TAX POLICY, ELECTRONIC COMMERCE, AND DEVELOPING COUNTRIES

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Summary

Electronic commerce permits companies to conduct worldwide activities without any physical presence in foreign markets. Customers can simply access products and services through web sites provided by these companies. But international tax principles have traditionally emphasized the need for a physical presence within foreign markets before foreign governments are permitted to tax cross-border transactions taking place within their borders. As a result of these traditional rules, developing countries and other net e-commerce importing nations will suffer tax revenue losses. Mechanisms to share tax revenues with developing nations should be created. This solution is fair from an equity perspective because importing nations have traditionally been permitted to share in revenues when significant business activity takes place within their borders. The solution can also be defended on efficiency grounds because sharing revenues gives importing nations an incentive to cooperate with exporting nations to ensure international double taxation is eliminated, hence promoting international trade. Further, sharing revenues provides an incentive for developing countries to invest in their telecommunications infrastructure, which will ultimately increase the market for e-commerce goods and services.

1. Introduction

Electronic commerce is expected to lead to a dramatic increase in international trade and investment because businesses based in their home countries (hereinafter the "residence country") can access a foreign market (hereinafter the "source country") with greater ease. The Internet permits businesses to conduct transactions from remote locations and a physical presence within source countries is no longer required to reach local markets. But international tax rules emphasize the need for a physical location in the source country before the source country is permitted to impose its income tax on the profits emanating from cross-border business activities.

The biggest losers under this changing environment may be developing countries that will lose out on the tax revenues associated with electronic commerce activities within their borders. These countries are already concerned with the growing digital divide that arises when industrialized countries harness the commercial potential of the Internet while developing countries lack the human, financial and technological resources to do so. This paper suggests that the digital divide will be worsened by existing international tax laws and principles. As traditional commerce moves to the Internet, developing countries will suffer declining revenues that could otherwise subsidize the necessary technological infrastructure that would permit developing nations to create their own e-commerce industries one day.

The paper is organized as follows: Part 2 briefly discusses the taxation of international business profits, focusing on the legal rules that emphasize the need for a physical presence within source countries. Part 3 assesses the impact of these rules on a changing commercial environment that does not require physical locations within source countries in many circumstances. Part 4 describes how the tax authorities of most industrialized countries refuse to modify their tax rules to accommodate the changing environment, despite the likely loss of revenues that will be experienced by developing nations. Finally, Part 5 concludes that the proposed policy response to the taxation of e-commerce is unworkable because the proposed changes do not share revenues between e-commerce producing and because e-commerce importing nations or the proposed approach is administratively impracticable.

2. The Taxation of International Business Profits

Countries throughout the world have negotiated over 1500 bilateral tax treaties to govern the tax treatment of international business activities. The vast majority of these treaties contain a clause that indicates governments will not be able to tax foreign businesses unless the foreign business employs a "permanent establishment" within the source country. Under the United States model tax treaty and the Organization for Economic Cooperation and Development (the OECD) model tax treaty, a permanent establishment is defined to include fixed places of business like a building, a sales office or a manufacturing plant.

The rationale behind the rule—instituted soon after World War I—was that a fixed place of business within the source country represented evidence that significant business was taking place within the foreign market. A rule was needed to ensure that, for example, if an American company called ShoesRyou sold one pair of shoes to a consumer in Mexico, it would not have to file a tax return in Mexico and comply with Mexican tax laws. Permitting the Mexican tax authorities to tax this single activity would force ShoesRyou to incur significant compliance costs for nominal sales activities.

The permanent establishment concept hence represented a practical way to help determine whether businesses were conducting significant business activities within source countries; for the most part, a business would not bother setting up a fixed place of business in foreign markets unless this business anticipated significant profits. Accordingly, if ShoesRyou sets up a sales office in Mexico, the Mexican government will be entitled, pursuant to the United States-Mexico tax treaty, to tax the profits associated with sales from the sales office to Mexican consumers.

Under most tax treaties, the permanent establishment definition is stretched to, for example, include a dependent agent who habitually concludes contracts in the source country. The United Nations model tax treaty, which is often used by developing countries as the starting point in their treaty negotiation process, offers a more expansive definition of a permanent establishment. Under the UN model tax treaty, a permanent establishment includes work conducted by independent agents in some circumstances. Further, the UN model tax treaty employs a "restricted force of attraction" provision, which asserts a source country will be able to tax cross-border profits as long as the foreign company maintains *any* permanent establishment within the source country and conducts transactions from the home base that are similar in nature to the transactions conducted by the permanent establishment.

For example, if ShoesRyou has a sales office in Mexico that constitutes a permanent establishment, then direct shoe sales from the U.S. home office to Mexican consumers can also be taxed by Mexico; the direct sales are "attracted" to the permanent establishment. In the absence of a restricted force of attraction rule in the United States-Mexico tax treaty, the Mexican tax authorities would only be able to tax the sales emanating from the permanent establishment within Mexico.

The permanent establishment concept has arguably well served the global community because the rule represented an administratively practical way to determine when a residence country should yield its tax jurisdiction over business transactions emanating from companies based within its borders. Further, the permanent establishment principle historically represented a balanced viewpoint from an international equity perspective because the principle permitted source countries to share in tax revenues from the profits created by the commercial opportunities presented by their markets. The emergence of e-commerce, however, upsets this balance because physical locations are no longer required in foreign markets in order to engage in significant commercial activities.

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Biographical Sketch

Arthur Cockfield is a professor of law in the Faculty of Law at Queen’s University, Kingston, Ontario, Canada. He has degrees from the University of Western Ontario, Queen’s University and Stanford University. His research interests focus on tax and cyberlaw issues.