it is hard to find goods or services that are not offered on the web. The relatively low cost of conducting of electronic commerce enables even small firms to access the world's markets. Some of the commercial activities that are conducted through electronic commerce include retailing and wholesaling, sale of computer software, photographs, on-line information, services, health care, telecommunication, videoconferencing, gambling, stock trading, offshore banking and incorporation.

¹³ RICHARD L. DOERNBERG ET AL., ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION 33 (2001).

¹⁴ *Selected Tax Policy Implications of Global Electronic Commerce* (Nov. 22, 1996) at <http://www.ustreas.gov> (last visited Feb. 13, 2002).

“Financial commentators have likened current e-commerce participation to a “modern day gold rush...as business rush to seek their fortunes with the software equivalents of shovels, picks, and pans”.¹⁶

“One of the main reasons for e-commerce’s booming popularity has been its beneficial effects on business’ bottom lines. By conducting transactions over the Internet, businesses have the potential to significantly improve market efficiencies by eliminating middlepersons, and allowing for better management of supplies, production, and distribution.¹⁷

1. Sales of Goods

“Merchants worldwide utilize the Internet as the medium for e-commerce. Sales over the Internet are becoming a predominant force in the commercial global community. E-commerce merchants owe their newfound success to the growth of the Internet.”¹⁸

“Retail sales of tangible products is the easiest type of activity to move to the Internet. Traditional mail-order companies have found the Internet to be a natural extension of their basic business. The differences between traditional and Internet-based retailers are: (1) transactions can be consummated on a Web site without customer sending in a form or talking to an employee of the company; (2) the company reaches a worldwide market, instead of a targeted market that is reached by traditional advertising resources; and (3) in the case of products that can be downloaded, such as software and publications, the retailer may not know the locations of the buyers.”¹⁹

¹⁵ *Id* at § 1.

¹⁶ Chan, *supra* note 9, at 234.

¹⁷ *See id.* at 234.

¹⁸ Richard Doernberg, Luc Hinnekens & Antonio Di Benedetto, *Electronic Commerce and International Taxation*, 24 SUFFOLK TRANSNAT’L L. REV. 233, 234 (2000).

¹⁹ HARDESTY, *supra* note 5, at 3-9.

One of the most attractive features of the Internet is that it removes the necessity for certain intermediaries. For example, customers of Barnes & Noble have the option instead of visiting a local store to buy books on Barnes & Noble's web site. In addition to this advantage, customers may like the fact that order on this kind of web sites can be placed twenty-four hours a day. "The disintermediation process continues at the international level as the Internet permits multinationals to consolidate or centralize many of their operations including sales, marketing, customer support, and administrative functions."²⁰

"A more recent phenomenon in e-commerce is a process called reintermediation, which is essentially the development of new intermediaries to facilitate business transactions over the Internet. These new intermediaries are online companies that do not require fixed places of business within source countries. For example, new online "infomediaries" link buyers and sellers on the Internet, generating cost savings for both sides of the transactions, mainly by reducing transaction costs. Companies have begun to outsource many of their previously performed functions to these intermediaries, such as Ariba.com that manages office equipment supplies for medium and large companies."²¹ Many online auctions and classifieds advertisements are built on the basis of this idea.

2. Personal and Professional Services

"Another source of growth of Internet-based commerce will be those personal services currently delivered exclusively by humans. Some of these services may combine computer applications with human interaction."²² For example, you can order online preparation of a report on stock performance of a company that you want to invest in.

²⁰ Cockfield, *supra* note 6, at 1183.

²¹ *See id.* at 1183.

Currently many law firms receive questions from their clients by e-mail and send their advice in the form of electronic files. Customers from Australia wishing to invest in Canada explore Canada's business regulations through online advice received from Canadian law firms. California-based Intuit, owner of TurboTax®, reported net income of \$119.9 million for the 1st quarter of 2002, compared to \$26.6 million, in the year-ago quarter. Intuit said that "more customers are using our Web-based tax solutions."²³

“As more and more products and services are delivered in digital form, the lines between software, service, and product companies will blur. The product and service companies will start to become software companies and visa versa.”²⁴ “Health care is also a service provided over the Internet, which may get larger in the future. As bandwidth increases, doctors can use the Internet to access the services of specialists. It is conceivable that a specialist can be brought into the examining room by camera and computer. The specialist might be located anywhere in the world. Patients may eventually be able to have a video conference consultation with a doctor without leaving the home.”²⁵

Many financial institutions offer online financial services. Most banks in the U.S. and Europe offer online banking to their clients. “Most brokerage houses offer some kind of Internet transaction processing, and some brokerage houses are exclusively Internet based.”²⁶ “Some offshore banks offer U.S. residents a means to easily set up an offshore banking relationship. It is also possible to incorporate in a foreign country using the Internet. All documents are handled online and there is no need to set foot in a foreign

²² HARDESTY, *supra* note 5, at 3-10.

²³ CNET News.com, *More People Using Turbo Tax* (Feb. 2002) at <http://news.com.com/2001-1017-0.html?tag=tab> (last visited Feb. 13, 2002).

²⁴ HARDESTY, *supra* note 5, at 3-10.

²⁵ *See id.* at 3-11.

²⁶ *See id.* at 3-12.

country. The ability to create an offshore corporation or an offshore bank account using the Internet vastly reduces the expense of these activities, and may result in their becoming commonplace. The U.S. Treasury has expressed concerns over the ease of offshore banking and incorporation, and the potential this creates for tax evasion.”²⁷

3. Other Commercial Activity

Although sales of tangible and intangible goods were the principal transactions conducted on the web at initial stages of development of electronic commerce, other types of electronic commerce have dramatically increased over the last years. Most businesses have realized the advantages of trading in borderless World Wide Web.

Nowadays advertising on the Web is considered to be a tremendous business opportunity. “Most Web sites are free. This is true even for Web sites with very high quality content. The goal is advertising revenues.”²⁸ For example, almost the only source of revenues of Yahoo!, a leading global Internet communications, commerce, and media company is advertising. Online advertising revenue in the U.S. surged to nearly \$1.8 billion in 1998 and is expected to grow to \$15 billion by 2003, according to Forrester Research.²⁹

Another business innovation that expanded dramatically as a result of the Internet is online databases. For example, databases such as Westlaw and LexisNexis are designed to provide access to a U.S. legal data for a fee. Structures of these sites are designed to allow sophisticated search engines for effective use of the database.

²⁷ See *id.* at 3-12.

²⁸ See *id.* at 3-14.

²⁹ Personal Web Page of Christopher Cox, Chairman of the House Policy Committee, *Web Commerce: A Tempting Target for Tax Collectors?* (Feb. 2002) at <http://cox.house.gov/nettax/> (last visited Feb. 17, 2002).

“Gambling has moved onto the Internet. Players can place bets using credit cards or electronic cash. Winnings can be credited to credit card accounts or bank accounts. Traditional games such as slot machines, video poker, video blackjack, etc., translate easily to the Internet. While gambling may be illegal in different parts of the United States, Internet gambling Web sites operated from offshore are accessible from within the United States. Internet gambling can be very profitable for the operators, because there are no costs other than the cost of the Web site and the costs of transaction processing.”³⁰

“In the future, video conferencing may become commonplace, and may reduce the amount of air travel required by executives and sales people. Currently, video conferencing requires specialized equipment. As bandwidth increases, video conferencing over the Internet may become accessible to most businesses.”³¹

4. Payment Systems

“The success and future of electronic commerce is interwoven with the development of electronic payment systems. If payment mechanisms cause a bottleneck in the electronic commerce environment, then many of the advantages of networked commerce will be negated. Traditional payment methods such as checks or bank drafts can take days to process and can disrupt the mercantile process. Moreover, the delay along with the processing costs make the traditional payment methods unsuitable for micropayments – payments for small amounts of information made available by a vendor (e.g., a report or an answer to question).”³² Currently a large portion of payments is made through wire transfers. “...roughly 90 percent of financial transactions, by value, are now

³⁰ HARDESTY, *supra* note 5, at 3-15.

³¹ *See id.* at 3-15.

³² DOERNBERG, *supra* note 13, at 55.

conducted electronically.”³³ Development of electronic technologies created new forms of money. Electronic money steadily replaces traditional means of payment such as physical tokens and paper instruments. Experts classify four different types of electronic payments: “electronic cash; smart cards; electronic checks; and credit cards.”³⁴

Major problems in the development of electronic payment systems remain privacy and security issues. Unfortunately, the current level of development of the Internet technologies does not fully guarantee privacy and security of electronic payment systems that makes many Internet users reluctant to be involved in online transactions. These issues are also reflected in the Clinton Administration’s report “A Framework for Global Electronic Commerce” of July 1997: “government action may be necessary to ensure the safety and soundness of electronic payment systems, to protect consumers, or to respond to important law enforcement objectives.”³⁵

Despite the obvious advantages of electronic payment systems, they pose certain compliance problems. The anonymous and untraceable nature of electronic payments makes it almost impossible for governmental authorities to audit taxpayers spending. The U.S. Treasury, in its 1996 report entitled “Selected Tax Policy Implications of Global Electronic Commerce” raises concerns regarding compliance issues created by electronic payment systems.³⁶ It indicates “the major compliance issue posed by electronic commerce is the extent to which electronic money is analogous to cash and thus creates the potential for anonymous and untraceable transactions.”³⁷ It also determines the issues

³³ RICHARD A. WESTIN, INTERNATIONAL TAXATION OF ELECTRONIC COMMERCE 15 (2000).

³⁴ DOERNBERG, *supra* note 13, at 56.

³⁵ *A Framework for Global Electronic Commerce* (1997) at <http://www.ecommerce.gov/framework.htm> accessed (last visited Feb. 14, 2002).

³⁶ Selected Tax Policy Implications of Global Electronic Commerce, *supra* note 14.

³⁷ *See id.* at § 1.

related to “...identifying parties to communications and transactions utilizing these new technologies and verifying records when transactions are conducted electronically.”³⁸ The report suggests that development of new technologies in the future may allow verification of identity of parties involved in online transactions.

C. Historical Development of Application of Jurisdictional Tax Laws to E-Commerce:
International Experience

The rapid growth of electronic commerce has forced governments of many countries to seek appropriate legal policy for its regulation. One of the keenest legal issues related to e-commerce remains to be taxation of revenues generated on the Web. It appeared that current tax laws may not be capable of addressing the novel issues brought on by e-commerce. “Both national governments (as well as sub-national governments in the United States) and international organizations (*e.g.* the OECD) have responded to the challenges posed by electronic commerce. They are monitoring these challenges and searching for appropriate legislative and administrative measures that can strike a balance between protecting the integrity of the existing tax regimes and promoting the development of electronic commerce.”³⁹

One of the earliest responses to the e-commerce taxation problems was a report “A Framework for Global Electronic Commerce” presented by the Clinton Administration in July 1997. The Report recognized the importance of e-commerce and listed the main issues that needed to be addressed in the future. The Report stated the Administration’s views on the prospective international e-commerce taxation policy: “Any taxation of Internet sales should follow these principles:

³⁸ *See id.* at § 1.

³⁹ DOERNBERG, *supra* note 13, at 164.

- It should neither distort nor hinder commerce. No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions.
- The system should be simple and transparent. It should be capable of capturing the overwhelming majority of appropriate revenues, be easy to implement, and minimize burdensome record keeping and costs for all parties.
- The system should be able to accommodate tax systems used by the United States and our international partners today.

Wherever feasible, we should look to existing taxation concepts and principles to achieve these goals.”⁴⁰

Prior to the Clinton Administration’s report, the U.S. Treasury Department issued Discussion Paper on "Selected Tax Policy Implications of Global Electronic Commerce" on November 21, 1996.⁴¹ The Discussion Paper did not offer solutions on how to tax international electronic commerce transactions. It was designed to initiate public discussion of electronic commerce taxation issues and was “neither intended, nor should be taken as an expression of the legal or policy views”⁴² of the U.S. Government. “Other countries followed suit, with Australia, Canada, France, Ireland, the Netherlands, New Zealand, and the United Kingdom, among others, issuing their own papers. All of the papers allude to the need to strike a balance between tax base preservation and allowing e-commerce to reach its full potential unimpeded by unwarranted regulation and restrictions.”⁴³

⁴⁰ *A Framework for Global Electronic Commerce*, *supra* note 35, § 1.

⁴¹ *Id.*

⁴² *Selected Tax Policy Implications of Global Electronic Commerce*, *supra* note 14.

⁴³ Ned Maguire, *Taxation of E-Commerce*, 47-JUN Fed. Law. 24 (2000).

On November 18, 1997, the Organization for Economic Cooperation and Development (OECD) held its first government/business roundtable on e-commerce taxation in Finland; similar meetings followed throughout 1998, leading up to the Ministerial Conference in Ottawa, Canada, in October 1998, which resulted in the signing of “The Taxation Framework Conditions.”⁴⁴ “The Taxation Framework Conditions” - agreed in Ottawa in 1998 - provides the principles which should guide governments in their approach to e-commerce. It states that e-commerce should be treated in a similar way to traditional commerce and emphasises the need to avoid any discriminatory treatment.”⁴⁵

After the Ottawa Ministerial Conference, the OECD Committee on Fiscal Affairs (CFA) has been working on the development of international consensus on the international e-commerce taxation policy. In May 2001, the CFA has published “a comprehensive set of reports and technical papers which illustrate strong progress toward implementation of the Ottawa Taxation Framework Conditions. Taken together these reports represent a major step forward toward reaching an international consensus on the taxation treatment of E-Commerce”.⁴⁶

⁴⁴ *Electronic Commerce: Taxation Framework Conditions*, *supra* note 2.

⁴⁵ *Id.*

III. INTERNATIONAL TAXATION OF E-COMMERCE

Taxation of electronic commerce has become a high priority issue for governments of most countries. The dramatic increase in the volume of e-commerce in recent years is a serious threat to traditional source of tax revenues for governments. Tax authorities of all countries found themselves as struggling with the ability to give timely responses to e-commerce challenges that grow at a meteoric speed. Existing legal regulations in many instances are silent as to how to treat new types of electronic commercial activities. “By virtue of the Internet, a large amount of international business can be conducted without the need for persons and facilities located in the customer’s market place. Digitization and electronic delivery allow a new universe of intangible products to cross borders without going through the normal entry procedures. The potential anonymity of Internet activity, the development of electronic cash, the high mobility of Cyber-business, the use of private Internet communications networks, and the allure of tax havens combined to raise fears of massive tax-base erosion.”⁴⁷

The most fundamental question of taxation of electronic commerce is extent to which electronic commerce should be taxed. There is no common agreement among governments of different countries on this issue. The positions are divided between those who call for limited taxes on the Internet and who strive to tax most commercial activity

⁴⁶ Organization for Economic Cooperation and Development, *Publication of Report and Technical Papers*, at <http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-101-nodirectorate-no-4-1564-29,FF.html> (last visited Feb. 14, 2002).

⁴⁷ Maguire, *supra* note 43, at 25.

on the Internet. The position of the U.S. government is distinctive by its aggressive domestic and international policy to limit the taxes on e-commerce.

On October 20, 1998 U.S. Congress approved “The Internet Tax Freedom Act”.⁴⁸ The Act declared the following:

- 3-year moratorium on special taxation of the Internet--barred state or local governments from taxing Internet access;
- 3-year moratorium on multiple and discriminatory taxes on electronic commerce--barred state or local governments from imposing taxes that would subject buyers and sellers of electronic commerce to taxation in multiple states;
- No federal excise taxes-- no federal taxes on Internet access or electronic commerce should be introduced;
- Declared that the Internet should be tariff-free zone--called on the Clinton Administration to work aggressively through the EU and WTO to keep electronic commerce free from tariffs and discriminatory taxes.⁴⁹

President Bush has signed congressional legislation extending the validity of the Act through November 1, 2003. President Bush praised the legislation, noting that “the government should be promoting Internet usage and availability, not discouraging it with access taxes and discriminatory taxes.”⁵⁰

Due to the proactive position of the U.S. government, the World Trade Organization’s (WTO) Geneva Ministerial Conference on May 20, 1998 declared that WTO “members will continue their current practice of not imposing customs duties on

⁴⁸ PL 105-277, 1998 HR 4328, 112 Stat 2681, *available at* <http://cox.house.gov/nettax/>.

⁴⁹ *See id.*

electronic transmissions.”⁵¹ “While large number of (mainly developed) countries prefer to extend the moratorium, some developing countries have expressed concern about potential revenue losses resulting from border tariffs.”⁵²

A very distinctive point of view on the problem was expressed in an “Appeal for Fair and Equal Taxation of Electronic Commerce” signed by American academic specialists in tax policy. It fairly indicates that “there is no principled reason for a permanent exemption for electronic commerce.”⁵³ The Appeal also states that “[e]lectronic commerce should not be permanently be treated differently from other commerce.”⁵⁴ Based on the provisions of the Appeal, Walter Hellerstein, Professor of Taxation at the University of Georgia Law School, believes that “since the guiding principle is that ‘electronic commerce should be taxed neither more nor less heavily than other commerce’, the answer to the ‘big’ question is that e-commerce should or should not be taxed according to whether equivalent conventional commerce is or is not being taxed”.⁵⁵

“The tax issues raised by global electronic commerce are emerging abruptly and dramatically from the shadow realm of theory and hypothesis. A subject that over the past three years has preoccupied international bodies such as Organization for Economic Cooperation and Development (OECD) and the European Union (EU), governments, academics, and industry and professional organizations around the world, has become a

⁵⁰ Personal Web Page of Christopher Cox, Chairman of the House Policy Committee, *President Bush Signs Chairman Cox’s Internet Tax Freedom Bill Into Law* (Nov. 28, 2001) at <http://cox.house.gov/nettax/> accessed on 02/17/02.

⁵¹ *Declaration on Global Electronic Commerce* (May 20, 1998) at http://www.wto.org/english/tratop_e/ecom_e/mindecl_e.htm (last visited Feb. 17, 2002).

⁵² *E-Commerce and Development Report 2001*, United Nations Conference on Trade and Development at §6(f) at http://www.unctad.org/ecommerce/docs/edr01_en/edr01pt0_en.pdf (last visited Feb. 17, 2002).

⁵³ *Appeal for Fair and Equal Taxation of Electronic Commerce signed by American academic specialists in tax policy* at <http://www.ntanet.org/documents/AppealList.PDF> (last visited Feb. 17, 2002).

⁵⁴ *Id.* at 1.

practical concern for every business engaged in or contemplating e-commerce transactions.”⁵⁶

A. E-Commerce Challenges

“Nations have identified three main concerns facing the global business community as a result of international tax issues: the erosion of source country tax revenues, the inability to tax international financial capital, and the harmful effects of international tax competition.

All three concerns are interrelated and overlap to certain extent. These problems arose long before the arrival of e-commerce. The explosion of e-commerce, however, will likely exacerbate the problems because it will become increasingly easier (less costly and more efficient) to transfer mobile factors of production – goods, services, and capital – around the world.”⁵⁷

1. International Direct Tax Issues

The international tax framework provides for some important guiding principles which include neutrality, equity, fair share of revenue, and administrative efficiency.⁵⁸

Neutrality is one of the most important principles of taxation. It provides that taxation rules should not be the determinative factor in choosing to invest in home country or abroad. The principle of neutrality in applicability to e-commerce is also reflected in the U.S. Treasury’s Discussion Paper on "Selected Tax Policy Implications of Global Electronic Commerce": “In order to ensure that these new technologies not be impeded, the development of substantive tax policy and administration in this area should

⁵⁵ Walter Hellerstein, *Deconstructing the Debate Over State Taxation of Electronic Commerce*, 13 HARV. J. L. & TECH. 549, 551 (2000).

⁵⁶ Maguire, *supra* note 43, at 24.

⁵⁷ Cockfield, *supra* note 6, at 1222.

be guided by the principle of neutrality. Neutrality rejects the imposition of new or additional taxes on electronic transactions and instead simply requires that the tax system treat similar income equally, regardless of whether it is earned through electronic means or through existing channels of commerce.”⁵⁹

A second guiding principle of taxation is tax equity. Tax equity usually means that similarly situated taxpayers should be taxed the same.⁶⁰

The principle of fair share of revenue provides that both the source and the residence countries receive their fair share of revenue from cross-border transactions.⁶¹

The requirement of the principle of administrative efficiency is to make the tax compliance feasible for both taxpayers and tax authorities and minimize the compliance costs.⁶²

In addition to the above mentioned principles, in “The Taxation Framework Conditions” of October 1998, the OECD member-countries established that there should be certainty and simplicity of the tax rules and the taxation systems should be flexible to “...keep pace with technological and commercial developments.”⁶³

The current international taxation model is based on two fundamental principles: residence of the taxpayer and the source of income. These principles are established in the OECD Model Tax Convention on Income and on Capital⁶⁴ that has served and

⁵⁸ DOERNBERG, *supra* note 13, at 67.

⁵⁹ *Selected Tax Policy Implications of Global Electronic Commerce*, *supra* note 14, § 1.

⁶⁰ DOERNBERG, *supra* note 13, at 68.

⁶¹ *See id.* at 68.

⁶² *See id.*

⁶³ *Electronic Commerce: Taxation Framework Conditions*, *supra* note 2, at 4.

⁶⁴ MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, Dec. 14, 1960, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT at <http://www.oecd.org/pdf/M00005000/M00005346.pdf> [hereinafter Model Treaty].

continues to serve as a basis for most of the international tax treaties. Therefore, the relevant parts of the Model Treaty will be used in an analysis in this thesis.

a. Residence Jurisdiction

Article 4 of the Model Treaty determines a country of residency where a person has “domicile, residence, place of management or any criterion of similar nature”.⁶⁵ This type of jurisdiction is referred to as “domiciliary” jurisdiction. Countries exercise their rights to tax based on the fact that particular person has territorial nexus to that country. The nexus with a taxing country is determined based on the political and economical ties between a taxpayer and a taxing country. Most of the countries use residence or domicile criteria for exercising taxing power. However, only the United States and a few other countries use citizenship of an individual for imposing tax liability on an individual’s worldwide income.

Frequently double taxation arises due to residence-residence conflicts where two countries treat a person as a resident under their respective tax laws. The main goal of Double Tax Conventions is to prevent such double taxation cases.

Article 4(2) of the Model Convention provides tie-breaker rules to determine the residency of individuals in case of dual residency. Obviously, the tie-breaker rules for individuals are not appropriate for companies and other corporate entities. Paragraph 3 of Article 4 of the Model Convention provides that a non-individual “shall be deemed to be a resident only of the State in which its place of effective management is situated.”⁶⁶ Article 4 of the Model Convention does not give the definition of the place of effective

⁶⁵ *Id.* at art. 4.

⁶⁶ *Id.*

management. However, paragraph 24 of the Commentary to the Model Convention gives some guidance:

“24. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”

The determination of the place of residence in a traditional business environment is relatively straightforward process. However, the modern Internet and telecommunication technologies complicate the application of the place of effective management rule. The Discussion Paper issued by the OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits gives an example of the problem presented: If senior managers adopt conferencing through the Internet, for example, as a key medium for making management and commercial decisions and those managers are located throughout the world, it may be difficult to determine a place of effective management. In such cases, a place of effective management might be regarded as existing in each jurisdiction where a manager is

located at the time of making decisions, but it may be difficult (if not impossible) to point to any particular location being the one place of effective management.⁶⁷

Mobility of e-commerce where a server operating the entire business is accessible from everywhere in the world creates the potential for individuals to avoid being of resident of any jurisdiction. “Individuals can more easily avoid numerical residency rules based on a period of physical presence by absenting themselves from a jurisdiction for the necessary number of days while still maintaining employment through telecommuting.”⁶⁸

b. Source Jurisdiction

Countries exercise a right to tax based on source jurisdiction when income of nonresidents is earned from sources within their borders. If nonresident has a permanent establishment in a source country then it becomes subject to taxes of such a source country. Article 5 of the Model Treaty establishes two ways of creating a permanent establishment: through either a ‘fixed place of business’ or through an activity of dependent agent.

i. Permanent Establishment Issue

The Taxation Framework Conditions, approved at the OECD Ministerial Conference in Ottawa, Canada, in October 1998, provides that “The taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. The CFA⁶⁹ believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement

⁶⁷ *A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits: The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule* (Feb. 2001) at www.oecd.org.

⁶⁸ DOERNBERG, *supra* note 13, at 164.

these principles.”⁷⁰ To implement The Taxation Framework Conditions, the group of OECD experts have developed Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5 (hereinafter “Proposal”).⁷¹ This document reflects the OECD’s views on the issue of a permanent establishment in application to e-commerce.

The Proposal makes a distinction “between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment.”⁷² According to the Proposal a web site does not create a permanent establishment because it “does not in itself constitute tangible property.” “On the other hand, 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.”⁷³ In addition, “in order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period.”⁷⁴ It would be immaterial whether the server is owned or rented from third party in determining whether a permanent establishment exists.⁷⁵

Further the OECD Proposal provides that servers may create a permanent establishment even though no human intervention is required.⁷⁶ The Proposal explains:

⁶⁹ CFA - Committee on Fiscal Affairs.

⁷⁰ *Electronic Commerce: Taxation Framework Conditions*, *supra* note 2, at 3.

⁷¹ *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* (Dec. 2000) at <http://www.oecd.org/pdf/M000015000/M00015535.pdf> [Clarification on the Application].

⁷² *Id.* at 5.

⁷³ *Clarification on the Application*, *supra* note 70, at 5.

⁷⁴ *See id.* at 5.

⁷⁵ OECD Commentaries, 2001, Art. 5, para. 23: “It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise.”

⁷⁶ *Clarification on the Application*, *supra* note 70.

“the presence of personnel is not necessary to consider that an enterprise wholly or partly carries on business at a location when no personnel are in fact required to carry on business activities at that location.”⁷⁷ This position is similar to the view taken in the case heard by the Second Chamber of the German Supreme Tax Court.⁷⁸ A Dutch corporation owned underground pipelines in the Netherlands and Germany, through which it supplied oil to German companies.⁷⁹ The Dutch company controlled the pipeline from the Netherlands, had no employee in Germany and independent contractors did all maintenance works. The pressure in the pipeline was supplied from the Netherlands. The court held that the Dutch corporation had a permanent establishment in Germany and explained that in the case of fully automated equipment, a permanent establishment can exist without a human intervention.

It should be noted that the introductory part of the Proposal indicates that some countries do not agree that servers, of themselves can create a permanent establishment (*e.g.* United Kingdom).

The Proposal establishes that no permanent establishment will be created by conduct of preparatory and auxiliary activities through computer and gives some examples of such activities: providing a communication link, advertising of goods and services, relaying information through a mirror server for security and efficiency purposes, gathering market data, or supplying information.⁸⁰ However, if these “functions form in themselves an essential and significant part of the business activity of the

⁷⁷ *See id.*

⁷⁸ John K. Sweet, *Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles*, 146. U. PA. L. REV. 1949 (1998) (outlining the facts of the case).

⁷⁹ *Id.* at 1975.

⁸⁰ *Clarification on the Application*, *supra* note 70, at 6.

enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment” then a permanent establishment would exist.⁸¹

Article 5 (5) of the Model Treaty provides a second way of creating a permanent establishment through dependent agent in the source country, even if the enterprise does not have a fixed place of business in the source country. It provides that a permanent establishment exists where (1) a dependent agent (2) acts on behalf of an enterprise and (3) has, and habitually exercises, in a source country (4) an authority to conclude contracts in the name of the enterprise.⁸² The OECD Proposal determines that the activity of an Internet Service Provider (ISP) generally will not constitute a permanent establishment within the meaning of paragraph 5 of article 5 of the Model Treaty. The ISPs will not be dependent agents due to the fact that they will not have authority to conclude binding contracts in the name of their clients “and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises.”⁸³ And lastly the Proposal states that “the web site through which an enterprise carries on its business” is not a permanent establishment because it is not considered as a “person.”⁸⁴

ii. Location of Servers Is Highly Mobile

As noted above, the OECD Proposal considers the existence of a permanent establishment through the location of a server at a fixed place. A very interesting issue arises when one considers the possibility of servers to transmit software to customers’

⁸¹ *See id.*

⁸² MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, *supra* note 64.

⁸³ Clarification on the Application, *supra* note 70, at 7.

⁸⁴ *See id.*

computers from a different jurisdiction.⁸⁵ “As web applications become more complex, a likely trend will be for the end user’s computer to perform more functions in order to free up the server for other tasks.”⁸⁶ “In these circumstances, it may be difficult to assert that business is being conducted through a server owned or leased by the resident-based e-commerce business. In this regard, the emergence of new networking techniques may ultimately frustrate proposals that focus on physical aspects of the network.”⁸⁷

Authors of the book titled “Electronic Commerce and Multijurisdictional Taxation” considers the hypothetical case when a foreign entity conducts business through multiple servers with “each server performing particular function.”⁸⁸ The OECD Commentaries state that “in such a case each place of business has to be viewed separately and in isolation for deciding whether or not permanent establishment exists”. The authors conclude that multiple servers in different locations “...could not be cumulated into a single permanent establishment.”⁸⁹

Article 7(1) provides that a source country can tax only profits attributable to a permanent establishment. Therefore, even if a server constitutes a permanent establishment, a source country may tax a portion of profit that is attributable to such a permanent establishment. “The profits attributable to the permanent establishment do not include profits that an enterprise may derive other than through the permanent establishment. This limits the taxing rights of a host country so that profits of a non-resident enterprise that are not attributable to the permanent establishment cannot be

⁸⁵ DOERNBERG, *supra* note 13, at 213.

⁸⁶ Cockfield, *supra* note 6, at 1194.

⁸⁷ *See id.*

⁸⁸ DOERNBERG, *supra* note 13, at 212.

⁸⁹ *See id.*

subject to tax, for example under the “force of attraction” principle.”⁹⁰ It is possible “that very little profit is attributable to a server-permanent establishment”⁹¹ where there are no people of the represented company and where the true value is created outside the source country.⁹²

Arthur Cockfield, an expert in electronic commerce taxation, foresees tax-planning opportunities to taxpayers if servers can constitute permanent establishments.⁹³ He believes that these tax planning strategies “could allocate tax revenues away from the residence country where the e-commerce business is based and the source country where the consumers of the e-commerce goods and services are located.”⁹⁴ It will be possible, mainly due to the possibility of remote control of servers. It would allow an enterprise to base servers in tax havens without the need to maintain an employee in or to visit the tax haven. Arthur Cockfield also indicates that there are already some “data havens” to protect the web privacy. He gives an example of “Sealand,” “headquartered on a 6,000 square foot, World War II anti-aircraft deck off the coast of England. Sealand will serve as a co-location for the placement of computer servers which will be maintained by individuals working at a Sealand—to facilitate gambling, pyramid schemes, pornography, and, perhaps most worrisome to tax authorities, untraceable bank accounts.”⁹⁵

⁹⁰ *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions: A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits* (Feb. 2001) at <http://www.oecd.org/pdf/M000015000/M00015525.pdf> [hereinafter *The Discussion Paper*].

⁹¹ DOERNBERG, *supra* note 13, at 212.

⁹² *See id.*

⁹³ Cockfield, *supra* note 6.

⁹⁴ Cockfield, *supra* note 6, at 1195.

⁹⁵ *See id.*

iii. Attribution of Profit to a Permanent Establishment in Electronic Commerce

In February 2001 the OECD Technical Advisory Group (TAG) issued a discussion paper on attribution of profit to a permanent establishment involved in electronic commerce transactions.⁹⁶ Article 7(2) provides for profit attribution to a permanent establishment “which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.”⁹⁷

The paper sets out a two-step analysis in the application of profit to a permanent establishment: first, a functional and factual analysis of the permanent establishment to determine activities conducted by the enterprise and the permanent establishment in order to allocate profits to the permanent establishment.⁹⁸ This includes an analysis to determine the assets used and the risks assumed by the permanent establishment. The paper explains that it is necessary to determine the risks assumed by the permanent establishment despite the fact that all the risks are legally assumed by the enterprise. The paper makes reference to paragraph 1.28 of the OECD Transfer Pricing Guidelines (Guidelines) and provides that “the division of risks and responsibilities within the enterprise will have to be “deduced from their (the parties) conduct and economic principles that govern relationship between independent enterprises.”⁹⁹ As a result of these analyses, the risks assumed by the permanent establishment should be taken into account in attributing to the permanent establishment.

⁹⁶ The Discussion Paper, *supra* note 89.

⁹⁷ MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, *supra* note 62.

⁹⁸ The Discussion Paper, *supra* note 89, ¶ 27.

⁹⁹ *See id.* at ¶ 30.

The second step the paper considers is determining the profits of the hypothesized distinct and separate enterprise based upon a comparability analysis. It makes “a comparison of dealings between the permanent establishment and the enterprise of which it is a part, with transactions between independent enterprises¹⁰⁰...by following, by analogy, the comparability analysis described in the Guidelines.”¹⁰¹ The paper explains despite the fact that inter-branch dealings occur within a single entity they “should be have the same effect on the attribution of profits between the permanent establishment and other parts of the enterprise, as would comparable transactions between independent enterprises”.¹⁰² Further the paper gives a hypothetical example with a number of variations under assumption that server constitutes a permanent establishment.

Although the discussion paper is not capable of covering all possible questions that stem from electronic commerce, it is a valuable step in addressing one of the most important aspects of international taxation of electronic commerce.

iv. Income Characterization

One of the most problematic issues of current international taxation of electronic commerce is income characterization. “From the characterization of income comes its source, and from the source comes identification of the country with the right to tax that income.”¹⁰³ The unique nature of e-commerce creates new aspects in the income characterization issue. Traditional income characterization rules applicable to conventional commerce are not relevant to e-commerce. “Some types of income, such as income from sales of physically delivered goods, are familiar and thus present no

¹⁰⁰ *See id.* at ¶ 33.

¹⁰¹ *See id.*

¹⁰² The Discussion Paper, *supra* note 89, ¶ 37.

¹⁰³ HARDESTY, *supra* note 5, at 11-16.

problems. Other types of income, such as income resulting from electronically delivered digital products and services are new, and are not well-addressed by either domestic or international tax laws.”¹⁰⁴

Some countries have attempted to adopt regulations concerning income characterization. For example, the section 861 Regulations for international software transactions were the first attempt in the United States to regulate the characterization of e-commerce income.¹⁰⁵ However, unilateral attempts to regulate this issue on the level of national tax administrations would potentially lead to double taxation of e-commerce transactions.

On February 1, 2001, the OECD Technical Advisory Group (“TAG”) on Tax Treaty Characterization of Electronic Commerce Payments issued a Report to Working Party No.1 of the OECD Committee on Fiscal Affairs (“Report”). The TAG was mandated “to examine the characterization of various types of electronic commerce payments under tax conventions with a view of providing the necessary clarifications in the Commentary¹⁰⁶.”¹⁰⁷ The Report appears to be an important step in finding international consensus on income characterization issues. It makes certain suggestions for changes to the Commentary. Below we consider the analysis of some issues discussed in the Report.

The first issue discussed in the Report is “distinction between business profits and the part of the treaty definition of ‘royalties’ that deals with payments for the use of, or

¹⁰⁴ *See id.*

¹⁰⁵ *See id.*

¹⁰⁶ Commentaries on the Articles of the Model Tax Convention [hereinafter Commentary].

¹⁰⁷ *Tax Treaty Characterization Issues Arising From E-Commerce: Report to Working Party No.1 of the OECD Committee on Fiscal Affairs* (Feb. 2001) at www.oecd.org at 5 [hereinafter Tax Treaty Characterization Issues].

the right to use of, or the right to use, a copyright.”¹⁰⁸ The Report provides: “In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of the consideration for the payment.”¹⁰⁹

It further explains that if the consideration for the payment is to acquire digital products (such as software, images, sounds or text) “for the acquirer’s own use and enjoyment,” it does not give rise to “royalty” payments. “To the extent that the act of copying the digital signal onto the customer’s hard disk or other non-temporary media constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal.”¹¹⁰ However, where the consideration for the payment is for granting of the right to use a copyright in digital product, it will constitute royalties.¹¹¹

Another subject of consideration of the Report is the need to distinguish payments for supply of know-how and payments for the provision of services. In the proposed changes to the Commentary it provides some criteria to make the distinction:

- Contracts for the supply of know-how concern information that already exists or concern the supply of information after its development or creation and include provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge,

¹⁰⁸ *See id.*

¹⁰⁹ *See id.*

¹¹⁰ *See id.*

¹¹¹ *See id.*

skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.¹¹²

The Report examines a very interesting issue as to the distinction between the provision of services and the acquisition of property. It provides that the basic distinction should be made based on the fact of whether the acquired property was readily available in the beginning of the transaction or was created based on the customer's order. "For example, if one party engages another party to create an item of property that the first party will own from the moment of its creation, then no property will have been acquired by the first party from the other and the transaction should be characterized as the provision of services."¹¹³ "If, however, the customer acquires a valuable report or other property that was not created specifically for that customer, then the transaction could give rise to income from the sale or property".¹¹⁴

The Report provides an analysis of various categories of typical e-commerce transactions. In the case when a customer places an electronic order to deliver tangible goods, the payment made should be considered as business profit under Article 7 of the OECD Model Tax Convention ("Convention").¹¹⁵ However, if the customer orders and downloads digital products for commercial exploitation of the copyright, the payment qualifies as a royalty.

The Report states that web site hosting services (when the provider offers on its server to host web sites), should be treated as business profits under Article 7 of the

¹¹² Tax Treaty Characterization Issues, *supra* note 107, at 7.

¹¹³ *See id.* at 13.

¹¹⁴ *See id.*

¹¹⁵ *See id.* at 20.

Convention.¹¹⁶ It also states that data warehousing services should be treated in the same way allowing “the customer to access, upload, retrieve and manipulate data remotely.”¹¹⁷

Payment for using data retrieval services where “the principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data”¹¹⁸ should be characterized as business profits. Web advertising services are classified in the same category.¹¹⁹ The report also classifies under Article 7 payments received for electronic access to professional advice, information delivery, using online shopping portals, participation in an online auctions, etc.¹²⁰

c. Counteracting Harmful Tax Competition

Cross-border transactions present a great potential for the tax avoidance. There are many different opportunities to avoid tax. With the growth of the world’s economy, the tax avoidance problems become real threats to revenue collections of many countries. “A principal concern of tax authorities is that the highly mobile nature of the new Internet technologies will lead to the proliferation of tax haven operations that will further erode their tax base.”¹²¹

In last decade the OECD has become the main organization coordinating efforts of its member countries to solve the problems of harmful tax competition. As a first action in this respect, in 1998 the OECD issued a Report on Harmful Tax Competition: An Emerging Global Issue.¹²² The report indicates the tax havens and harmful

¹¹⁶ *See id.* at 25.

¹¹⁷ *See id.* at 26.

¹¹⁸ Tax Treaty Characterization Issues, *supra* note 107, at 27.

¹¹⁹ *See id.* at 28.

¹²⁰ *See id.*

¹²¹ Maguire, *supra* note 43, at 28.

¹²² OECD Report on Harmful Tax Competition: An Emerging Global Issue (1998) at www.oecd.org.

preferential tax regimes as main elements of the harmful tax competition. With respect to taxation of income from mobile activities the report states that:¹²³

Tax havens or harmful preferential tax regimes that drive the effective tax rate levied on income from mobile activities significantly below rates in other countries have the potential to cause harm by:

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

i. Tax Havens

According to the report, the main factors in identifying tax havens are:

- no or only minimal taxes;
- lack of effective exchange of information;
- lack of transparency;
- no substantial activities in that jurisdiction.¹²⁴

In a follow up of the report, the OECD issues a list of thirty-five tax havens and forty-seven potentially harmful preferential tax regimes.¹²⁵

¹²³ *See id.*

¹²⁴ *See id.*

¹²⁵ *OECD Report on progress in identifying and eliminating harmful tax practices: Towards Global Tax Co-operation* (2000) at www.oecd.org.

“In addition, technological innovation has affected the ways in which (multinational enterprises) MNEs are managed and made the physical location of management and other service activities much less important to the MNE.”¹²⁶

ii. Harmful Preferential Tax Regimes

The report identifies four key factors characterizing harmful preferential tax regimes:

- no or only minimal taxes;
- ring-fencing;
- lack of transparency;
- lack of effective exchange of information.

The report provides for a list of defensive measures against uncooperative tax havens or harmful tax regimes:

- to disallow deductions, exemptions, credits, or other allowances related to transactions with Uncooperative Tax Havens or to transactions taking the advantage of their harmful tax practices;
- to deny the availability of the foreign tax credit or the participation exemption with regard to distributions that are sourced from Uncooperative Tax Havens or to transactions taking the advantage of their harmful tax practices;
- to impose withholding taxes on certain payments to residents of Uncooperative Tax Havens;
- not to enter into any comprehensive income tax conventions with Uncooperative Tax Havens, and to consider terminating any such existing conventions unless certain conditions are met.

¹²⁶ *OECD Report on Harmful Tax Competition: An Emerging Global Issue* (1998) at

It should be noted that the OECD-led anti tax havens policy is subject to controversial evaluations by low-tax jurisdictions. They point out that the high-tax countries, which mainly represent the developed countries, try to prevent “tax haven” countries from exercising their legitimate fiscal policy rights independently. Some experts also have expressed concerns that OECD’s effort deviates from traditional international taxation principles “...and usurps basic tenet of fiscal legislation: national sovereignty.”¹²⁷

2. Consumption Taxes and Electronic Commerce

Almost all countries of the world impose consumption taxes in their different forms. The main forms of consumption taxes are value added tax, sales and turnover taxes, transaction taxes, and excise taxes.¹²⁸ The most popular form of consumption tax is a value added tax (VAT). “The VAT is applied in more than 100 countries. A common VAT system is in place in all 15 Member States of the European Community.”¹²⁹ The only one OECD Member States that does not impose VAT is the United States.¹³⁰ In addition to VAT, European countries use excise taxes, mainly on alcohol, tobacco and fuel.¹³¹

The nature of consumption taxes is very well explained by the authors of *Electronic Commerce and Multijurisdictional Taxation* by Richard L. Doernberg, Luc Hinnekens, Walter Hellerstein, Jinyan Li: “From an economic viewpoint, consumption taxes are imposed on the consumption of goods and services. The tax burden is distributed according to consumption expenditure patterns. Therefore, consumption taxes

<http://www.oecd.org/pdf/M00004000/M00004517.pdf> at 14.

¹²⁷ Alexander Townsend, Jr., *The Global Schoolyard Bully: The Organization for Economic Co-operation and Development’s Coercive Efforts to Control Tax Competition*, 25 *FORDHAM INT’L L.J.* 215, 251 (2001).

¹²⁸ DOERNBERG, *supra* note 13, at 94.

¹²⁹ *See id.*

¹³⁰ HARDESTY, *supra* note 5, at 11-66.

are taxes on the consumption of economic wealth, whereas income taxes are taxes on the creation of wealth.”¹³²

Consumption taxes are usually applied to the sale goods and services. The American sales and use taxes “are single-stage taxes at the retail level”.¹³³ A VAT is imposed on value added at each stage of production and distribution.¹³⁴ Currently more than 135 countries impose consumption taxes out of which 107 apply a VAT.¹³⁵

Consumption taxes are one of the most important revenue sources of many countries. “OECD countries derive some 30 percent of their tax revenues from indirect taxes such as VAT (in the EU, VAT accounts for 44 percent of tax revenue)”.¹³⁶ “In the United States, the sales and use taxes imposed by 45 states yield 32.5 percent of total state tax revenues.”¹³⁷

a. Concept of Value Added Tax (VAT)

We will discuss the concept of the VAT using the example of the EU VAT because it serves as a model concept for other countries. The main legislative basis of the EU VAT system is the Sixth Council Directive of 1977.¹³⁸

The fifteen EU Member States have a common VAT system. VAT applies at a fixed rate to the gross price of goods and services at each stage up to and including retail trade tax. It is imposed on each transaction during the production and distribution. A VAT payable to tax authorities is determined as the difference between a taxpayer’s

¹³¹ WESTIN, *supra* note 33, at 123.

¹³² DOERNBERG, *supra* note 13, at 94

¹³³ DOERNBERG, *supra* note 13, at 95.

¹³⁴ *See id.*

¹³⁵ *See id.*

¹³⁶ Maguire, *supra* note 43, at 2.

¹³⁷ DOERNBERG, *supra* note 13, at 99.

¹³⁸ Council Directive 77/388, O.J. (L145).

output VAT and input VAT, i.e. the amount charged to clients and the amount paid to suppliers. This method is called “VAT credit” or “invoice” method.¹³⁹ Where input VAT exceeds output VAT, VAT should be refunded. However, where output VAT exceeds input VAT, VAT is payable. Input VAT paid on purchases only for business purposes is refundable. In cross-border trade the VAT is imposed at the rate of the destination country (the “destination taxation” principle). Under the “destination taxation” principle a VAT is imposed not by the country of export but by the country of import.¹⁴⁰ It should be noted that there were some proposals to change the EU VAT system from the “destination taxation” principle to the “origin taxation” principle to eliminate fiscal barriers for the single market.¹⁴¹ However, for the moment and foreseeable future, the EU VAT system is based on the “destination taxation” principle, except with respect to certain intra-community supplies.

EU imposes VAT on the supply of goods and services by a taxable person within the territory of the country, on the intra-Community acquisition of goods within the territory of the country by a taxable person or a non-taxable person, and on the importation of goods.¹⁴² Goods acquired in another county of the Community are taxed in the country where the goods arrive.¹⁴³ EU Member States are fiscally sovereign. Every Member State has established a fixed VAT rate. However, certain supply of goods and services could be subject to VAT at reduced or zero rate.

Responsibility to pay VAT is with the taxable person who is identified as any person who independently carries out, in any place, any economic activity defined to

¹³⁹ DOERNBERG, *supra* note 13, at 102.

¹⁴⁰ *See id.* at 104.

¹⁴¹ *See id.*

¹⁴² Council Directive 77/388, art. 2, O.J. (L145).

include all activities of producers and traders.¹⁴⁴ Every taxable person is assigned an individual identification number.¹⁴⁵

An important element of the EU VAT system is the mechanism of a self-assessment.¹⁴⁶ It provides for the obligation of a EU-based business customer for assessment and payment of VAT to her/his home-country from services provided by a non-EU provider. Thus, "...the EU based business customer of those services becomes responsible, in lieu of the non-EU based supplier, for accounting and payment of tax, as if the business customer had self-supplied the services."¹⁴⁷ It should be noted that the self-assessment mechanism, which is also called as a reverse charge, does not apply to individual customers.

i. Application of VAT to E-Commerce Transactions

We will base our analysis again on the European Union VAT system "because it is the most mature of the world's VAT systems."¹⁴⁸

The issue of the place of supply in the EU legislation is of great importance in the process of taxation of electronic commerce. Article 9 of the Sixth Directive provides for rules establishing the place of supply of services provided that under Article 6 of the Sixth Directive, the electronic delivery of digital products is treated as the supply of services. The same position is expressed in the OECD Framework Conditions for taxation of electronic commerce: "For the purposes of consumption taxes, the supply of

¹⁴³ DOERNBERG, *supra* note 13, at 102.

¹⁴⁴ Council Directive 77/388, art. 4, O.J. (L145).

¹⁴⁵ DOERNBERG, *supra* note 13, at 118.

¹⁴⁶ *See id.* at 118.

¹⁴⁷ *See id.*

¹⁴⁸ *See id.* at 401.

digitized products should not be treated as a supply of goods.”¹⁴⁹ Under Article 9, electronic services are supplied at the place of the establishment of the supplier. However, for advertising services, services of lawyers, accountants, data processing and supply of information, financial and insurance services, Article 9(2) provides the following:

The place where the following services are supplied when performed for customers established outside the Community or for taxable persons established in the Community but not in the same country as the supplier, shall be the place where customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such place, the place where he has his permanent address or usually resides.¹⁵⁰

In the absence of clear provisions in the current legislation regarding the place of supply of digital goods and electronically delivered services, most EU countries tend to consider Article 9(2)(e) as applying to those goods and services as “supply of information.”¹⁵¹

In the context of VAT treatment of digital goods and electronically delivered services, another important issue is what constitutes a “place of business” and a “fixed establishment”. These two terms are not defined in the Sixth Directive.

According to some experts, the “place of business” should be interpreted as the registered office.¹⁵² However, this view is not commonly shared in particular with regard to the case “when no significant business carried out through the registered office.”¹⁵³

¹⁴⁹ *Electronic Commerce: Taxation Framework Conditions*, *supra* note 2, at 5.

¹⁵⁰ Council Directive 77/388, art. 9, O.J. (L145).

¹⁵¹ DOERNBERG, *supra* note 13, at 405.

¹⁵² *See id.* at 408.

With respect to the term “fixed establishment,” the European Court of Justice’s decision in the *Berkholz* case has stated that this expression should be interpreted to mean the permanent presence of both human and technical factors.¹⁵⁴

One of the most important problems of the application of VAT to electronic commerce concerns the distinction between goods and services. The lack of uniformity among the EU Member States in classification of goods and services creates many difficulties. For example, the different countries depending on the form of delivery treat software differently.¹⁵⁵ However, the European Court of Justice took the view that the treatment of a good or service should not depend on the form of distribution.¹⁵⁶

Yet another complex of tax problems arises from classification of composite supplies – the combined supply of goods and services. There is no uniform approach how to treat these sorts of transactions performed over the Internet between the EU Member States.¹⁵⁷ Experts see two potential solutions to this problem: (a) the fees received from composite supplies should be apportioned, or (b) be treated by reference to the predominant nature of the supply.¹⁵⁸

With the aim of finding international consensus on consumption tax issues of electronic commerce, the OECD Working Party No. 9 prepared a report on “Consumption Tax Aspects of Electronic Commerce” [the Report] in February 2001.¹⁵⁹ The Report provides guidelines on the definition of the place of consumption,

¹⁵³ *See id.*

¹⁵⁴ WESTIN, *supra* note 33, at 137.

¹⁵⁵ DOERNBERG, *supra* note 13, at 422.

¹⁵⁶ *See id.*

¹⁵⁷ *See id.* at 424.

¹⁵⁸ *See id.*

¹⁵⁹ *A Report from Working Party No. 9 on Consumption Taxes to the Committee on Fiscal Affairs: Consumption Tax Aspects of Electronic Commerce* (2001) at www.oecd.org.

recommendations on collection mechanism options and international administrative co-operation, simplification of tax compliance requirements.

Guidelines on the definition of the place of consumption provide that in cross-border business-to-business supplies of services and intangible property the place of consumption “should be the jurisdiction in which the recipient has located its business presence.”¹⁶⁰ In cases where this approach leads to a distortion of competition or avoidance of tax, countries may use different criterion to find the place of consumption. In business-to-consumer transactions the place of consumption should be the place where customer “has their usual residence.”¹⁶¹

The Working Party recommends using self-assessment or reverse charge mechanisms in cross-border business-to-business transactions where the seller is not registered or required to be registered in the recipient’s country. The Report acknowledges that tax collection in business-to-consumer international transactions is associated with certain difficulties. In order to prevent distortion of competition or revenue loss, it is recommended that a registration system be used for foreign suppliers that are not registered or required to be registered. The Report also underlines the importance of further work in the spheres of development of effective means of verifying of the customers’ jurisdiction in B2C transactions, their status (business/individual), use of technology in tax collection, international administrative co-operation, etc.

¹⁶⁰ *Id* at 24.

¹⁶¹ *See id.*

b. The European Union's Proposal

On June 8, 2000, the European Commission made a proposal for a directive regarding the application of VAT to digital products ordered on-line.¹⁶² The European Union's Council of Economics and Finance Ministers (ECOFIN) recently approved the proposal.¹⁶³ “The rules will apply to products such as computer games and software, delivered online as opposed to in a physical form, as well as to subscription-based and pay-per-view radio and television broadcasting.”¹⁶⁴

The new rules pursue several goals:

- equalization of EU and non-EU taxpayers when they are providing electronic services to EU customers;
- EU suppliers will no longer levy VAT when exporting electronically delivered services from EU;
- non-EU suppliers will be obliged to charge VAT on supplies to individual customers; They will be required to register for VAT purposes in any EU Member State and charge VAT at the rate of customer's country if their annual sales within the EU exceed 100,000 Euros. The country where the supplier is registered will re-allocate the VAT received to the country of the customer. Non-EU suppliers involved in business-to-business operations should not be registered for VAT purposes. VAT, in this case, will be self-imposed by the buyer under the reverse charge scheme.

¹⁶² WESTIN, *supra* note 33, at 138.

¹⁶³ Newsbytes, *EU E-Commerce Tax Makes Crucial Gain*, (Dec. 14, 2001), at <http://www.newsbytes.com/news/01/172983.html> (last visited Apr. 09, 2002).

¹⁶⁴ *EU Council Agrees to Value Added Tax on Digital Products*, (Feb. 13, 2002), at <http://www.eurunion.org/news/press/2002/2002005.htm> (last time visited Apr. 09, 2002).

- the seller will be able to comply electronically with VAT registration, filing, and remittance.¹⁶⁵

The main consequence of the directive will be elimination of unfair treatment of EU e-businesses compared to their foreign competitors. Current rules levy VAT on EU suppliers of digital products while non-EU operators in countries not imposing VAT on such sales are free of the tax. Another important effect of the proposal will be the application of VAT to electronic services where they are consumed. Thus, the proposal follows the OECD principles on the taxation of e-commerce agreed at the 1998 conference in Ottawa that (1) electronic and conventional forms of commerce should be treated in equal and neutral manner, (2) electronically delivered products should be treated as services, (3) services should be taxed where they are consumed (4) in business-to-business transactions the reverse charge mechanism should be used, and (5) compliance costs for taxpayers and administrative costs for tax authorities should be minimized.¹⁶⁶

Despite its importance, the proposal was subject to criticism by some experts. For instance, the threshold for registration gives “an advantage for non-EU suppliers that are not available to EU suppliers, and they are therefore discriminatory”.¹⁶⁷ In addition, experts express concerns about the enforceability of the new system.¹⁶⁸

¹⁶⁵ *See id.*

¹⁶⁶ *Electronic Commerce: Taxation Framework Conditions, supra note 2.*

¹⁶⁷ DOERNBERG, *supra* note 13, at 438.

¹⁶⁸ *See id.*

c. US State and Local Sales Tax

There is no national consumption tax in the United States.¹⁶⁹ However, 45 of the 50 states and District of Columbia and many local jurisdictions impose retail sales taxes.¹⁷⁰ “The sales tax is the second leading source of state tax revenue.”¹⁷¹ Some states are very dependent on sales tax revenues. For example, “in 1998, sales tax accounted for 57% of Florida’s tax revenues.”¹⁷²

“Sales tax is charged on gross sales, and collected from the buyer by the company making the sale. The company is responsible for paying the collected sales tax to the state where the sale is made. A company may be required to collect this tax regardless of whether that company is based in the state where the sale is made or is based in some other state or country.”¹⁷³ “A theoretically ideal retail sales tax would apply to all consumer purchases of goods and services, and it would exclude business inputs from the tax base.”¹⁷⁴ However, the existing tax regimes in many states tax only selected services and do not exclude business purchases from the tax base.¹⁷⁵

“Although most states traditionally taxed some services (*e.g.*, public utility services and hotel services), and a few states (*e.g.*, Hawaii and New Mexico) always taxed a broad range of services, the states historically limited the sales tax base to tangible personal property and selected services. The original explanation for the limited scope of the sales tax base lies partly in the desire to create a simple and easily administrable tax and partly in the perception that a tax on services would have

¹⁶⁹ *See id.* at 134.

¹⁷⁰ *See id.*

¹⁷¹ *See id.*

¹⁷² David E. Hardesty, *Taxation of E-Commerce: Recent Developments*, 618 PLI/Pat 177, 203 (2000).

¹⁷³ HARDESTY, *supra* note 5, at 14-4.

¹⁷⁴ DOERNBERG, *supra* note 13, at 135.

constituted a tax on labor.”¹⁷⁶ “The states currently exhibit great diversity in the extent to which they tax the full range of potentially taxable services.”¹⁷⁷

The US Constitution imposes certain restrictions on states’ ability to impose a sales tax on goods and services purchased outside that state’s borders.¹⁷⁸ The states can overcome these restrictions through enactment of “complementary” or compensating” use taxes. “All states and many local governments that impose sales taxes also impose complementary use taxes on the purchase price of goods that were acquired out-of-state but brought into the state for consumption or storage. The idea behind the use tax is to eliminate the incentive to buy goods out-of-state where they might be taxed at a lower rate or not at all. If use taxes were not imposed and some consumers could buy out-of-state on a no-tax or lower-tax basis, the State and local governments imposing sales taxes would obviously lose revenue. Also, merchants who had to charge sales taxes would lose business, perhaps damaging the local economy.”¹⁷⁹ “The use tax imposes an exaction equal in amount to the sales tax that would have been imposed on the sale of property in question if the sale has occurred within the state’s taxing jurisdiction.”¹⁸⁰ “In principle, then, the in-state purchaser stands to gain nothing by making an out-of-state or interstate purchase free of sales tax because it will ultimately be saddled with an identical use tax when the property is bought into the taxing state.”¹⁸¹

¹⁷⁵ *See id.*

¹⁷⁶ *See id.* at 137.

¹⁷⁷ *See id.* at 139.

¹⁷⁸ *See id.* at 151.

¹⁷⁹ WESTIN, *supra* note 33, at 81.

¹⁸⁰ DOERNBERG, *supra* note 13, at 152.

i. Application of US Sale and Use Taxes to E-Commerce Transactions

The U.S. General Accounting Office's estimates "sales tax losses from remote sales to be as high as \$20 billion in the year 2003, or about 8% of all sales tax collected."¹⁸² These figures explain the states' concerns regarding taxation of electronic commerce. The unique features of e-commerce bring additional difficulties to the highly complex state tax regimes. It is obvious that existing tax rules are not always applicable to taxation of electronic commerce.

Given the increasing volume of economic activity conducted through electronic commerce, the experts identify the following policy questions:

"Which states, if any, will have jurisdiction to impose (or require collection of) taxes on the sales or income generated by such economic activity? To which states should the receipts or the income from such economic activity be assigned? And how will states administer, and taxpayers comply with, a taxing regime that attempts to capture the receipts or income from such economic activity?"¹⁸³

Two of the main problems of the sales and use taxation of electronic commerce are associated with: the nexus or jurisdictional issue and the double taxation or pyramiding issue.¹⁸⁴

Nexus Issue

One of the main problems in sales and use taxation of electronic commerce is related to enforcement and collection of use taxes on out-of-state purchases. "The circumstances under which an out-of-state vendor may be required to collect a use tax

¹⁸¹ *See id.*

¹⁸² Hardesty, *supra* note 167, at 200.

¹⁸³ Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues*, 52 U. MIAMI L. REV. 691, 693 (1998).

that is due to the state from the customer (on products sold to customers within the state) has been the focus the legal and political controversy in the context of mail-order and other remote selling for over 30 years.”¹⁸⁵

In traditional business transactions, the out-of-state vendor is required to collect and remit the use tax to the state of the purchaser. However, the collection of the use tax on goods and services purchased in interstate commerce is associated with certain constitutional difficulties.¹⁸⁶ It is questionable whether a state can require an out-of-state vendor to collect the use tax provided that the vendor has little or no presence in the state. The U.S. Supreme Court has twice ruled on this issue based on the Due Process¹⁸⁷ and Commerce Clause.¹⁸⁸ For some time these constitutional requirements were considered the same. However, in *Quill Corp. v. North Dakota*,¹⁸⁹ the Supreme Court differentiated the Due Process and Commerce Clause restraints on a state’s power to require out-of-state vendor to collect use taxes.

The Court observed in *Quill* that the “due process requires both that some definite link or minimum connection exist between state and the person, property or transaction it seeks to tax, and that income attributed to state for tax purposes be rationally related to values connected with taxing state.”¹⁹⁰ Although, the Court in *Quill* found that the due process “nexus” requirement was satisfied without physical presence, it clearly stated that

¹⁸⁴ *See id.*

¹⁸⁵ *The National Tax Association's Communications and Electronic Commerce Tax Project: Final Report* (1999) at <http://www.ntanet.org/ecommerce/final.pdf> at 7.

¹⁸⁶ DOERNBERG, *supra* note 13, at 155.

¹⁸⁷ Under the Fourteenth Amendment of the Constitution of the United State, no state shall “deprive any person of life, liberty, or property, without due process of law”, U.S. CONST. AMEND. XIV.

¹⁸⁸ Article I, § 8, cl. 3 of the US Constitution grants Congress power to “regulate Commerce with foreign Nations, and among several states, and with the Indian Tribes.” In addition, the US Supreme Court’s interpretation of the Commerce Clause imposed restraints on the states’ ability to legislate even when Congress has not acted; U.S. CONST. art. I, §8, cl.3.

¹⁸⁹ *Quill Corp. v. North Dakota* By and Through Heitkamp, 504 U.S. 298 (1992).

minimal contacts do not of themselves satisfy the requirements of the commerce clause. “Corporation may have ‘minimum contacts’ with taxing state, as required by due process clause, and yet lack “substantial nexus” with state as required by commerce clause.”¹⁹¹

The commerce clause requirement assumes that the out-of-state vendor must have physical presence in the state for obliging the vendor to collect a use tax.¹⁹² The experts indicate that the nexus requirement creates an important opportunity for Congress “to legislate on this question in the future and to provide a broad solution to the tax collection problems associated with distance selling and electronic commerce.”¹⁹³ “By resting the physical presence requirement of nexus entirely on its interpretation of the Commerce Clause, the Court made it clear that Congress has the power to change this rule should it see fit to do so, perhaps in conjunction with a requirement that the states harmonize their sales tax regimes to remove the burden that the existing patchwork of state and local tax laws impose on remote sellers.”¹⁹⁴

Despite the fact that *Quill* was dealing with taxation of out-of-state mail-order vendor, the approach taken by the Supreme Court can guide us in the taxation of electronic commerce transactions. Therefore, it can be assumed that the seller that has no physical presence in states of residence of its consumers cannot be compelled to collect use taxes on its sales to such consumers.

Agency and Nexus

Another interesting question was posed as to whether “the physical presence of on-line service providers (OSPs) and internet service providers (ISPs) in the customer’s

¹⁹⁰ *See id.*

¹⁹¹ *See id.*

¹⁹² DOERNBERG, HINNEKENS, HELLERSTEIN & LI, *supra* note 13, at 155.

¹⁹³ *See id.* at 158.

state (through their local nodes), as well as the physical presence of local telecommunication providers, may be sufficient to establish nexus over an out-of-state information provider whose services are sold through electronic commerce.”¹⁹⁵ This view is based on the argument that OSPs and ISPs act as in-state representatives for remote vendor, thus create the necessary physical presence that allows the state where the sales are made to require the vendor to collect the use tax on its sales to residents of that state. In this regard, the useful guidance is provided in *America Online, Inc. v. Johnson*¹⁹⁶, heard by a Tennessee trial court. AOL’s customers were accessing its services through Internet while AOL did not have any physical presence. The court held that AOL’s activities in Tennessee did not amount to creation of physical presence.

The Interactive Services Association also argued that the use of the Internet should not be interpreted as evidence of agency, any more than is the use of telecommunications facilities.¹⁹⁷

Nexus by Affiliation

In the search for the appropriate means to solve the problems of taxation of electronic commerce, the states have attempted to create a theory “that entities have nexus where their corporate affiliates (parents, sisters, or subsidiaries) have nexus.”¹⁹⁸ However, in *SFA Folio Collections, Inc. v. Tracy*,¹⁹⁹ the Supreme Court of Ohio held that a foreign retailer that had no physical presence in state, but whose sister corporation

¹⁹⁴ *See id.*

¹⁹⁵ *See id.* at 474.

¹⁹⁶ No. 97-3786-III, Tennessee Chancery Court, 20th Judicial District, Davidson City, Part III, March 13, 2001.

¹⁹⁷ Interactive Services Association’s Task Force, White Paper: Logging On To Cyberspace Tax Policy, St. Tax Notes, 209, 209 (Jan. 20, 1997).

¹⁹⁸ Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 Tax L. Rev. 269, 332 (1997).

¹⁹⁹ *SFA Folio Collections, Inc. v. Trac*, 652 N.E. 2d 693 (Ohio 1995).

operated retail outlets in state, did not have sufficiently substantial nexus with state that it could be required to collect use tax.

Impact of the Internet Tax Freedom Act on Creation of Nexus

As mentioned above, on October 20, 1998 the U.S. Congress approved The Internet Tax Freedom Act²⁰⁰ (ITFA), which was extended by Congress through November 1, 2003. Among other prohibitions, the ITFA barred state or local governments from imposing multiple and discriminatory taxes on electronic commerce.

The ITFA establishes that a discriminatory tax exists where “a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of--

- (I) the display of a remote seller's information or content on the out-of-State computer server of a provider of Internet access service or online services; or
- (II) the processing of orders through the out-of-State computer server of a provider of Internet access service or online services.”²⁰¹

Thus, the ITFA answers some very important policy issues. First, the states cannot compel out-of-state vendors to collect the use tax only based on the vendors’ use of in-state OSPs or ISPs. Second, although the language of the ITFA contains some ambiguity,²⁰² it suggests that a state may not impose obligation to out-of-state seller to collect a use tax based on the solely of the seller’s tax server in the taxing state. Third, under the ITFA the mere ability to access a web site in a state does not create a basis for a claim for the state that an out-of-state vendor has nexus.

²⁰⁰ The Internet Tax Freedom Act , *supra* note 47.

²⁰¹ *See id.* at §1104(2).

The Advisory Commission on Electronic Commerce (the Commission) has also made several proposals for the taxation of e-commerce that confirms some principal positions established in the ITFA.²⁰³ In its Report to Congress of April 2000 the Commission proposed that "the following factors would not, in and of themselves, establish a seller's physical presence in a state for purposes of determining whether a seller a sufficient nexus with that state to impose collection obligations: (a) a seller's use of an Internet service provider ("ISP") that has a physical presence in a state; (b) the placement of a seller's digital data on a server located in that particular state; (c) a seller's use of telecommunications services provided by a telecommunications provider located in that state; (d) a seller's ownership of property that is used or is present in that state; (e) the presence of a seller's customer in a state; (f) a seller's affiliation with another taxpayer that has physical presence in that state; (g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state; (h) a contractual relationship a seller and another party located within that state that permits goods or products purchased through the seller's Web site or catalogue to be returned to other party's physical location within that state; and (i) the advertisement of a seller's business location, telephone number, and Web site address."²⁰⁴

Pyramiding

As stated above, theoretically, a retail sales tax is imposed on final consummation of goods and services to the customer. Tax laws of all jurisdictions are designed to exclude intermediate transactions from taxation to prevent the pyramiding or double

²⁰² DOERNBERG, *supra* note 13, at 482.

²⁰³ *Report of Advisory Commission on Electronic Commerce to Congress* (2000) at http://www.ecommercecommission.org/acec_report.pdf (last visited Apr. 9, 2002).

²⁰⁴ *See id.* at §II(A).

taxation. “This adds the complexity for sellers who must determine whether a purchaser’s exemption certificate is legitimate.”²⁰⁵

As a general rule, sales for resale are excluded from the retail sales tax base.²⁰⁶ However, it should be noted that producers’ share of sales taxes is quite significant. “Indeed, a nationwide study concluded that producers’ share of the sales tax base averaged forty percent for forty-five states and the District of Columbia.”²⁰⁷

The pyramiding problem is especially important in the context of taxation of electronic commerce for the following reasons: “First, the states’ separate taxation of related services (e.g., telecommunications, data processing, and information services) creates the risk that each separately-identified service will be taxed even if they are all part of a single economic process. Second, the sale-for-resale exemption is not as clearly refined with respect to the sale of tangible personal property.”²⁰⁸

Experts believe that elimination of pyramiding problem “is complicated by the well-entrenched tradition of taxing many business inputs under state retail sales taxes.”²⁰⁹ They believe that, following the principle of neutrality, the solution to this problem should equally reflect the interests of both electronic and conventional commerce.²¹⁰

Sale of Electronically Delivered Software

Another important policy issue in taxation of electronic commerce is the application of sales tax to downloaded software. Currently, there is no uniform approach to this issue among the states. The following states subject electronically delivered

²⁰⁵ *The National Tax Association's Communications and Electronic Commerce Tax Project: Final Report*, *supra* note 180, at 10.

²⁰⁶ Hellerstein, *supra* note 178, at 697.

²⁰⁷ *See id.*

²⁰⁸ *See id.*

²⁰⁹ *See id.* at 699.

software to their sale and use taxes: Alabama, Illinois, Louisiana, Nebraska, New York, North Dakota, Texas, Washington and Wisconsin.²¹¹ To the contrary, the following states exempt downloaded software from their sale and use taxes: California, Kentucky, Massachusetts, Missouri, South Carolina, Vermont and Virginia.²¹²

In this respect, the Louisiana Supreme Court's Decision in *South Central Bell Telephone Co. v. Barthelemy* is illuminating.²¹³ "Holding that electronically delivered software is tangible personal property for purposes of sales and use tax, the court drew no distinction between software delivered on physical media and software delivered electronically."²¹⁴

"Some states have determined that electronically delivered software is a nontaxable service; others have held that to the contrary. Some have determined that such software is intangible, and thus not taxable; others have ruled it to be tangible and taxable".²¹⁵ Obviously, the issue of taxability of electronically delivered software is major source of uncertainty to vendors and demands an adequate and prompt solution.

ii. Potential Solutions to the State Taxation of Electronic Commerce

The search for solutions to the problems raised by state taxation of electronic commerce continues to be one of the vital tasks for experts in the field and for the state tax administrations. Below we discuss some of the interesting proposals made to address main issue of state taxation of e-commerce.

²¹⁰ *See id.*

²¹¹ WESTIN, *supra* note 33, at 79.

²¹² *See id.*

²¹³ *South Central Bell Tel. Co. v. Barthelemy*, 637 So. 2d 451 (La. 1994).

²¹⁴ HARDESTY, *supra* note 5, at 14-45.

²¹⁵ *See id.*

An interesting solution to the “nexus” problem is expressed by Walter Hellerstein, Professor of Taxation of the University of Georgia Law School, in his article “State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issue.”²¹⁶

Hellerstein states that the key problem to solving the problems of state taxation of electronic commerce is related to the “nexus” issue. He points out that the needs of vendors require establishment of effective tax mechanism with clear “tax collection obligations.”²¹⁷ “One way of achieving these objectives would be by establishing nexus over out-of-state vendor in the state of the purchaser, defined by reference to the purchaser’s billing address or other locational information furnished to the vendor by the purchaser (e.g., the area code and local exchange from which the purchaser accessed the seller’s Web site).”²¹⁸ Using this information the vendor will be able to remit the tax to the appropriate jurisdiction. It is indicated that this approach is consistent with the policy approach that “state sales taxes are, in principle, levied on a destination basis.”²¹⁹

Further the author suggests that in cases where it is impossible to identify, the mechanism can include the application of the income “throwback” rule. The author explains: “Under the “throwback” rule embodied in the Uniform Division for Income Tax Purposes Act,²²⁰ sales of tangible personal property, which are normally assigned to the destination state in the sales factor of the tax apportionment formula, are ‘thrown back’ to the state of origin when the taxpayer is not taxable in the destination state. In the sales tax context, the statute might provide for a “throwback” of the sale to the state of origin when

²¹⁶ Hellerstein, *supra* note 178.

²¹⁷ *See id.* at 702.

²¹⁸ *See id.* at 703.

²¹⁹ Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving Sovereignty in a Digital World*, 14 STATE TAX NOTES 1169 (1998).

²²⁰ 7A U.L.A. 331, § 16 (West. Supp. 1997)

the vendor was unable by reasonable and good faith efforts to determine the purchaser's billing address.”²²¹

As an alternative to the ‘throwback rule,’ the author proposes to use “a ‘throwaround’ rule that effectively distributes sales to unidentifiable purchasers to states where the vendor makes sales to identifiable purchasers. The ‘throwaround’ rule serves the same function as the ‘throwback’ rule, but, rather than assigning the tax base to the single state from which the sale are made or in which the taxpayer’s principal place of business is located, it spreads the tax base around all of the states in which the vendor makes taxable sales of electronically-transmitted information or services.”²²²

The Advisory Commission's on Electronic Commerce Report to Congress of April 2000 proposed the adoption of a uniform sales and use tax act that would provide the following:

- (a) uniform tax base definitions;
- (b) uniform vendor discount;
- (c) uniform and simple sourcing rules;
- (d) one sales and use tax rate per state and uniform limitations on state rate changes;
- (e) uniform audit procedures;
- (f) uniform tax returns/forms;
- (g) uniform electronic filing and remittance methods;
- (h) uniform exemption administration rules (including a database for all exempt entities to determine exemption status;

²²¹ Hellerstein, *supra* note 178, at 704.

²²² *See id.*

- (i) a methodology for approving software that sellers may rely on to determine state sales tax rates;
- (i) a methodology for maintaining revenue neutrality in overall sales and use tax collection within each state (such as reducing the state-wide sales tax rate) to account for any increased revenues collected (on voluntary basis otherwise) from remote sales.²²³

One of the significant projects to address the problems of the sales taxation of electronic commerce is the Streamlined Sales Tax Project (the SSTP). With the primary purpose to simplify and modernize sales and use tax collection and administration, the state governments initiated the SSTP. As a result of the SSTP's work, on December 22, 2000, the representatives of the states to the SSTP approved a Uniform Sales and Use Tax Administration Act (Act)²²⁴ and Streamlined Sales and Use Tax Agreement (Agreement).²²⁵ The Act and Agreement authorize state legislatures to amend their tax systems toward simplification from January 2001.

The issues that the Agreement has addressed are the following:

- State level administration of sales and use tax collections.
- Uniformity in the state and local tax bases.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Uniform definitions within tax bases.

²²³ *Report of Advisory Commission on Electronic Commerce to Congress*, *supra* note 198, at §II9(A).

²²⁴ Uniform Sales and Use Tax Administration Act (2000) at <http://www.geocities.com/streamlined2000/> (last visited Apr. 9, 2002).

- Simplified administration of exemptions.
- Simplified tax returns.
- Uniform rules for deductions of bad debts.
- Simplification of tax remittances.
- Protection of consumer privacy.²²⁶

While the majority of experts have positive opinions about the importance of the solutions outlined in the Agreement, some of the solutions have been criticized. For example, with respect to provisions addressed to product exemptions, instead of granting the exemption solely based on the status of purchaser, the Agreement continues to follow the current approach, which depends on the type of products in question.²²⁷

An interesting point of view on the problems of state sales taxation was expressed by Charles E. McLure, Jr., of the Hoover Institution, Stanford University, in his article “SSTP: Out of the Swamp, But Whither? A Plea to Rationalize the States Sales Tax.”²²⁸

McLure tried to create “Elegant Simplicity” in the sale tax structure through implementation the following:

- Exemption of products would solely depend on the status of the purchaser; therefore it would not be required to define products.
- To eliminate the pyramiding problem, all sales to business purchasers would be exempt.

²²⁵ Streamlined Sales and Use Tax Agreement at <http://www.geocities.com/streamlined2000/> (last visited Apr. 9, 2002).

²²⁶ *See id.*

²²⁷ Charles E. McLure, Jr., *SSTP: Out of the Swamp, But Whither? A Plea to Rationalize the States Sales Tax*, *Multistate Tax Commission Review*, Volume 2002 Number 1.

²²⁸ *See id.*

- To treat Main Street businesses equally with online retailers, nexus with a taxing state would depend on the volume of sales in that particular state, but on the physical presence.
- To simplify tax compliance for multi-state vendors, vendors would need to deal with only one tax administration in each state.²²⁹

While the foregoing proposals of McLure sound very promising, their practical workability can be tested only through application in real business environment.

Despite the obvious progress in legislative development and interesting scholarly proposals, the problems posed by e-commerce are far from being adequately addressed. It further reveals that the complexity and lack of uniformity of the current U.S. state tax regimes create formidable problems for state taxation of electronic commerce.

²²⁹ *See id.* at 8.

IV. PROPOSALS TO TAX E-COMMERCE AND INTERNATIONAL COOPERATION

We have discussed above some of the interesting proposals for taxation of electronic commerce made by OECD, European Union. Below we will also consider some proposed solutions to tax electronic commerce that have been subject of discussion by the experts in the field.

A. “Bit Tax”

One of the most controversial solutions to tax electronic commerce was the “bit tax.” Arthur J. Cordell and Thomas Ide initially proposed the “bit tax” in a paper presented at The Club of Rome in December 1994.²³⁰ “The tax would apply to all digital ‘bits’ of information that flow through telecommunications traffic lines that carry interactive digital information. The tax would be applied on the flow volume of bit data, and then collected by telecom carriers, satellite networks, and cable systems, who would send it directly to governments.”²³¹

The proposal elicited many critical comments. The experts have indicated a number of unanswered questions posed by the “bit tax” proposal:

- Which transmission will be subject to tax?
- How will intranet transactions be handled?
- How do you handle redistributions of tax revenues among governments?
- Will educational, governmental or charitable organizations be exempt?

²³⁰ DOERNBERG, *supra* note 13, at 577.

- How will the inherent pyramiding in wholesale/retail transactions be eliminated?
- Which jurisdiction will collect the tax, origination vs. termination? How will double tax be avoided?²³²

It was also pointed out that the “bit tax” “would very likely burden electronic commerce, impeding its growth, eroding its productivity, and discriminating against internet users and providers. Nor does it satisfy the tax policy criteria of neutrality and equity. It is not neutral since it is imposed only on digital (as distinguished from nondigital) transfers. It is not equitable since it taxes consumers without regard to the nature of the message being transmitted – a vital medical report would be taxed in the same manner as unsolicited junk e-mail. Bits and bytes are hardly an expression of economic value or wealth.”²³³

The European Commission²³⁴ rejected the idea of the “bit tax” and it did not find practical support neither in the United States.

B. Trusted Third Parties

The Clinton Administration made a proposal for taxation of electronic commerce which is similar to the traditional VAT scheme.²³⁵ It has been proposed that consumption taxes on e-commerce could be collected through advanced technologies using third-party collecting agents. “Consumers would purchase digital cash cards (also known as “smart cards,” or “e-cards”) at banks that would allow the seller to identify the country the purchase was from. The VAT would be calculated, based upon the place of consumption,

²³¹ Chan, *supra* note 9, at 256.

²³² Jeanne Goulet, *Multi-Jurisdictional Taxation of Electronic Commerce* (Apr. 5, 1997) at <http://meritbbs.unimaas.nl/cybertax/ibm.html#1>.

²³³ DOERNBERG, *supra* note 13, at 578.

²³⁴ *See id.* at 577.

²³⁵ Chan, *supra* note 9.

and immediately collected with the sale. The funds would then be placed by the seller with a third party escrow agent, who would funnel the money to the appropriate government.”²³⁶

The proposed scheme is a tax-neutral and treats equally both conventional and e-commerce transactions.²³⁷ In addition to this advantage, the proposal would allow to preserve the consumers’ privacy.²³⁸

Because of the importance of the role of escrow agents under the proposal, the crucial factor is credibility of escrow agents. In this respect, the experts identify two main questions: “(1) who will be selected to be the escrow agent, and in which country will the agent be located, and (2) how will the agent’s activities be monitored to ensure the accuracy and the integrity of performance?”²³⁹

C. US trend to adopt residence-based Taxation: Potential Unfairness to Developing Countries

As the discussion throughout the thesis shows, it is extremely difficult to determine the source country in the world of cyberspace. Moreover, e-commerce complicates the application of the tax threshold concepts of permanent establishment.²⁴⁰

The U.S. Treasury, in its 1996 report entitled “Selected Tax Policy Implications of Global Electronic Commerce” proposed a shift from source-based taxation to residence-based taxation.²⁴¹ The report explains:

²³⁶ See *id.* at 262.

²³⁷ See *id.*

²³⁸ See *id.*

²³⁹ See *id.* at 265.

²⁴⁰ John K. Sweet, *Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in Era of Eroding Traditional Income Tax Principles*, 146 U. PA. L. REV. 1949, 1993 (1998).

²⁴¹ Selected Tax Policy Implications of Global Electronic Commerce, *supra* note 14.

“In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere. An individual is almost always a citizen or resident of a given country and, at least under U.S. law, all corporations must be established under the laws of a given jurisdiction.”²⁴²

The simple nature of the residence-based approach offers some advantages over the source-based approach. The residence-based taxation will no longer require exercising of the difficult task to identify whether the taxpayer has a permanent establishment or not. Residence-based taxation also meets the requirements of capital-export neutrality where investment decisions are not affected by tax considerations.²⁴³

Along with positive features of the residence-based taxation, there are certain disadvantages this approach. Because of the lack of the information, the residence country will not be able to enforce the tax.²⁴⁴ It allows the taxpayer to escape the taxation and invest in third countries. The growth of electronic commerce opens new possibilities for “capital flight”. Because the source country possesses the relevant information regarding the earned income, some experts indicate that source-based taxation is more suitable to prevent the capital flight problem.²⁴⁵

Yet, there is another significant disadvantage of the residence-based taxation that creates serious doubts about its possible acceptance. It is a commonly shared opinion that

²⁴² *See id.* at 22.

²⁴³ Sweet, *supra* note 235, at 1995.

²⁴⁴ *See id.*

²⁴⁵ *See id.*

the residence-based approach in international taxation will put developing countries in disadvantageous position. Due to capital-import nature of developing countries, change from source-based to residence-based taxation “could have a major impact on the division of taxing revenues between developed and developing nations.”²⁴⁶

It is not surprising that the United States is among countries that actively promote the idea of a shift to residence-based taxation. “In the case of E-commerce, the United States accounts for an estimated 90% of the world’s commercial Web sites (and presumably, therefore, derives a substantial percentage of global revenues from Internet commerce). The United States, therefore, would be the primary beneficiary of a policy endorsing the residence-based taxation of E-commerce transactions.”²⁴⁷

I also believe that adoption of residence-based tax system in electronic commerce would distort fundamental principles of international taxation (*e.g.* the primary right of source-country to tax). This approach could be a serious damage to revenues of developing countries and be a major barrier for their development.

D. Tax Administration and International Cooperation

Unique features of electronic commerce complicate enforcement problems for taxing authorities. Unlike transactions with physical goods, e-commerce of digital goods is hardly be subjected to control and taxation. “Taxpayers may disappear in Cyberspace, reliable records and books may be difficult to obtain, and taxing points and audit trails may become obscure.”²⁴⁸ It is obvious that traditional mechanisms of control and audit are not fully capable to meet all aspects of e-commerce.

²⁴⁶ *See id.*

²⁴⁷ *See id.* at 1997.

²⁴⁸ DOERNBERG, HINNEKENS, HELLERSTEIN & LI, *supra* note 13, at 388.

One of the major problems of tax administrability of e-commerce transactions is determining the taxpayer's identity. "If the identities behind e-commerce transactions cannot be established, they are useless as evidence, even if transaction records and contracts are available to the tax authorities."²⁴⁹

Tax authorities are already facing and will likely to face the problem of gathering the relevant information related to e-commerce transactions. E-commerce is accompanied by corresponding new methods of bookkeeping which are not reliable and can easily be manipulated or even altered.²⁵⁰ Moreover, tax records are commonly encrypted and tax authorities cannot access them without the decryption key. Experts also indicate another challenge caused by the use of electronic cash. Electronic cash does not necessitate the use of financial intermediaries by buyers. Unlike traditional business transactions where financial institutions can furnish tax authorities with an audit trail of the transactions, electronic commerce involving the use of electronic cash does not leave audit trails.²⁵¹

In cross-border transactions, the tax withholding mechanism is important means of tax collection. Agents (financial intermediaries or legal entities-residents of particular country) usually withhold taxes from payments made to foreign entities. The withholding mechanism may not be of use in electronic commerce transactions where digital products are sold through the Internet directly consumers.²⁵² There is no need for an intermediary between sellers and buyers. Most of the consumers, especially individuals, have no understanding of their obligation to withhold the relevant taxes from payments made overseas.

²⁴⁹ *See id.* at 389.

²⁵⁰ *See id.*

²⁵¹ *See id.* at 390.

²⁵² *See id.*

“The Taxation Framework Conditions” - agreed in Ottawa in 1998 – provides some suggestions to improve tax administration in the sphere of electronic commerce:

- Adopting conventional identification practices for businesses engaged in electronic commerce.
- Developing internationally acceptable guidelines on the levels of identification sufficient to allow digital signatures to be considered acceptable evidence of identity in tax matters.
- Developing internationally compatible information requirements, such as acceptance of electronic records, format of records, access to third party information and other access arrangements and period of retention and tax collection arrangements.²⁵³

It is important for tax authorities of different countries to cooperate and assist each other in the process of tax collection. The absence of provisions regarding tax collection assistance between countries leaves significant taxes revenues uncollected. The OECD is trying to make changes to the OECD Model Treaty to include tax collection assistance provisions.²⁵⁴ The OECD has also actively been engaged in developing recommendations regarding tax administration issues of e-commerce taxation.²⁵⁵

²⁵³ Electronic Commerce: Taxation Framework Conditions, *supra* note 2, at 6.

²⁵⁴ DOERNBERG, *supra* note 13, at 388.

²⁵⁵ Report from the Forum on Strategic Management to the Committee on Fiscal Affairs: Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities (Feb. 2001) and Report by the Professional Data Assessment Technical Advisory Group (TAG) (Dec. 2000) at www.oecd.org (last visited Apr. 9, 2002).

V. CONCLUSIONS

The thesis discussed the various aspects of taxation of electronic commerce. We tried to show how the existing tax regulations treat e-commerce transactions. We have seen that there are many questions that do not find answers in the current tax laws. As a result of that, the national governments and sub-national governments continue to lose significant tax revenues. The thesis identified the main reasons that complicate taxation and tax enforcement in electronic commerce.

E-commerce challenges application of traditional taxation rules (*e.g.* permanent establishment rule). It further complicates tax administration and tax enforcement. Apparently, there is no need for financial intermediaries and therefore, traditional taxing and collection points are disappeared.

The experiences of the past years proved that the global nature of electronic commerce requires the global cooperation of all countries. While the work within the framework of OECD is a positive example of cooperation, the nations should further consolidate their efforts to address the issues posed by e-commerce. We believe that the existing cooperation through the OECD should actively involve the non-member states in pending discussions and forums. Participation of developing countries in tax discussions could be a significant factor in the creation of fair tax solutions meeting interests of all countries. “International consensus cannot be achieved merely through some type of EU or OECD or US understanding. Pacific Rim countries, India, Russia, Eastern Europe,

Africa, Latin America and other must participate in reassessment of international tax rules.”²⁵⁶

The current work in finding solutions for e-commerce taxation is mainly built on the adaptation of the existing tax regulations. However, it is not clear if traditional tax laws are fully capable of being a platform for e-commerce regulation. Therefore, it is important to continue the work of finding alternative tax solutions for the new economic realities.²⁵⁷

It is vital for tax administrations of different countries to find consensus on issues of tax enforcement. The absence of mutual assistance between countries will further exacerbate existing problems in tax enforcement. In this respect, it is very important to continue further work with “tax havens” to bring their tax regulations to agreement with existing internationally accepted tax principles.

Nations should also strive to eliminate the potential double taxation problems. It is crucial that tax laws should not become barriers for development of electronic commerce.

It is obvious that electronic commerce is a tremendous factor for future economic progress and has enormous potential to serve the interests of all humanity. However, the realization of many of the positive features of electronic commerce will depend substantially on how it will be taxed in the future.

²⁵⁶ DOERNBERG, HINNEKENS, HELLERSTEIN & LI, *supra* note 13, at 594.

²⁵⁷ *See id.*

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