International E – Taxation of E – Commerce using Systemic Analysis

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Abstract
Electronic commerce has the potential to be one of the greatest economic developments of the 21st century. Electronic commerce provides a fundamentally new way of conducting commercial transactions. It has potentially far-reaching economic and social implications on many facets of life including the environment, the nature of work, and the role of governments. The economic distance between producers and consumers shrinks, new products and markets will be created, traditional intermediaries are being replaced and new and far closer relationships will be forged between businesses and consumers and between the different parts of global enterprises.

Revenue authorities have a role to play in realizing this potential. There is, at least on the general conceptual level, a wide consensus about the need for such a set of higher tax principles and even about their general identification. While much of the attention on e – commerce taxation is focused on state sales and use tax, a lot of work is being done on the international income taxation of e – commerce. There are four areas that are being looked: the effect of a web server in a country, the effect of in – country Web site hosting services, the character of transactions involving digital products and the attribution of profits to a Web Server. This paper discusses the situation on e – taxation and proposes new ways of achieving a just and reliable taxation system for the proper the attribution of profits to a Web Server, using systemic methodologies. The methodologies used are Strategic Assumption, Surfacing , & Testing, Interactive Planning and meta-systems.

Keywords:
International E - Taxation, E - Commerce, systemic methodologies

1. Introduction

E-commerce is a continiously growing new market. For the the potential consumer e-commerce gives the oportunity of information availability, it provides the search mechanisms and online product testing. Since e-commerce is a global phenomenon, new challenges arise in areas such as taxation, where governments wish to raise revenue without distorting economic or technological choices.

It is necessary for tax law to be just and good [5]. In order to acieve that, a tax system should not develop by chance but by design and objective. The rules of taxation that apply to commerce according to [5] are:

- Fairness
- Legal certainty
- Convenience
- Efficiency
- Simplicity
- Flexibility
- Tax effectiveness
- International perspective

When it comes to cross-border income taxation and tax treaties of e-commerce, the main international forum is that of the Organization of Economic Cooperation and Development (OECD) Committee on Fiscal Affairs (CFA).

In this paper the issues of Web Server as a Permanent Establishment, the character of transactions involving digital products and attribution of profits to a Web Server are examined. Then a five step systemic approach is suggested for the solution of the complex problem of attribution of profits to a Web Server. First of all the taxation Principles of e-commerce are mentioned.

2. Taxation Principles of e-commerce

According to the Taxation Framework Conditions which were presented at the October 1998 OECD Ministerial Conference "A Borderless World – Realizing the potential of Electronic Commerce" the principles which should apply to e-commerce [4], [5] are:

- Neutrality

  Taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and e-commerce, so as to avoid double taxation or unintentional non-taxation.

- Efficiency

  Compliance costs to business and administration costs for governments should be minimized as far as possible.

- Certainty and Simplicity

  Tax rules should be clear and simple to understand, so that taxpayers know where they stand.

- Effectiveness and Fairness

  Taxation should produce the right amount of tax at the right time and the potential of evasion and avoidance should be minimized.

- Flexibility

  Taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments.

3. Effects of a Web Server in a country

Tax treaties among countries say that a foreign owned company is not subject to tax on business profits in a country unless that company has a Permanent Establishment (PE) in that country. Business profits are profits arising from sales of goods and services in the ordinary course of business. A PE definition could be the following:

- A PE is a fixed location in a country from which business is transacted.

In the case of e-commerce a Web Server could be considered a PE for a company that has electronic transactions in a foreign country. For several years tax experts argued about whether a Web Server in a country is a PE. The CFA agreed that a Web Server could establish a PE according to the following rules [3]:

- A website alone is not a PE. For this purpose a website is “a combination of software and electronic data,” and does not include the computer on which the software and data are housed.

- A Web server in a country that merely displays advertising or other information will not result in a permanent establishment.

- The server on which the website is stored can be a PE, but only if the server is “at the disposal” of the company that owns the website. A server is usually “at the disposal” only if it is either owned or leased by the company.

- The server must remain in one place for a sufficient time for its location to be fixed.

- The core business activities of the company must be carried on through the server. Activities that are merely preparatory or auxiliary to the organization’s core business activities are not activities that create a PE.

- A Web server can establish a PE even if the company has no employees at the location of the server.

Another much discussed issue is the effect of e-commerce enabling agents in a country on a foreign company's taxability in that country. Experts seem to agree that most hosting relationships involve independent agents acting on their own behalf. These agents may occasionally enter into agreements on behalf of their foreign clients, but this activity does not cause a permanent establishment to arise because these agents are operating in an independent capacity. If a Web server is hosted in a country, and if the hosting company provides services that enable e-commerce, the hosting company cannot be an agent that results in a permanent establishment.

4. Character of E-Commerce Transactions

In cross-border transactions, the character of a transaction, in most cases, determines its taxability [2]. For instance, the cross-border sale of a product is ordinarily subject to income tax in the customer's country only when the seller has a permanent establishment in that country.

On the other hand, where a cross-border royalty is paid, the recipient of the payment is ordinarily subject to tax in the country in which the customer is located, regardless of whether the recipient has a permanent establishment in the country. Ordinarily, the customer must withhold tax on the royalty payment.
So there are two different types of transactions as mentioned in [2]. Those, which result in business profits and those, which result in royalties. This distinction is important because royalties are ordinarily taxable in a country if they have a source in the country, while business profits are ordinarily taxable in a treaty country only if they are attributable to a PE in the country. Only one category of transaction results in royalties. This is the ordering and downloading of copyrighted digital products, for purposes of commercial exploitation of the copyright.

5. Attribution of Profits to a Web Server

For taxpayers subject to the U.S. model tax convention, or the OECD model tax convention, a foreign company's business profits are subject to tax in a country only if they are attributable to a PE in the country. When a company earns profits through a Web server located in a country two issues must be examined. The first is whether the Web server is a PE. This issue was clarified above. Once a Web server is established as a PE, the question is how much profit to attribute to the server.

The main proposition at this point for allocation of profit to a Web server, is based on the idea that ***a PE should be treated as a separate profit center***. A profit center, which has its own assets, activities and risks. Profit should be allocated based on the PE's exploitation of its own assets, and on the risks it bears. A PE should be treated as a separate entity, even if it is not a separate legal entity. Assets should be allocated to the PE based on "economic" ownership, rather than legal ownership. Risks should be assigned based on an in-depth analysis of the risks associated with the functions carried on through the PE.

Assuming there is a corporation, engaged in sales of online services of any kind, such as entertainment services. Assuming all of the entertainment assets are developed in country X and all marketing activities are performed by personnel based in this country. Access to the entertainment assets is accomplished through a Web server, owned by the corporation and located in country Y. The Web server is a PE in country Y according to rules that apply. Taking into consideration the idea that a PE should be treated as a separate profit center, the economic ownership of the entertainment assets, in this case, resides in country X, where the assets were created. The risks associated with the business, which are primarily marketing risks, are also located in country X, where marketing activities take place. Based on this analysis, profits associated with the exploitation of the entertainment assets and the assumption of risk would not be attributed to the Web server. Therefore, a Web server in a country, with the sole function of allowing access to a website, would not attract very much profit because there is no economic ownership of assets and little assumption of risk.

If intangible assets are developed at the site of a Web server, and are exploited through the server, the economic ownership of the assets resides at the server's location, and profit commensurate with the exploitation of the assets should be attributed to the PE represented by the server. It is essential that a Web Server should be allocated profits commensurate with the services it provides.

It is really complicated to judge all these matters of attribution of profits to a Web Server. It is extremely difficult to determine the server's own assets and the risks. The situation becomes more complicated because each country has it's own perspective or rules for such matters. At this point Systemic Analysis can provide the means of flattening this problematic situation.

6. Systemic Approach for Attribution of Profits to a Web Server

This approach consists of 5 steps. The main and original idea here is the one proposed above. ***A PE should be treated as a separate profit center.*** Having that in mind we can proceed to the steps of the proposal.

Step 1 – Establishment of Local Tax Committee (LTC) and International Tax Committee (ITC).

Each country that follows the OECD model tax convention should establish a Local Tax Committee. The ***aim*** of this committee will be the attribution of profits to a Web Server. It will determine the server's own assets and the risks. It will have the ability to judge each case of corporation, which has e-commerce transactions in the country of the committee. If a PE is determined then the committee will proceed to the attribution of profits to the Web Server of the Corporation. Each country will have one LTC, which will be autonomous from the other LTCs. ***Members of each LTC*** will be a group of economists, a group of lawyers, a group of computers scientists specialized in e-commerce issues from its technical view and a group of revenuers of the internal revenue service. The establishment of each LTC will be the responsibility of each country's government.

According to this approach an International Tax Committee should also be established. Its ***aim*** will be the responsibility for watching over the situation in the area of E-Taxation and discussing the new issues that arise. Its main responsibility will be to provide with directions the Local Tax Committees so as to achieve their goals more effectively. The ITC should be under the supervision of the CFA. ***Members of ITC*** will be a group of economists, a group of lawyers, a group of computers scientists specialized in e-commerce issues from its technical view and a group of revenuers. They will be appointed by the CFA. They should have global knowledge of e-commerce taxation issues.

Step 2 – Use of SAST in the LTC.

For the achievement of LTC's aim, SAST systemic methodology is proposed [1]. ***SAST will be used for the proper attribution of profits to a Web Server according to each case***. Churchman's Strategic Assumption, Surfacing & Testing methodology (SAST) is a dialectical methodology which tries to bring synthesis through conflicts. SAST methodology has four stages:

- Formation of groups.
- Assumption formation.
- Dialectical conversation.
- Composition.

In this methodology, the participants will be the members of the LTC. The first phase of SAST is the Formation of groups. The groups that will participate are the existing groups of economists, lawyers, computer scientists and revenuers. Of course there should be a systemic analyst to co-ordinate the whole application of SAST. The key issues during the proccess should be:

- Assets developed in the Web Server.
- Assets exploited in the Web Server.
- Activities of the Web Server.
- Risks of the Web Server.

Step 3 – Use of SAST among the LTCs.

As mentioned before each LTC will be autonomous to take each own decisions. But in order ***to transmit each LTC's experience and deal effectively and in a similar and just way with similar problems*** the use of SAST is proposed among LTCs. So we have a two level SAST application, one inside each LTC and one among the LTCs. The participants of SAST will be representatives of each LTC. Each LTC will have as representatives its own members of the groups of economists, lawyers, computer scientists and revenuers. The first phase of SAST is the Formation of groups. The groups that will participate consist of each LTC's delegation. Again there should be a systemic analyst to co-ordinate the whole application of SAST. The key issues during the proccess should be:

- Harmful Tax Competition.
- Similar treatment of cases that have common charateristics.

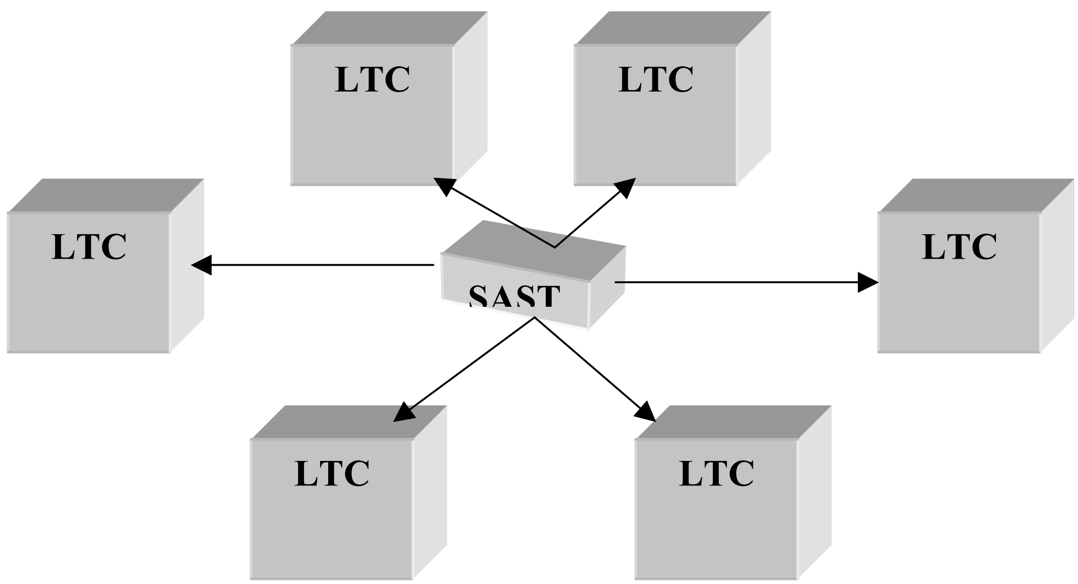

Figure 1: Use of SAST among LTCs.

Step 4 – Use of IP in the ITC.

For the inner operation of the ITC, the Interactive Planning (IP) methodology is suggested. The principles of Ackoff's IP are shown in [1]. IP is a dialectical methodology, which has five phases:

- Mess formulation.
- Goals designing.
- Designing of means.
- Designing of resources.
- Designing of implementation and control.

In this methodology, the participants will be the members of ITC. As it has been already mentioned these are a group of economists, a group of lawyers, a group of computers scientists specialized in e-commerce issues from its technical view and a group of revenuers. In each discussion group there will be a representative of the other groups as suggested in IP. As in implementation of SAST, there should be a systemic analyst to co-ordinate the whole proccess. ***<u>The aim is to keep an eye to the situation in the area</u>***

of E-Taxation and discussing the new issues that arise, suggesting new solutions that can be globally applied. This can be achieved by considering what would happen if the International E-Taxation situation stayed as it was, without evolving (Mess formulation phase). Then with the aid of the other phases of IP, actions will be designed for the solution of the emerging new issues and the implementation of the conceived ideas.

Step 5 - ITC assigned the role of meta-controller.

At this point the approach of meta-systems in decision-making is suggested [1]. According to this approach a control system C, consists of the controlled system CS and a controller CR. The behavior of the controlled system is affected from the environment and control activities of the controller. In this case the CS are the LTCs. There is also the concept of meta-controller MCR, who exercises meta-control to the controller. This means that he interferes and helps to the structure of the decision-making procedure. The system of MCR and CR constitute a new meta-control level. CR is the new controlled system CS' of the meta-control level. Meta-control is the control of the control, meaning the directed change of the controller which aims to improve its control.

In this case the role of MCR must be assigned to the ITC. ***The ITC should not make decisions but advise and directs the way LTC make decisions***. Only if ITC acts as a meta-controller can achieve its aim, which is described in step 1.

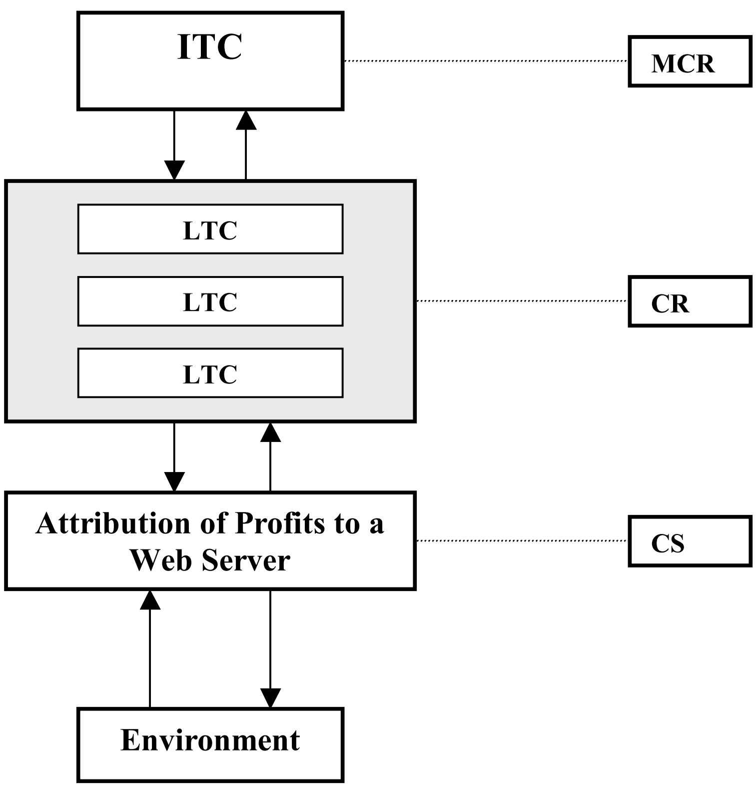

Figure 2: The approach of meta-systems in decision-making.

7. Conclusions

The concepts of international e-commerce taxation are presented in this paper. The main issues clarified are under which cicumstances a Web Server can establish a PE and the character of e-commerce transactions involving digital products. The matter of attribution of profits to a Web Server is deeply examined and the idea that a ***PE should be treated as a separate profit center*** is suggested. This idea is the basis of a five step systemic approach that is proposed, using SAST methodology, IP methodology and meta-systems in decision-making. The establishment of two committees is also suggested in this approach. These are LTC and ITC. The key-factor is that ITC should be the meta-controller of LTCs so as to have each committees' goals succeeded.

At this point, it must be mentioned that SAST and IP are dialectical methodologies and such methodologies cannot always give the desirable results. Good faith from all the participants is a key element for the goals achievement of SAST and IP. Mitroff and Mason have reached to the conclusion that SAST cannot be practicaly proven [1]. The principles and the philosophy of SAST and IP are the only guarantee for their success. However the use of these systemic methodologies has given results in similar problems at the past [1].

International e-commerce taxation is a very important issue. The systemic approach followed, tries to present a reliable tax system which approaches effectively the complex problem of attribution of profits to a Web Server.

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