AMERICAN UNIVERSITY OF ARMENIA

E-COMMERCE: ISSUES OF TAX ADMINISTRATION AND PROSPECTS TO INCREASE PUBLIC REVENUES

A MASTER'S ESSAY SUBMITTED TO THE FACULTY OF THE GRADUATE SCHOOL OF POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS FOR PARTIAL FULFILMENT OF THE DEGREE OF MASTER OF ARTS

BY

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LIST OF ABBREVIATIONS

OECD – Organization for Economic Development and Cooperation

EU – European Union

ITFA – Internet Tax Freedom Act

TAG – Technical Advisory Group

VAT – Value Added Tax

WTO – World Trade Organization

ABSTRACT

This essay discusses main problems that tax authorities in many countries face in addressing the process of taxation of electronic commerce. It analyzes examples of problems posed by the growth of e-commerce in the context of international direct and indirect taxation. Current international policy issues are subject of discussion in this the essay. The essay also analyzes e-commerce sector of Armenia and makes some recommendations regarding development and taxation of electronic commerce.

Introduction

The electronic commerce (throughout this paper, the terms "electronic commerce" and "e-commerce" are used interchangeably) develops rapidly and brings challenges for the tax administration in effect. It is quite hard to obtain the full tax information from the parties involved in e-commerce, using the conventional practices of tax administration. Openness is the most outstanding feature of the e-commerce. It is a network, which people can get into without a name. Neither side engaged in the economic activities needs to appear at the transaction place.

The development of e-commerce has weakened the connection between economic activities and physical locations. For this reason it challenges to the traditional mode of tax administration and generation of public revenues.

Next, if a country's right of collecting tax can't get fully protected, then the country's sovereignty can't get fully embodied, either. At the same time, electronic business makes the trend of globalization even more obvious. How to capture the flow of revenues possibly generated within the boundaries of the country and therefore correctly and fully protect the interests of a country's fiscal sovereignty obviously remain problems that need solution. If these problems can't be handled very well, contradiction in international trade will take place.

The non-traceable and 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."[1]

This masters' essay is an attempt to examine the most prominent national and international efforts undertaken to regulate e-commerce, as well as current state and recent developments in the legal and policy issues related to taxation of e-commerce worldwide. Special attention will be given to the current state of e-commerce in Armenia and issues of taxation within the existing legal framework.

[1] Mentioned in a letter from Benjamin Franklin to Jean-Baptiste (1789)

Research Questions and Hypothesis

The following research questions have been addressed in this study.

Research Question 1

Which governmental entity[2] shall have the authority to tax a transaction that spans several jurisdictions?

Research Question 2

How to avoid either double-taxation or tax evasion for entities doing e-commerce?

Research Question 3

Is there a need to treat e-commerce specially or the existing taxation practices and schemes are applicable to this type of business?

Research Question 4

What is the current legal arrangement/framework that regulates e-commerce activity in the US and EU? Is there a similar legislation in Armenia?

Research Question 5

What steps have been taken by different international organizations or forums to systematize/standardize/regulate e-commerce for different geographical regions of the world?

Research Question 6

What technical features of network systems are likely to have significant impact on the operations of tax systems? (The lack of any central control and registration; the difficulty of tracing transactions; the weak correspondence between a domain name and the actual location).

[2] Both within the same country and between countries. US inter-state commerce, US-EU transactions, for example.

Research Question 7

What scheme of taxation is currently applied to e-commerce activities in Armenia?

The following hypothesis describes the main idea behind this research.

Hypothesis

Rapidly growing electronic commerce activities are important additional source of public revenues and at the same time a serious challenge to traditional methods of tax administration.

Methodology

This research mainly used content analysis methodology, which allowed reviewing related legal and scholarly documents and articles existing in the international setting. Comparative analysis was employed to review and compare legal environment and regulatory practices existing in different countries.

In order to understand the current state of the development of e-commerce in Armenia and explore the existing regulations governing the field as well as the level of participation of Armenia in international developments (discussed in the first part of this paper), in-depth interviews with Armenian government officials and e-commerce companies have been conducted. In addition, participation in "ICT for SME Development" Round Table offered an opportunity to get the latest statistical information about the field and get acquainted with the opinions of experts from the regions of Armenia.

Taking into consideration the explorative nature of the research, purposive sampling method has been used for the selection of interviewees. Purposive sampling offers an opportunity to pay more attention to those governmental agencies and e-commerce activities that could best represent and describe current state and trends of e-commerce regulation in Armenia and will help to reveal the existing issues and prospects for improving overall functioning of the sector.

The following list represents the final selection of interviewees:

1. *Vakhtang Mirumyan*, Ministry of Finance, Head of State Revenues Policy Department
2. *Garegin Chugaszyan*, Executive Director, IT Foundation
3. *Aram Hajyan* (www.madeinarmeniadirect.com)
4. *Gevorg Poghosyan*, Director, E-DRAM

Two different questionnaires have been designed for e-commerce business companies and government/NGO representatives.

Questionnaire 1 (E-business)

1. What tax scheme is applied (if any) to your e-commerce activities?
2. On your opinion, how does current tax legislation impact e-commerce in general and your business in particular?
3. Is there a need to officially register your e-commerce activity?
4. Where is your Web-site, server located? Are there any incentives to maintain it in a particular country/jurisdiction?
5. Is there a need to treat e-commerce specially or the existing taxation practices and schemes are applicable to this type of business?
6. What scheme of taxation is currently applied to e-commerce activities in Armenia?

Questionnaire 2 (government officials)

1. What are the dynamics of e-commerce activity in Armenia? (rapidly growing, stagnant)? Was there any research done?
2. Are electronic commerce activities considered as important additional source of public revenues in Armenia?
3. Is there a need to officially register e-commerce activity?
4. Is there a need to treat e-commerce specially or the existing taxation practices and schemes are applicable to this type of business?
5. What scheme of taxation is currently applied to e-commerce activities in Armenia?
6. Did Armenia participate to any international agreement or policy document regarding regulation of E-Commerce? Is there a similar legislation in Armenia?

What is 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." (US Treasury Report 1996, note 35)

Electronic commerce is a rapidly growing channel for both wholesale and retail trade. In these days it is hard to find goods or services that also are not offered on the web. The relatively low cost of conducting electronic commerce enables even small firms to access the global markets. Some of the commercial activities that are conducted through electronic commerce include retailing and wholesaling, sale of computer software, photographs, online information, services, health care, telecommunication, videoconferencing, gambling, stock trading, offshore banking and incorporation. E-commerce can be classified into following four subgroups.

1. Sales of Goods

Sales over the Internet are becoming a predominant force in the global commercial activity.

"Retail sales of tangible products are the easiest type of activity to move to the Internet. Traditional mail-order companies have found the Internet to become 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." (Hardesty 1999, 3)

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 the order on this kind of web sites can be placed twenty-four hours a day.

> "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." (Cockfield 2001, 1183)

Many online auctions and classified 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." (Hardesty 1999, 4) For example, you can order online preparation of a report on stock performance of a company that you want to invest in.

More and more law firms receive questions from their clients by e-mail and send their advice in the form of electronic files. Customers from US wishing to invest in France explore France's business regulations through online advice received from French law firms.

"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 vice versa." (Hardesty 1999, 4) Health care is also a service provided over the Internet, which may get larger in the future (Hardesty 1999).

Many financial institutions offer online financial services. Most banks in the U.S. and Europe offer online banking to their clients. 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 physically be in that country.

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. 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.” (Hardesty 1999, 14) For example, for Yahoo!, a leading global Internet communications, commerce, and media company advertising is almost the only source of revenues.

Gambling also has moved onto the Internet. While gambling is considered illegal in certain parts of the Unites States, Internet gambling Web sites operated from offshore are accessible anywhere from within the United States. Internet gambling is profitable for the operators, because there are no costs besides the cost of the Web site and the transaction processing (Hardesty 1999). In the future, as bandwidth increases, video conferencing may reduce the amount of air travel required by executives and sales people (Hardesty 1999).

4. Payment Systems

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.” (Doernberg 2001, 56)

Major problems in the development of electronic payment systems remain privacy and security issues. Moreover, 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 (US Treasury Report 1996).

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." (Cockfield 2001, 1222)

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 (OECD Report on Harmful Tax Competition 1998). The report indicates the tax havens and harmful preferential tax regimes as main elements of the harmful tax competition.

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." (Townsend 2001, 251)

International Taxation of E-Commerce

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 challenging 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." (Hardesty 1999, 164)

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:
• 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." (US Treasury Report 1996, note 35)

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. 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" (US Treasury Report 1996, note 14) 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." (Maguire 2000, 2)

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. (OECD Report on E-Commerce Taxation Framework Conditions 1998) It provides the principles which should guide governments in their approach to e-commerce and states that e-commerce should be treated in a similar way to traditional commerce and emphasizes the need to avoid any discriminatory treatment.

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". (Publication of Report and Technical Papers, at http://www.oecd.org)

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 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 (ITFA). The Act declared the Internet tariff-free zone and established three-year moratorium on Internet taxation.

The ITFA did not prevent local sales taxes from being collected by states, but did prevent multiple or discriminatory taxes on electronic commerce by defining such fees as taxes on “interstate commerce.” (http://cox.house.gov/nettax/) Contrary to popular belief, ITFA does not exempt sales made on the Internet as they will be taxed at the same rate as non-Internet sales just like mail order sales. The Act did not renounce any state sales or use tax but rather prohibits new and discriminatory taxes on the Internet.

ITFA has been twice extended by the US Congress since its original enactment, and is currently scheduled to expire in November 2007. The most recent extension signed into law on December 3, 2004, by President George W. Bush was titled the Internet Tax Nondiscrimination Act.

During the Internet tax moratorium, under the ITFA’s definition of discriminatory tax, products or services delivered uniquely over the Internet, with no tangible counterpart, may not be taxed by state or local governments (Weiss & Noto 2005).

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 electronic transmissions.” (WTO Declaration on Global Electronic Commerce 1998)

“While large number of (mainly developed) countries prefers to extend the moratorium, some developing countries have expressed concern about potential revenue losses resulting from border tariffs.” (UN E-Commerce and Development Report 2001)

A 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." (http://www.ntanet.org) The Appeal also states that "electronic commerce should not be permanently treated differently from other commerce."

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 (Hardesty 1999). 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 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 treats similar income equally, regardless of whether it is earned through electronic means or through existing channels of commerce." (US Treasury Report 1996, note 14)

A second guiding principle of taxation is tax equity. Tax equity usually means that similarly situated taxpayers should be taxed the same (Hardesty 1999).

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 (Hardesty 1999).

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 (Hardesty 1999).

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." (OECD Report on E-Commerce Taxation Framework Conditions 1998, 4)

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 Capital (OECD 1960) - 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 essay.

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". (OECD 1960, Article 4) 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.

Article 4(2) of the Model Convention also 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." (OECD 1960, Article 4) Article 4 of the Model Convention does not give the definition of the place of effective 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. For example, it may be difficult to determine a place of effective management if conferencing through the Internet is used as a key medium for communicating decisions between the managers located worldwide. In such cases, it may be impossible to consider any particular location being the one place of effective management (OECD Discussion Paper on the Communications Revolution and the Application of "Place of Effective Management" as a Tie-Breaker Rule 2001).

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 a 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." (Hardesty 1999, 164)

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.

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 CFA believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles." (OECD Report on E-Commerce Taxation Framework Conditions 1998, 3)

In order to implement The Taxation Framework Conditions, the group of OECD experts has developed Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention[3] on Article 5 (OECD, December 2000). 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

[3] hereinafter "Proposal"

data and software which is used by, or stored on, that equipment." (OECD Changes to the Commentary 2000, 5)

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." (OECD Changes to the Commentary 2000, 5) 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." (OECD Changes to the Commentary 2000, 5) It would be irrelevant whether the server is owned or rented from third party[4].

Further the OECD Proposal provides that servers may create a permanent establishment even though no human intervention is required. The Proposal explains: "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." (OECD Changes to the Commentary 2000, 5)

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 (OECD Changes to the Commentary 2000, 5).

[4] 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."

However, if these “functions form in themselves an essential and significant part of the business activity of the 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 (OECD Changes to the Commentary 2000, 5).

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. (OECD 1960, note 64).

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. 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.” (OECD Changes to the Commentary 2000, 5)

As noted above, the OECD Proposal considers the existence of a permanent establishment through the location of a server at a fixed place.

Article 7(1) provides that a source country can tax only profits attributable to a permanent establishment. Some experts point out that 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.” (Cockfield 2001, 1195) It will be possible, mainly due to the possibility of remote control of servers.

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.” (Hardesty 1999, 16) Traditional income characterization rules applicable to conventional commerce are ignorant with regard to e-commerce.

Some countries have attempted to adopt regulations concerning income characterization (Hardesty 1999). 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 Commentary”. (OECD Commentaries, 2001, Article 5) 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.

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 the right to use of, or the right to use, a copyright.” (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001) 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.” (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001) 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.

However, where the consideration for the payment is for granting of the right to use a copyright in digital product, it will constitute royalties (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001). The Report also 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." (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001, 13)

"If, however, the customer acquires a valuable report, other property that was not created specifically for that customer, then the transaction could give rise to income from the sale or property". (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001, 14)

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 (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001). 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, payment for using data retrieval services, web advertising services, payments received for professional advice, information delivery, using online shopping portals, participation in an online auctions, etc. should be characterized as business profits under Article 7 of the OECD Model Tax Convention (OECD Report on E-Commerce Tax Treaty Characterization Issues 2001).

Consumption Taxes and Electronic Commerce

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)". (Maguire 2000, 2) "In the United States, the sales and use taxes imposed by 45 states yield 32.5 percent of total state tax revenues." (Doernberg 2001, 99)

Application of VAT to E-Commerce Transactions (EU Proposal)

Prior to July 1, 2003, EU e-commerce transactions, including goods and services delivered in both tangible and digital form, were taxed under the EC (European Community) Sixth VAT Directive (Directive 77/388/EEC). The VAT was collected from EU companies on all sales, including exports to customers outside of Europe.

This contrasted the treatment of other exports, for which the VAT was rebated. For EU companies, no distinction was made between physically and digitally delivered goods. In contrast, non-EU companies were taxed on imports of tangible goods and services but not taxed on imports electronically delivered into Europe (Weiss & Noto 2005). On June 8, 2000, the European Commission made a proposal for a directive regarding the application of VAT to digital products ordered on-line. (Westin 2000)

On July 1, 2003, the European Union (EU) began requiring U.S. and other firms located outside the EU to pay value added tax (VAT) on the sale of goods and services digitally delivered to individual consumers in EU countries. The VAT on E-Commerce Directive (2002/38/EC, May 7, 2002) amended earlier EU tax legislation, changing the rules for VAT collection on digitally delivered products. EU firms are no longer required to pay tax on exports from the EU.

Non-EU firms are now required to pay a tax on their sales to individual consumers within the EU (imports into the EU). EU firms pay the single VAT rate for the country where they are located. (As described below, these changes conform with the tax treatment of digital commerce to that of other goods and services.) If a non-EU firm establishes a subsidiary in an EU country, it can follow the tax rules for EU companies and pay a single rate. Otherwise, non-EU firms are required to register in one EU country and pay the VAT on each sale at the tax rate in the customer's home EU country.

Thus, non-EU companies must collect potentially up to 25 separate VAT rates, corresponding to the 25 member countries of the EU. 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 (Weiss & Noto 2005).

The main consequence of the directive is the elimination of unfair treatment of EU e-businesses compared to their foreign competitors. Former rules levied VAT on EU suppliers of digital products while non-EU operators in countries were not imposing VAT on such sales are free of the tax. Another important effect of the proposal is the application of VAT to electronic services where they are consumed.

Interestingly enough, the EU 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 (OECD Report on E-Commerce Taxation Framework Conditions 1998).

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” (Doernberg 2001, 438). In addition, experts express concerns about the enforceability of the new system (Doernberg 2001).

US State and Local Sales Tax

There is no national consumption tax in the United States. However, 45 of the 50 states and District of Columbia and many local jurisdictions impose retail sales taxes (Doernberg 2001). “The sales tax is the second leading source of state tax revenue.” (Doernberg 2001, 151)

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

According to the Census Bureau, U.S. consumer purchases through e-commerce topped $109 billion in 2006, up from $88 billion the year before. With few exceptions, these transactions did not include sales taxes. Assuming an average 8 percent sales tax, the states collectively lost $8.7 billion in 2006. And according to one recent study, by 2011 the growth of e-commerce will cause local and state governments to lose as much as $54 billion annually from untaxed purchases. These figures explain the states' concerns regarding taxation of electronic commerce.

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** (Hellerstein, 1998).

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. 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 (Doernberg 2001).

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 Process*[5] and *Commerce Clause*[6]. For some time these constitutional requirements were considered the same. However, in *Quill Corp. v. North Dakota (1992),* 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.

[5] 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.
[6] 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.

Although, the Court in *Quill* found that the due process “nexus” requirement was satisfied without physical presence, it clearly stated that 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.” (Quill Corp. v. North Dakota, 504 U.S. 298 (1992))

Despite the fact that *Quill* was dealing with taxation of out-of-state mail-order vendor, the approach taken by the Supreme Court can also be a guide 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.

Based on aforementioned, it becomes clear that why purchases from Amazon.com, the largest online retailer, are typically sales-tax free. As an Internet retailer, Amazon does not have a physical presence in most states. However, purchased items that are shipped to Kansas, North Dakota and Washington are subject to state sales and use taxes. These three states are special because Amazon has a “substantial nexus” in each of them. Amazon’s computer servers are physically located in Seattle, Washington, and Amazon has fulfillment centers in both North Dakota and Kansas (Amazon Austin Business Journal 2005).

Pyramiding

Theoretically, a retail sales tax is imposed on final consumption 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 taxation. This 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." (Hellerstein 2000, 697)

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. Some states impose sale and use taxes to electronically delivered software, others do not." (Hellerstein 2000, 699)

Streamlined Sales Tax Project

One of the significant projects to address the problems of the sales taxation of electronic commerce is the Streamlined Sales Tax Project (SSTP). SSTP is a project undertaken by 42 states to develop measures to implement a sales and use tax system that simplifies sales and use taxes for all out-of-state commerce, including Internet transactions. The SSTP is specifically designed to combat the argument that collecting online taxes would impede interstate commerce.

Thus, the main goal of the SSTP is to promote passage of a federal law that would allow sales tax to be uniformly collected in all domestic Internet transactions requiring out-of-state companies to collect sales tax (Menhart 2007, 8).

Interesting Proposals for E-Commerce Taxation

In addition to aforementioned proposals for taxation of electronic commerce made by OECD, European Union, below are consider some proposed solutions to tax electronic commerce that have been subject of discussion by the experts in the field.

"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 (Doernberg 2001).

"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." (Chan 2000, 256)

The proposal elicited many critical comments. It was pointed out that the "bit tax" "would very likely burden electronic commerce and impede its growth. It is not neutral since it is imposed only on digital (as distinguished from non-digital) transfers. It is not equitable since it taxes consumers without regard to content of the message. It was asserted that "bits and bytes are hardly an expression of economic value or wealth." (Goulet, 1997)

Finally, the European Commission rejected the idea of the "bit tax" and it did not find practical support neither in the United States (Doernberg 2001).

Trusted Third Parties (TTP)

The Clinton Administration made a proposal for taxation of electronic commerce which is similar to the traditional VAT scheme (Chan 2000). It has been proposed that consumption taxes on e-commerce could be collected through advanced technologies using third-party 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, 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." (Chan 2000, 262)

The proposed scheme is a tax-neutral and treats equally both conventional and e-commerce transactions. However, the weakest points of TTP approach remain the credibility of escrow agents and consumer privacy issues (Cleland 2000).

US Trend to Adopt Residence-Based Taxation

It is extremely difficult to determine the source country in the world of cyberspace. 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 (US Treasury Report 1996).

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." (Sweet 1998, 235)

Findings

It is obvious that traditional mechanisms of control and audit are not fully capable to meet all aspects of e-commerce. Tax authorities are already facing and will likely to face the problem of gathering the relevant information related to e-commerce transactions. One of the major problems for tax administration of e-commerce transactions is determining the taxpayer's identity.

The absence of provisions regarding tax collection assistance between countries leaves significant taxes revenues uncollected. It is important for tax authorities of different countries to cooperate and assist each other in the process of tax collection. The following findings represent important milestones/issues regarding e-commerce tax administration.

- **OECD actively tries to reach consensus on e-commerce taxation issues**

Even though nations have made several unilateral approaches to face the challenges posed by e-commerce, the main forum and basis for all discussions remains OECD.

- **Different approaches to Internet and E-Commerce regulations worldwide**

Despite obvious tendency to agree on important issues like income characterization, different countries/regions still have number of different approaches to taxation of e-commerce.

- **Armenia is neither participating nor following international developments**

At the same time when international community pays special attention to growing demands of Information Age and possible issues that can be raised be rapid development of e-commerce, the responsible and interested entities in Armenia are not following the international discourse.

- **Law on E-Documents and E-Signature (2004) – not used in practice**

Interestingly enough, in 2004, Armenia has adopted an important law on electronic signature, which constitutes a legal base for signing and enforcing electronic contracts. However, by and large, currently it is not in practice.

- **No special treatment of IT & e-commerce - conventional taxation scheme applies**

Even though Information Technology is declared as a priority direction in Armenia's economy, legislation provides no tax incentives for any type of IT business, including e-commerce.

- **No statistical information on e-commerce (volumes, range of services, share in GDP)**

According to the executive director of IT Foundation, Mr. Garegin Chugaszyan, no systematic approach has been taken so far in the field for the quantitative assessment of e-commerce companies in Armenia. The research is yet to be done. Moreover, many IT business representatives do not agree on the estimated numbers.

- **Mainly concentrated in Yerevan, where Internet is more accessible**

Just like the majority of other developing industries, IT sector in Armenia is also mainly concentrated in Yerevan. In many cases due to the absence or low quality of internet people in the regions can hardly check their e-mail, not to say about running an e-commerce company.

- **IT companies complain on the absence of appropriate state policies and coordination to assist development of the sector**

Every single stakeholder, be it a teacher from Vanadzor or the director of E-Dram electronic payments company stresses the need of state assistance and even intervention the only remedy to change the current stagnant situation in IT field.

- **Tendency to move servers/databases out of Armenia due to insufficient quality of network infrastructure**

Another important issue that comes from the bad quality of network infrastructure is tendency to locate servers outside Armenia.

Analysis & Conclusion

E-commerce is a rapidly and dynamically growing sector in the West. Each year more and more goods and services are provided and purchased by electronic means. Certain technical and organizational features of this “new economy” pose serious challenge to traditional methods of tax administration. The debate over taxation of e-commerce is at the agenda of US, EU, OECD. In contrast, e-commerce is a marginalized sector in Armenia. That is why Government of Armenia does not pursue to introduce new regulations complying international standards. At the same time, US policy of keeping internet tax-free is constantly being contested. If some day internet usage is taxed, Armenia can lose its current advantage and appeal for outsourcing companies.

Poor infrastructure and bad quality of connection is one of the main impediments for the growth of e-commerce in Armenia. Any relatively large e-commerce company prefers to locate its servers outside Armenia (mainly in US). In a long run, this can be substantial source of lost revenues for Armenia, since according to OECD developments they can be regarded as “permanent establishment” and automatically become the source of tax revenues for the country in which they are located.

A few existing e-commerce companies in Armenia are mainly private initiatives. No government assistance or support was provided. They identified their niches in the market. The same E-DRAM electronic payment system, which potentially can gain a regional importance, was implemented solely by private means and investment. Initiatives to further develop the sector should be supported by the government.

Based on the aforementioned findings, it can be inferred that the hypothesis of the research is validated. Nevertheless, the bulk of relevant legal publications and the small number of books for wider public puts some limitations on the study and leaves a room for further and deeper research of the subject by the experts with legal background.

Recommendations

In Armenia e-commerce is at the stage of naissance. At this stage priority should be given to creating incentives to support this infant industry rather than taxing it at full scale.

Armenia is a landlocked country without substantial natural resources. Due to number of reasons Armenia is being left out of many important regional development projects. Internet and IT technology on the other hand, could become a tremendous opportunity for borderless cooperation and application of Armenia's traditional competitive advantage, which is human capital. Local markets in Armenia are small and demand for IT products is limited. E-commerce provides appealing opportunities to local business to expand the horizon of their business to the global markets practically without limits. Political tensions with neighbors, closed borders and economic blockade pose no problems for e-commerce. In that regard, the following possible directions are crystallized from this research as possible recommendations for policy-makers.

1. The quality of provided Internet service needs significant improvement. It has to be high quality and low price, not vice-versa.
2. Adopt new legislative acts or amend the existing legislation, which for several years would provide tax/tariff incentives for e-commerce companies.
3. Special campaigns must be conducted to increase public awareness and inform the public that in case of usage of certain electronic equipment in commercial operations (web-site, on-line order mechanisms for example), certain tax exemptions are provided by law.
4. Government should have a strategic goal to attract investments in building IT capacity in the regions of Armenia, to strengthen the technical base in the secondary schools, colleges and universities to make at least the younger generation 100% computer literate and capable of using internet. Each school has to be equipped with computer

lab and have internet connection no matter what marz/region it is located. This is a challenging program, which needs money, commitment, specialists and training programs.

5. Government should act as a role model in IT consumption. This means that the Government should become the primary shareholder and customer in the development of IT. The more governmental services are provided by the use of IT, the faster IT technologies will develop, in turn boosting the development of IT in private sector. Part of public services payment may move onto Internet allowing the citizens to pay for their utilities on-line.

6. It is important to have many web-sites in Armenian language. By and large, people in the regions do not know English. At this stage promoting internet usage means promoting Armenian websites. Certain steps in this direction have already been done, since existing Armenian fonts make the development of software and websites with Armenian content possible.

7. Lastly, it is important to always follow the international developments. By the words of Charles Darwin "Survives not the strongest or the smartest but the one who is more sensitive to changes."

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APPENDIX: COMMON MYTHS REGARDING E-COMMERCE TAXATION

(Annette Nellen, San José State University)

Myth: The ITFA exempts e-commerce transactions from taxation in US.

Reality: The ITFA provides a temporary moratorium on state and local taxes on Internet access, and multiple or discriminatory taxes on e-commerce. The ITFA preserves state and local taxing authority to the extent a particular tax is not covered under the moratorium. Thus, sales and use taxes still apply to sales of taxable items made via e-commerce.

Myth: The ITFA prevents states from imposing use tax collection obligations on remote sellers.

Reality: The *Quill* decision (504 U.S. 298 (1992)) prevents states from imposing use tax collection obligations on remote sellers, not the ITFA.

Myth: Loss of sales and use taxes on e-commerce transactions will not hurt state and local governments. Other revenue sources exist.

Reality: The impact of the loss of sales and use tax revenues varies across jurisdictions. In California, sales and use taxes represent 32% of tax collections at the state level, and for cities, these taxes represent 27% of general revenues. For states without an income tax, the loss is even more significant. For example, Nevada and Texas obtain over 50% of their tax revenues from the sales tax. Even in states with a corporate and personal income tax, most local governments neither have an income tax nor receive income tax revenue from the state government.

Myth: The sales tax problem would be resolved if Congress would pass a law overturning the *Quill* decision.

Reality: The Internet allows a company to have customers in many different locations while having very few physical locations. It also allows new companies to operate in many states without needing any capital for physical (bricks and mortar) expansion. Such new and small companies would likely be put out of business or not seek the market potential presented by the Internet, if faced with obligations to collect use tax from customers in 6,000+ jurisdictions. Thus, it is unlikely that we will see the *Quill* physical presence standard eliminated by Congress under its Commerce Clause authority without significant simplification of the sales and use tax systems in the 46 states and hundreds of local jurisdictions that impose such taxes. Also, while Congress could allow states to collect sales and use tax from remote vendors located in the U.S., it would not be so easy or possible to get vendors in foreign countries to collect state sales tax. Thus, there would still be uncollected sales and use tax unless states can get consumers to voluntarily remit the tax.

Myth: Imposing sales tax on Internet commerce is unfair because buyers are often already paying shipping costs on the goods.

Reality: This argument is a distracter. The purpose of the sales tax is to tax consumption. Just because the buyer has directly paid shipping costs does not mean that consumption has not occurred. Also, buyers always pay shipping costs. The goods at a retail store were shipped there and such costs are factored into the prices paid by customers. Finally, taxes are collected by government and shipping costs do not replace those revenues.

Myth: Online vendors have less infrastructure needs than Main Street Retailers so it does not make sense to make them collect sales and use taxes.

Reality: Many online vendors still use the roads to deliver goods. Also, the consumer resides in the state and the sales tax is a consumption tax to be collected in the state of consumption (market activity).