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# TAXATION OF ELECTRONIC COMMERCE – A COMMENTARY

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## ABSTRACT

*The advent of e-commerce provides a new way of conducting commercial transactions in today's global market. However, despite being considered as an important developmental and trade facilitation tool, the rapid growth of e-commerce has fueled a global debate about the nature of taxation regimes to be used to curb the revenue losses at sub-national, national and international levels emanating from its usage without stifling its development. This revenue loss is particularly worrying to governments which rely heavily on tax revenue as a source of funding their fiscal programs. To provide a better understanding of this critical but complex subject, this paper explores the issues related to e-commerce taxation through a review of relevant extant literature. It analyzes the challenges posed by the growth of e-commerce and makes proposals on how e-commerce can be developed with proper tax regulations by articulating key policy recommendations that will aid/inform the establishment of a sound regulatory framework for e-commerce taxation. The study has important policy recommendations which if implemented, would provide tax administrations with an appropriate and effective response to some of the challenges of electronic commerce.*

**Key Words:** Electronic commerce, taxation, e-taxation, digital disruption, Kenya.

## 1. INTRODUCTION

The extraordinary growth of the internet has given rise to the concept and practice of electronic commerce (e-commerce), which has revolutionized the way business is conducted in the world today (Qin, 2009, p.4). For consumers, e-commerce means shorter shipping times, flexible payment options, relevant products and local language interfaces. It connects local industries and reduces reliance on imports<sup>1</sup>. With e-commerce, enterprises can sell their products or services worldwide with very limited physical presence in any particular consumer's country and can operate without agents because they can directly, easily, and cheaply contact customers worldwide (Gałuszka, 2011, p.195). Because e-commerce exists in a borderless virtual world, political contestation and power. Professionals such as lawyers are trained in specialised knowledge and skills, that they generally deploy on behalf of their clients. However, in my view they also have wider this makes it impossible to effectively determine the buyers and sellers' locations<sup>2</sup> for purposes of taxation. Governments are thus losing millions in tax revenue owing to increased e-commerce usage within their jurisdictions, and their tax authorities are finding it more and

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<sup>1</sup> Global Business Coalition (March 2019). 'UNCTAD: New policy brief launched ahead of global eCommerce Week 2019', Available at <http://www.globalbusinesscoalition.org/global-governance-news/unctad-new-policy-brief-launched-ahead-of-global-ecommerce-week-2019/>

<sup>2</sup> Historically goods were physical, the production, distribution and consumption of these goods was easily traceable and therefore easily taxable. Tax collection was in the hands of the retailers who would charge the consumer VAT or sales tax and then remits this to the taxing authorities. However, global e-commerce makes the cross-border movements in goods, capital and labor less transparent allowing companies and individuals to exploit tax differences between countries, or even to evade taxation at all (Jones & Basu, 2002).

more difficult to stop this erosion (Basu, 2008, p. 2). This revenue loss, occasioned by the expanded use of e-commerce, has fueled debate on the need to come up with feasible ways of taxing e-commerce transactions so as to curb tax avoidance.

Consequently, lawmakers in various jurisdictions are reviewing tax policies relating to e-commerce to determine how such policies may impede or facilitate economic objectives. However, taxation itself is a complex and controversial issue and it should not come as a surprise that there are conflicting arguments and disputes in various jurisdictions regarding taxation of e-commerce transactions<sup>3</sup>. Given its potential for growth and the uncertainty surrounding appropriate principles to guide internationally consistent taxation approach to electronic commerce coupled by the desire by governments to maintain the principal source of government revenue (Cockfield, 2006, p.140), the tax treatment of e-commerce is generating considerable debate<sup>4</sup> at sub-national, national and international levels (Jones & Basu, 2002, p.36).

This paper therefore seeks to provide a better understanding of the key taxation issues relating to e-commerce by critically reviewing relevant extant literature on the area and subsequently synthesizing the information into a high-level discussion paper, thereby contributing to the body of knowledge on e-commerce taxation. It starts by providing a background on the evolution of e-commerce, before assessing its nature. It then examines the various principles that guide e-commerce taxation. This is followed by an assessment of the challenges posed by e-commerce taxation. It then concludes by making policy recommendations of significant import.

## **2. EVOLUTION OF E-COMMERCE**

Although the general public has become familiar with e-commerce only in the last decade or so, e-commerce has actually been around for over 30 years (Tian & Stewart, 2008, p.1). E-commerce was made possible by the development of electronic data interchange (EDI) in the 1960s for the exchange of business documents from one computer to another in a standard format. (Tian & Stewart, 2008, p.2). This first generation of e-commerce, or EDI, allowed companies to securely and efficiently exchange information, place orders, and conduct electronic funds transfer through computers (Sawanibi, 2001). The advent of the Internet in the middle and late 1990s ushered in the second era of e-commerce

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<sup>3</sup> Basu, 2008, *International taxation of e-commerce: persistent problems and possible developments*, p. 2.

<sup>4</sup> Einav et al., 2014. *Sales Taxes and Internet Commerce*.

characterized by the transaction of goods and services through the Internet, (Tian & Stewart, 2008, p.2). As the e-commerce market for providing services over the internet continues to grow, a number of online companies have emerged to serve the growing needs of internet users. They include Dell, Amazon, Yahoo, Baidu, Sina and Ebay amongst others (Qin, 2009, p.6).

The total value of global e-commerce transactions, both domestic and cross-border, was US\$ 25 trillion in 2015, up 56 per cent from US\$ 16 trillion in 2013 (UNCTAD, 2017). Current estimates indicate that global e-commerce sales grew 13% in 2017, totaling around 29 trillion dollars. The number of online shoppers has registered a similar increase with the share of those buying from abroad rising from 15% in 2015 to 21% in 2017<sup>5</sup>.

While projections regarding its future growth vary, most analysts expect that both the volume and value of international e-commerce will continue to expand for the remainder of this decade and beyond, probably outpacing growth in the “traditional” economy. Such growth has many governments worried that they are not adequately prepared to effectively tax e-commerce. Developing economies in particular are weakly positioned to extract taxes from non-resident e-commerce businesses, leaving them with fewer domestic resources at their disposal for development (Global Business Coalition, 2019).

## **2.1. Nature of e-commerce**

The fact that e-commerce is carried out almost exclusively via the internet makes it different from conventional commercial activities (Siliafis, 2008, p. 143). We therefore need to clarify what e-commerce is, and what it entails. While e-commerce has been defined in various ways<sup>6</sup>, one of the widely accepted definitions is by the Organization for Economic Corporation and Development (OECD), which defines e-commerce as ‘the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders’. Under this definition, ‘the goods or services are ordered electronically, but the payment and the ultimate delivery of the goods or services do not have to be conducted online’<sup>7</sup>.

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<sup>5</sup> Remarks by DG Azevêdo, Director-General World Trade Organization. Entire speech Available at [https://www.wto.org/english/news\\_e/spra\\_e/spra260\\_e.htm](https://www.wto.org/english/news_e/spra_e/spra260_e.htm)

<sup>6</sup> Much of the debate on definitions is concerned with quantification – what transactions to include or not to include. This gives rise to broad and narrow definitions, distinguished by whether they focus solely on Internet-generated transactions, or include computer networks more generally (Humphrey, Mansell, Paré & Schmitz; 2003).

<sup>7</sup> Organization for Economic Corporation and Development. Electronic and Mobile Commerce, OECD Digital Economy Papers, No. 228, 2013, Paris: OECD Publishing, Paris. <http://dx.doi.org/10.1787/5k437p2gxw6g-en>.

Broadly, e-commerce can also be divided into domestic and cross-border e-commerce<sup>8</sup>. Still, e-commerce transactions can be further classified into various categories based upon the entities involved in a transaction. They include business-to-business (B2B), business-to-consumer (B2C), consumer-to-business (C2B), consumer-to-consumer (C2C) and business-to-government (B2G) e-commerce (Bhasker, 2009). In addition to these categories, we have newer forms subsumed within the definition of e-commerce such as mobile commerce (m-commerce) and social commerce (s-commerce). We can additionally distinguish between three types of e-commerce: ecommerce in tangible products, ecommerce in intangible products and e-commerce in services<sup>9</sup>.

## **2.2. Principles of e-commerce taxation**

Taxation refers to the compulsive or coercive money collection by a levying authority, usually a government and applies to all involuntary levies, from income, to capital gains to estate tax (Teixeira & Paiva, 2018, p. 90). Taxation makes up a major source of government revenue in most countries (Jones & Basu, 2002, p.36) and constitutes a key part of the state and nation building (Azam, 2007, p.20). Ideally, a well-functioning tax system should be able to raise enough revenue for essential government services while allowing for normal economic activity to take place within the confines of international tax treaties and agreements (Jones and Basu, 2002, p.35).

Taxation of e-commerce is a broad topic of tax policy<sup>10</sup> with diverse opinions on how e-commerce relates with traditional principles of taxation i.e. the source rules and the permanent-establishment rule. The most dominant principle in international taxation is the “source based” taxation, or territorial jurisdiction, whereby “the country with the primary right to tax the profits of an enterprise is the country in which the enterprise earns the income”<sup>11</sup>. The second basis for tax jurisdiction is permanent establishment or residence, according to which the enterprise’s country of residence or permanent establishment has primary taxing jurisdiction over the income generated (Forst, 1999, p.712).

As pointed out by Li (2000), e-commerce ‘directly challenges these existing tax principles that were by large conceived in an era that could not have foreseen the technological advances of the present’. As most countries tax systems link commercial activities to a particular area, e-commerce challenges

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<sup>8</sup> Mwencha, 2016 E-Commerce Sub-Sector Assessment Report for Kenya, p.11.

<sup>9</sup> D. Johnson, D. Post: Law and Borders – The Rise of Law in Cyberspace. 48 STAN L. REV. 1996, 1367, 1370-76

<sup>10</sup> The scope of e-commerce taxation is very broad, extending to issues such as income taxation, sales and use taxes, value-added taxes, internet access, and other telecommunications taxes and fees (Ward & Sipior, 2004).

<sup>11</sup> The justification for source taxation is that the source country has contributed infrastructure and other facilities in the income production process (Azam, 2007, p.6).

this assumption as it is inherently non-territorial (p.162). By ignoring the basic territorial connections that form the basic premise of these rules, the logic and concepts of the rules lose their relevance in the e-commerce sphere (Azam, 2007, p. 30).

As a result, there has been no shortage of discussion on the challenges related to the taxing of e-commerce. The issue has attracted the attention of international organisations such as the OECD, the Financial Action Task Force, the United Nations Conference on Trade and Development (UNCTAD) as well as at the national levels in the respective jurisdictions (Low, Kabasunakatuba and Sharma, 2013, p. 6).

In order to address these e-commerce tax challenges, the OECD has taken the lead role in establishing the guiding principles and tax rules to govern the tax treatment of international e-commerce transactions (Cockfield, 2006, p.139). Under the auspices of the OECD, member countries through their tax authorities came up with the Ottawa Taxation Framework in which a consensus was arrived at that the conventional taxation principles (neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility) should also be applied to the taxation of e-commerce (OECD, 2001, p. 5). These widely accepted general tax principles that should apply to electronic commerce are summarized in Table 1<sup>12</sup>.

**Table 1: Ottawa taxation framework conditions – principles of e-commerce taxation**

Type of Principle	Description
1. Neutrality	Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
2. Efficiency	Compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.
3. Certainty and Simplicity	The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.
4. Effectiveness and Fairness	Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counteracting measures proportionate to the risks involved.
5. Flexibility	The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments

Source: OECD, (2001)

<sup>12</sup> In addition to these well-recognised principles, equity is an important consideration for the design of tax policy (OECD, 2014, p.30).

These principles may conflict and governments and businesses may have different views on the balance and priority of their application in particular contexts<sup>13</sup>. That said, the application of these principles to e-commerce should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double and unintentional non-taxation. (OECD, 2001, p. 5). The challenge facing Revenue authorities is how to implement the broad taxation principles in a rapidly changing environment (OECD, 1998, p.5).

### **3. CHALLENGES TO E-COMMERCE TAXATION**

Despite its obvious advantages, e-commerce poses various challenges to existing tax systems<sup>14</sup> at sub-national, national and international levels<sup>15</sup>. These challenges have been well documented<sup>16</sup> and include how to identify taxpayers engaged in e-commerce and determine their taxing jurisdiction; how to ensure that appropriate records are created of business conducted by e-commerce; and how to collect taxes in the e-commerce environment (Jones & Basu, 2002). This section examines the taxation challenges and presents the current responses by various bodies.

#### **3.1. Identification of taxpayers**

One of the biggest challenges that e-commerce presents to tax regimes is that it leads to disintermediation<sup>17</sup>, or the elimination of intermediaries or middlemen who are critical for identifying taxpayers in business transactions<sup>18</sup>. This may lead to loss of taxation, complication of tax administration as well as weakening of tax declaration (Qin, 2010, p 214). One of the proposed solutions to this problem includes confirming jurisdiction according to international common understanding and bilateral taxation pacts. Alternatively, the stakeholders could co-develop software or equipment to deal with withholding taxation and other declarations<sup>19</sup>. However, de Sousa (2014) warns that ‘making the virtual stores to collect taxes on behalf

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<sup>13</sup> A study by Maguire (2013) identified four major economic issues related to state taxation of internet transactions in the United States: efficiency, equity, differential effect among states and revenue loss estimates.

<sup>14</sup> Ronald Paris, “The globalisation of Taxation? Electronic Commerce and the transformation of the State” *International Studies Quarterly*, 2003 47, 154.

<sup>15</sup> Jolanta Gałuszka, 2011. How to tax e-commerce - global or national problem? pp.193-202.

<sup>16</sup> OECD Discussion Paper, ‘Electronic commerce: a discussion paper on taxation issues’ 19 September 1998, [www.oecd.org](http://www.oecd.org).

<sup>17</sup> According to Frost (1999), ‘an international example of disintermediation is a U.K. person purchasing a book from an Amazon.com website or an airline ticket from a Travelocity website rather than from a local bookseller or a local travel agent. In both cases, the U.K. middleman is cut out, and the U.K. loses tax revenue. However, whether disintermediation will result in a material reallocation of the world’s tax revenue is still unclear’ (p.715).

<sup>18</sup> Jones & Basu, 2002.

<sup>19</sup> Qin, 2010, p 214.

of the destination State would substantially increase the costs of compliance and thereby impede the continued growth of electronic trade'(p.18).

### **3.2. Record keeping**

Another challenge identified by Jones and Basu (2002) is how to ensure that appropriate records are created during e-commerce transactions given the digital nature of e-commerce transactions which are hard to trace. These electronic transactions create enormous problems for tax authorities in establishing audit trails, in verifying parties to transactions, in obtaining documentation, and in fixing convenient taxing points<sup>20</sup>. Nonetheless, electronic records and documents must be investigated and verified to minimize tax evasion (Qin, 2010, p 214). Therefore, businesses involved in online sales and which receive orders electronically and issue electronic invoices should ensure that for every transaction, a receipt is issued and recorded and an audit trail of these can be followed with ease for purposes of collecting tax revenue.

### **3.3. Means of tax collection**

How to ensure effective collection of taxes in the e-commerce environment is the third challenge identified by Jones & Basu (2002). For one, e-commerce increases the number of low-value shipments of physical goods which are exempted from customs duties and taxes in many countries as they fall under the de minimis rule. Additionally, it leads to discrepancies whereby foreign suppliers may be tax-exempt, whereas local suppliers would be required to charge value added tax (VAT) or sales taxes (p.37). To address these tax collection challenges, there are two alternative proposals proposed for direct international taxation of e-commerce transactions. The most feasible proposal is that of tax being withheld at source by financial intermediaries. This method of taxation entails the financial institutions' collaboration with different states. These institutions would have to keep an up-to-date database with the tax rates of each country to be applied in the different operations. An alternative proposal is based on technological solutions whereby consumption taxes on e-commerce are collected through advanced technologies using third-party collecting agents. This system defends having software that, at the time of purchase, would apply the appropriate rate of tax depending on the destination country. This method would give the tax authorities the ability to detect and tax operations in a timely manner (Teixeira & Paiva, 2018, p. 87).

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<sup>20</sup> Owens (1997) 'The Tax Man Cometh to Cyberspace', paper presented at the Harvard Law School International Tax Program Symposium on Multi-Jurisdictional Taxation of Electronic Commerce, April 5, 1997, p10.

## **4. CONCLUSION**

While e-commerce presents a tremendous opportunity for business and employment generation, it poses significant challenges to existing tax law and regulatory mechanisms due to the inherently non-territorial nature of its digital transactions which are hard to trace and could potentially lead to tax revenue losses at sub-national, national and international levels. This revenue loss is particularly worrying to governments which rely heavily on tax revenue as a source of funding for their fiscal programs. To address these issues, various policy interventions have been proposed and while some broad consensus has been reached on how to treat international e-commerce transactions, efficient taxation of e-commerce remains a challenge .

Consequently, the main purpose of this study was to critically explore the issues related to e-commerce taxation in order to provide a better understanding of this critical but complex subject. Through a review of extant literature, the study identified and discussed three key challenges that e-commerce usage poses to tax systems in various jurisdictions. The first challenge was the identification of taxpayers, the second one was record-keeping while the third was the means of tax collection. Despite these challenges, the literature reveals that e-commerce will increasingly be taxed just like conventional commerce due to the potential revenue derivable. Therefore, it will be up to governments to come up with innovative and feasible tax mechanisms which will allow for consumers and businesses alike to easily comply with their duties as taxpayers without impeding normal economic activity.

Drawing from the literature review, this study makes three policy recommendations which could provide tax administrations with an appropriate and effective response to some of the challenges of electronic commerce.

### **4.1. Need for tax policy reforms**

There is growing realisation and acceptance that without appropriate policy interventions, the tax base erosion that has been underway for many years is expected to persist as e-commerce usage continues expanding across the globe. Policy makers will therefore be forced to rethink their tax policies in order to come up with a feasible way of taxing e-commerce activities at local/state, national and international level without stifling its progress. A good example is the Marketplace Fairness Act, a proposed legislation pending in the United States Congress which if enacted would enable state governments to collect



sales taxes and use taxes from remote retailers with no physical presence in their state under specific conditions<sup>21</sup>.

#### 4.2. Better information sharing with stakeholders

Better information sharing between revenue authorities as well as with taxpayers through electronic service delivery will lead to better coordinated services and increased operational efficiency. As recommended under the Ottawa Taxation Framework Conditions, revenue authorities should consider developing websites/portals where information, such as tax legislation, rulings, case law, revenue statistics, frequently asked questions and forms can be viewed and downloaded. Such portals could also be supplemented by the development of an official guide on e-commerce taxation.

#### 4.3. Cross-border collaboration

Until now, national governments have designed and administered their tax policies in near-isolation from one another in line with state fiscal sovereignty. However, with the spread of e-commerce, it is vital for tax administrations of different countries to work together to facilitate the exchange of practices and knowledge between administrations to find consensus on issues of tax enforcement for their mutual benefit. As a first step towards harmonizing tax systems, countries can negotiate bilateral tax treaties to govern the tax treatment of cross-border e-commerce transactions, even as they work to bring their tax regulations to agreement with existing internationally accepted tax principles.

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<sup>21</sup> <https://www.congress.gov/bill/115th-congress/senate-bill/976>

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