# OF OLD DOGS AND NEW TRICKS: VIRTUAL GOODS AND INTERNATIONAL TAXATION — CONCEPTS, PROBLEMS, SOLUTIONS AND PERSPECTIVES

*Gerard L. Chan*

TABLE OF CONTENTS

# OF OLD DOGS AND NEW TRICKS: VIRTUAL GOODS AND INTERNATIONAL TAXATION — CONCEPTS, PROBLEMS, SOLUTIONS AND PERSPECTIVES*

*Gerard L. Chan***

*"Governments of the Industrial World, you weary giants of flesh and steel, I come from Cyberspace, the new home of Mind. On behalf of the future, I ask you of the past to leave us alone. You are not welcome among us. You have no sovereignty where we gather."*

*–John Perry Barlow, The Declaration of the Independence of Cyberspace (1996)*[1]

*"One day some social historian will look back with wonder on the havoc wreaked by the Internet."*

*–Michael Lewis, THE FUTURE JUST HAPPENED (2001)*[2]

## PROLOGUE

Atty. Dimaculangan has just retired from a very successful international tax law practice in Manila and has returned to his home province in Davao. To keep him busy during retirement, he decided to establish contacts with his former colleagues and friends in Manila, as well as his clients abroad.

Corollary to this, he set up a website where he offers to assist in drafting pleadings, briefs, memoranda as well as do legal research and writing for his former colleagues and associates. All they have to do is to send him the facts and other pertinent details of a given case, either through the website or by email. In turn, Atty. Dimaculangan researches the relevant

* *Cite as* Gerard Chan, *Of Old Dogs and New Tricks: Virtual Goods and International Taxation – Concepts, Problems, Solutions and Perspectives*, 83 PHIL. L.J. 13, (page cited) (2008).

** LLB, *cum laude*, University of the Philippines College of Law (2005). *Discovery Lawyer*, SPi Technologies. *Consultant*, Asian Development Bank Administrative Tribunal. *Professorial Lecturer*, University of the East College of Law. *Associate*, Angara Abello Concepcion, Regala & Cruz Law Offices (2005-2007). *Vice Chairman*, Philippine Law Journal, 2002-2003 & 2004-2005. *Editor*, DIGITAL (Digest of Information Technology and the Law) the official publication of the Internet and Society Program of the UP College of Law (UP LAW-ISP), *Member*, Phi Kappa Phi International Honor Society & Pi Gamma Mu International Honor Society in Social Science. B.S. Legal Management, *cum laude*, Ateneo De Manila University (2000).

[1] John Perry Barlow, *The Declaration of the Independence of Cyberspace*, *at* http://homes.eff.org/~barlow/Declaration-Final.html (last visited February 8, 1996).

[2] MICHAEL LEWIS, THE FUTURE JUST HAPPENED 1 (2001).

issues, drafts the arguments and writes the memoranda and pleadings then sends them back in exchange for an agreed fee. His clients simply enter their credit card numbers on Atty. Dimaculangan's website and they are automatically billed by their credit card companies. As a convenient alternative, his clients may also opt to setup and pay using a PayPal account. Thereafter, Atty. Dimaculangan's credit card company simply credits his account for the amount paid by his clients.

In addition, Atty. Dimaculangan writes journal articles, which he submits by email to the editors of foreign and local law journals and law reviews. He sometimes receives a minimal honorarium in the form of a check sent to his home address as compensation for articles accepted for publication.

Meanwhile, to enhance the appearance and performance of his website and to improve on the quality of his work, he downloads various software on legal forms and web development. He pays for the software either by entering his credit card number on the website where he downloaded the software and for which he is billed automatically by his credit card company, or through his PayPal account if said account has adequate credits.

In as much as there is a dearth of academic and legal materials in the law libraries of his home province, Atty. Dimaculangan has also decided to subscribe to online legal journals and legal resources database like Westlaw and Lexis Nexis to keep him up to date on legal trends and issues as well as to improve the quality of his research and writings. In a similar fashion, he pays for these subscriptions using either his credit card or by way of his PayPal account.

He also frequently logs on to www.amazon.com to purchase the latest novels and self-help books to update his collection and to read during his free time, since the local bookstore does not carry the works of his favorite authors. He orders and pays for these books through the Amazon website using his credit card and the books are shipped to his Davao residence.

It bears noting that all the above transactions, which were conducted and completed over the Internet, raise a number of taxation questions and issues.

## CHAPTER I

### I. INTRODUCTION

The Internet, established in the 1960s as a military communications and research system, is a global network of interconnected computers linked by high-speed data lines and wireless systems[3]. It began in 1969 as a military program called ARPANET, which was designed by the Advance Research Projects Agency of the U.S. Defense Department, to enable computers operated by the military, defense contractors and universities conducting defense-related research to communicate with one another by redundant channels, even if some portions of the network are damaged in a war[4].

The World Wide Web, developed in 1989 together with the Internet, has enabled millions of computers and other communication apparatuses using different hardware, operating systems and software application programs to link to each other by a common protocol. The Internet has since been increasingly used for social and communication purposes[5].

A decade ago, the Internet had less than 3 million users around the world and its application to electronic commerce was virtually inexistent. In the year 1999, about 250 million users had accessed the Internet and approximately 25% of them had made online purchases worth more than US$100 billion. A year later, there were almost 100 million new users[6].

The United Nations Commission on International Trade Law (UNCITRAL) has defined electronic commerce as "*commercial activities conducted through an exchange of information generated, stored, or communicated by electronic, optical, or analogous means...*"[7] Electronic commerce has become an umbrella term for telecommunications activities conducted over open computer networks, such as the Internet[8]. Such activities may include electronic data interchange (EDI), on line retailing, and electronic financial

---

[3] Arthur Andersen, *The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce*, *at* http://www.caltax.org/andersen/part1.htm (July 31, 2003).

[4] *Reno v. ACLU* (hereinafter "Reno"), No. 96-511, US S. Ct. (June 26, 1997), *at* http://caselaw.lp.findlaw.com/scripts/getcase.ph?court=us&vol=000&invol=96-511 (last visited Feb. 17, 2001).

[5] Andersen, *supra* note 3.

[6] Reno, *supra* note 4.

[7] Richard Hill & Ian Walden, *The Draft UNCITRAL Model Law for Electronic Commerce: Issues and Solutions*, 13 No. 3 Computer Law 18, 18 (March 1996).

[8] Organization for Economic Co-operation and Development, *OECD Policy Brief No. 1-1997*, *at* http://www.oecd.org/publications/Pol_brief/9701_pol.htm.

services (such as home banking, electronic fund transfer (EFT), payment processing, and business process reengineering)[9]. Professors Abrams and Doernberg define electronic commerce as "*the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the marketplace.*[10]"

The explosive growth of the Internet has revolutionized the way people conduct business. More and more transactions are being conducted electronically, and the geographical boundaries that have once played such a significant role in commerce are rapidly disappearing. While electronic commerce or "e-commerce" is already gaining ground in the Philippines, it has reached sizable proportions in developed countries like the United States.

This evolution in the way businesses are conducted necessarily has implications in the field of tax collection. The traditional means of taxing the sale of goods and services based on familiar concepts such as physical assets, geographical locations and face-to-face encounters have been transformed to include commerce based on technology where there is no locality, no physical presence, and no geographical boundaries

## II. INTERNET AND E-COMMERCE IN THE PHILIPPINES

### A. THE INTERNET IN THE PHILIPPINES

The Philippines connected to the Internet on March 1994, when the Philnet Foundation, a consortium of leading Philippine universities and the Department of Science and Technology, established a domestic data communications infrastructure and a connection to SprintNet in California[11]. According to a report by Computerworld Philippines, online spending in the Philippines rose by more than Php 400 million (USD 7.4 million) from December 2001 to June 2002. According to data from AC Nielsen, spending rose from Php3.2 billion (USD 500 million) at the end of 2001 to Php 3.7billion (USD 600 million) at the end of June 2002. AC Nielsen estimates that online transactions have grown two percent (2%)

---

[9] Craig Harding, *Selected Issues in Electronic Commerce: New Technologies and Legal Paradigms*, 491 PLI/Pat 7, Sept. 10, 1997.

[10] Howard E. Abrams & Richard L. Doernberg, *How Electronic Commerce Works*, 13 ST. TAX NOTES 123 (1997).

[11] Charles E. Gardner, *The Internet and the Philippines*, *at* http://www.cyberbayan.org/philnet/InternetPhil.html (last visited Feb. 18, 2001).

over the first six months of 2002 and it has calculated that the number of Internet users in the country will reach 3.4 million by the end of June 2002[12].

### B. E-COMMERCE IN THE PHILIPPINES

The growth and evolution of the Internet has been amazing. What was once conceptualized as a means and venue for sharing information has been transformed into a means of communication and correspondence (i.e., emails and chat), which has further evolved into a medium where trade and business can be conducted online.

Electronic commerce, defined as "transactions that involve the exchange of goods and services by electronic means"[13], refers to the "modern business use of computers that fulfills the needs of firms, customers and management to provide more efficient delivery of goods and services"[14] and covers a "wide array of commercial activities carried out through the use of computers, including online trading of goods and services, electronic fund transfers, online trading of financial instruments, electronic data exchanges between companies and electronic exchanges within a company".[15]

The transactions over the Internet may be classified according to form and according to class. There are generally two forms of electronic commerce. The first form of electronic commerce involves digitized content that can be downloaded from the World Wide Web, such as software, music, movies, games, and publications, some services (i.e., medical and legal consultation) can also be delivered in this form. Digitized products or "virtual goods" are ordered, paid for, and delivered electronically. These are termed as transactions "*over the Internet*". The second form involves the use of the Internet to order (and pay for) tangible products that must be delivered by conventional (non-electronic) means. This is akin to a mail-order system where the customer orders goods, which are delivered through the postal system. These are termed as transactions "*through the Internet*"[16].

---

[12] http://www.nua.ie/survey/index.cgi?f=VS&art_id=905358652&rel=true (Sept. 29, 2003).

[13] Andersen, *supra* note 3.

[14] RICHARD DOERNBERG ET AL., ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION 2 (2001).

[15] *Id.*

[16] http://www1.worldbank.org/publicsector/tax/ecommerce.htm (Sept. 26, 2003).

There are generally three classes of electronic commerce transactions. The first class, called the B2C transactions or "Business To Consumer" transactions, includes online stores like "www.amazon.com" which sell products to final consumers. The second class, called C2C or "Consumer To Consumer" transactions, includes auctions sites like "e-bay". The third class, called B2B or "Business To Business" transactions, includes job recruiting, online advertising, credit sales, market research, technical support, procurement, and different types of training; "Bayantrade" is a good example of a local B2B site[17].

## III. THE EMERGENCE OF DIGITAL TRADE

### A. HISTORY AND EVOLUTION

Commercial products can be divided into three broad categories—tangible products, services, and intangible products. History on the other hand may be divided into four distinct periods distinguished by developments in the technology of storage and communication of information[18].

#### 1. Tangible Products

Throughout most of history, the market basket of consumers has been dominated by tangible products, which play a key role in human survival (i.e., food, water, shelter, clothing). Until relatively recently, "intangible product" would probably have been considered an oxymoron.

Tangible products have value to business because of their capability of being resold, of being incorporated into other products, or of being directly used in the production and transportation of other products (i.e., fuels, machinery, and supplies), and of being used in the "non production aspect" of business.

Communication is to information what transportation is to tangible products: the way it is moved through space. Without communication there can be no commerce in information. Techniques in communications span

---

[17] Peter L. U, *Towards a National Tax Policy for E-Commerce, at* http://pascn.pids.gov.ph/DiscList/d02/s02-08pdf (last visited Sept. 26, 2003).

[18] Charles McLure Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints and Tax Laws*, 52 TAX LAW REVIEW 269.

the historical gamut, including the messenger who ran to Athens to deliver the message of victory at Marathon, packet ships and the pony express, early applications of electronics in telegraph, telephone, radio and television, and the high-tech systems that characterize the digital revolution.[19]

## 2. Evolution of Digital Trade

*a. Preprint Period*

Before the invention of the printing press, almost all storage and communication was done manually or personally, often by the same individuals. Among those who stored and communicated information were messengers, priests, story-tellers, and minstrels, sculptors, painters and copyists, including illuminators of manuscripts, who were more highly specialized in the storage of information through various media. Given these limitations on the storage and communication of information, consumption choices were limited primarily to the consumption of tangible products, which could be transported and traded and to information that was either produced and consumed in real time, without the benefit of communication, or stored manually and communicated in tangible form (i.e., paintings, sculptures, and manuscripts).

During the preprint age, there was relatively little commerce in information, as it is known today. Unlike goods, services were consumed almost entirely when and where they were produced and could not be transported or communicated. Intangible products did not yet exist.[20]

*b. Print Period*

The discovery of the printing press (and subsequently of photography) allowed information to be stored typographically (and photographically) and communicated in printed form via books, magazines, and newspapers. The possibility of separating production and consumption of information in time, as well as in space, and of doing so relatively cheaply, created the possibility of commerce in information and spawned the newspaper and publishing industries—the forerunners of the modern communications/media sector. The ability to produce catalogs cheaply (and eventually with photographs of products) created the mail-order industry,

---

[19] *Id.*
[20] *Id.*

which disrupted the historically valid presumption that retail commerce was a local activity and, incidentally, began the process of "disintermediation of commerce" that has recently received so much attention in discussions on electronic commerce. While the distinction between goods, which could be transported, and services, which could not, may have been slightly blurred (i.e., legal advice is disseminated in printed form), this development could easily be overlooked.[21]

*c. Electric/Analog Age*

At the dawn of the electric/analog age, electricity was the only intangible product of any consequence delivered to its users. However, the discovery of electricity made possible the invention of new ways to record and utilize information (initially in mechanical forms and subsequently in magnetic analog form) and to communicate it. Information stored electronically could be consumed at a different time or place. Thus, the invention of the telegraph, radio, telephone, and television, the hallmarks of the analog age, expanded consumption opportunities to include the possibility of distant real-time consumption of information (two-way and interactive in the case of the telephone and short-wave radio, but commonly one-way and non interactive in the case of commercial radio and television). The combination of new communications and recording technologies opened the way for recorded information to be communicated electronically—and for information communicated electronically to be recorded by the recipient.[22]

*d. Digital Age*

The digital age adds to the possibility of communicating electronically stored information cheaply, easily and rapidly, thereby increasing interactivity using a variety of technologies that produce high-quality signals. It is this ability that gives rise to electronic commerce, defined as "the use of computer networks to facilitate transactions involving the production, distribution, sale, and delivery of goods and services in the marketplace"[23].

---

[21] *Id.*
[22] *Id.*
[23] Thayer, *supra* note 10.

### B. THE EMERGENCE OF DIGITALIZATION

The digitalization of information is the process of converting information into a sequence of numbers. The converted information may be images, speech, music, diagrams, or the written word. Once converted, the information can be sent at the speed of light throughout the world where a recipient can convert the information back into its original format or otherwise manipulate it. An example may be given to illustrate the concept:

> Suppose you have a room that you want to illuminate with as much as 250 watts of electric lighting. If a 250-watt bulb were wired to a rotating dimmer, the dimmer could be turned to produce the desired level of lighting. But this system has drawbacks. Suppose that you adjust the dimmer lower for an intimate dinner. If the dimmer is unmarked, you can only guess what the wattage is. Even if the dimmer displays different wattage levels, it would be difficult to produce exactly the same level of lighting. If you wanted to communicate to a friend the exact level of lighting, you could only do so approximately (e.g. "turn the dimmer 1/5 of the way"). Errors may be magnified as the information is retransmitted from one friend to another. This is an example of "analog" information. The dimmer provides an analogy to the bulb's lighting level.
>
> Now consider a different way of describing the lighting in the room. Suppose that instead of a single 250-watt bulb, you use eight bulbs in a row—the first of which on the right is 1 watt with each other bulb doubling the wattage of the bulb to its right. Each bulb is connected to its own on-off switch. By turning switches on or off, any desired level of lighting can be achieved from 0 watts (all switches off) to 255 watts (all switches on). For example, if you desired 23 watts, you would turn on the 16-watt, the 4-watt, the 2-watt and the 1-watt bulbs. With this method of lighting, it is possible to duplicate precisely the level of lighting from one occasion to the next. Moreover, the exact level of lighting can be transmitted to another with precision so that the recipient of the information can accurately duplicate the sender's lighting level. Assuming that an "on" light switch is recorded as 1; an "off" switch is recorded as 0. Under this system, 167 watts of lighting would be represented by "10100111". Eight bits of information (sometimes referred to as a "byte") with each bit representing an "on" or "off" state that can be transmitted, providing the precise information.
>
> If we had the single, variable intensity light and wanted to record a particular intensity for later use, we could use the row of eight bulbs to "digitize" the state of the analog bulb. First, we would set the intensity of the analog to the desired intensity. Second, we would set the row of eight bulbs so that they approximated the variable intensity bulb. For example, it might be the case that a setting of 115

> watts on the row of bulbs is a little brighter than the analog setting we want to digitize but a setting of 114 watts is a little less bright. We would pick either 115 or 114 (say, 115) as our digitized value and record that for later use. Then, when we wanted to recreate the initial variable intensity, we would use the row of bulbs and set them to 115 watts. While we would never recreate the exact initial intensity (unless it happened to be an exact integral wattage value), we could indefinitely recreate the initial intensity with no more than a one-watt error created when the analog bulb was first digitized.[24]

This shift from physical to electronic commerce has brought about changes in the way businesses market, package, and distribute their products. Traditionally, the purchase of goods by customers involved either the consumer going to the merchant's local retail store and buying the good or a representative of the company coming to the consumer's home. Today, with personal computers and modems, consumers have instantaneous, twenty-four hour access to a full range of goods and services from all over the world without having to leave their home or office.

The type of goods and services that consumers purchase is also fast shifting from tangible to intangible. Conventionally, it is the packaging, and not the content of the good that classifies it as tangible. For example, in purchasing a compact disc recording of the songs of your favorite artist, you physically acquire a tangible item—the CD casing, the CD, the cover with the titles of the songs written on it. However, what you are really purchasing are the contents of the CD—the songs to be played, which are copied onto the CD. With the improvement of technology, there are now greater opportunities for purchasing goods such as books, software, music and videos electronically by downloading them over the Internet, thereby allowing the purchaser to acquire the content while avoiding the packaging altogether.[25]

### C. DIGITALIZATION AND ITS IMPLICATIONS ON TAXATION

Throughout history, taxation, almost as much as politics, has been the "art of the possible." Over time, custom duties and specific excises, which depend on counting and physical control, have given way to ad valorem excises, sales taxes, and income taxes, which rely on valuation and accounting. While most would agree that this shift in emphasis is a positive

---

[24] Andersen, *supra* note 3, at 11-14.

[25] Sandi Owen, *State Sales & Use Tax on Internet Transactions*, 51 FED. COM. L. J. 245 (1999), *at* www.law.indiana.edu/fclj/pubs/v51/no1/owen.PDF (last visited July 31, 2003).

one, it may reflect improvements in administrative capacity as well as an improved understanding of the proper objective of tax policy. As one author puts it, "*Tax administration is tax policy.*"[26]

The difficulties brought about by the emergence of digitalization are varied as transactions involving digitized products raise unique tax concerns. First, in transactions involving digitized products, it is difficult to establish a source country's power to tax the income or consumption derived from the exchange. The Internet's current architecture allows downloaded or "imported" digitized products to bypass border checkpoints undetected[27] and to be transported anywhere in the world without any determinative information regarding a customer's physical location.[28] While international transactions are usually taxed on the basis of the residency status of a business in the jurisdiction in which profits from the transaction arise, traditional residence concepts are based on criteria such as physical presence, place of incorporation, and place of operation. The notion of "permanent establishment" has been particularly diluted in an electronic trading environment.

Second, how income from a digital transaction should be characterized has not been settled, and has therefore been a recurring inquiry for tax purposes. The danger is that some countries may characterize income from transactions involving digitized goods and services differently from their physical analogs in order to acquire jurisdiction to tax a digital exchange that otherwise would not have been taxable.[29]

Third, in the physical world, the information to support the existing tax base is found in the financial record of a taxpayer or other entities like banks and asset registries, and source documents such as receipts and invoices. In contrast, electronic records can easily be altered without a trace rendering the reliability of those records questionable. "Disintermediation" which is the direct connection between producers and consumers, eliminates the middlemen such as wholesalers, distributors, and retailers. Internet buyers are thus able to browse through a virtually unlimited range of goods and buy them directly from the producers.[30]

---

[26] Milka Casanegra de Jantscher, Administering the VAT, in Value Added Taxation in Developing Countries 171, 179 (Malcolm Gillis, Carl S. Shoup & Gerardo P. Sicat eds., 1990)

[27] Ned Maguire, *Taxation of E-Commerce*, 47 JUN Fed. Law. 24, 25 (2000).

[28] Stephen J. Kobrin, *Taxing Internet Transactions*, 21 U. PA. J. INT'L ECON. L. 666, 670 (2000).

[29] Daniela Ivascanu, *Legal Issues in Electronic Commerce in the Western Hemisphere*, 17 ARIZ. J. INT'L & COMP. L. 219, 221 (2000).

[30] *Id.*

This process of disintermediation causes problems in record and information keeping which in turn affects administration. The "audit trails" needed for tax administration may no longer exist where "electronic cash" or "smart cards" are used for payment. Encrypted records can make it virtually impossible to determine the nature or value of the transactions. The incidence of non-compliance with the tax system is thus likely to increase as the volume and value of Internet transactions that are not taxed, grow and as businesses move their "residence" to Internet servers located in low tax jurisdictions or "tax havens". On the other hand, businesses may find themselves subject to double taxation if some of the questions regarding residency and applicable jurisdiction are not settled.[31]

Several key features of the Internet that are important from a tax perspective have been identified: First, the Internet is radically decentralized, has no physical location, and pays no regard to national boundaries.[32] Users have no control over, and usually no knowledge of, the routes taken by the data they transmit over the net. Net administrators have no control over the type of information that travels over their computers, as they are merely the transmission points that enable the system to operate.

Second, one key advantage of conducting electronic commerce over the Internet, and especially over the World Wide Web is that sellers can have direct contact with consumers with no need for intermediaries—"disintermediation". Moreover, if e-money develops as predicted, the banking institutions that act as intermediaries for credit card sales can largely be by passed as well.

Third, the addresses on the Internet give no indication as to the ownership of the website.[33] Even if the address contains a country code (i.e., ".ph" instead of merely ".com"), the real location of the computer carrying that address, or that company maintaining the website, need not be in the Philippines at all.

## IV. DEFINITION OF THE PROBLEM AND SCOPE OF THE PAPER

The exponential increase in the volume of Internet transactions has raised some concern over the possible erosion of a government's tax base.

---

[31] *Id.*
[32] TREASURY WHITE PAPER, note 2, § 2.4 at 5-6.
[33] TREASURY WHITE PAPER, note 2 at 17-18.

This has sparked the need to discuss what may be done and what measure may be taken to address this new phenomenon. Can old tax rules govern this new and emerging medium of commerce? What are the problems faced by applying traditional tax rules to this new paradigm?

This paper shall attempt to provide a framework for understanding the income and value-added tax issues and implications that have evolved in relation to the conduct of electronic commerce over the Internet. It will discuss the core issues, the emerging complexities, the common approaches and the current tax rules with the ultimate goal of providing a roadmap for understanding current and future issues related to the taxation of cyberspace.

While this paper shall argue that existing structures for taxation of physical commerce do not fit the developing reality of an electronic commerce based economy, this paper does not aim to take sides on the matter of Internet taxation. Rather, this paper shall approach the subject by looking at existing Philippine as well as international taxation laws and principles, how they might apply to transactions involving electronic commerce and what alternative approaches might be available.

This paper shall be divided into five chapters corresponding to the subtitle of the article—*Concepts, Problems, Solutions and Perspectives.* Chapter One comprises four subsections which gives the reader a brief introduction on the basic principles and workings of the Internet, the concept of digitalization and the emergence of digital trade as well as the definition of the problem and the scope of the paper.

Chapter two shall examine traditional tax and nexus rules, principles and concepts from the perspective of Philippine Income and Value Added Taxation Law as well as U.S. and international taxation principles. It shall also include a short discussion on the concept of nexus and permanent establishment and its impact on the State's power of taxation.

Chapter III will discuss the problems and issues raised by the emergence of this new phenomenon and shall examine and analyze the inability of traditional taxation laws to address the special problems posed by digital products downloaded and obtained from the Internet.

Chapter IV shall take a look at current solutions and approaches undertaken here and abroad to address this new phenomenon. Finally, Chapter V shall examine a number of proposals and alternative perspectives obtained from various sectors in attempting to solve this problem.

# CHAPTER II

# CONCEPTS

## V. INTERNATIONAL TAXATION

### A. GENERAL PRINCIPLES OF INTERNATIONAL TAXATION

There are two main sources of international tax rules: domestic law and treaty law. The term "international tax law" although used generally to encompass all sources and aspects of taxation actually is more of a descriptive term to encompass all sources and aspects of taxation that have international implications.[34]

Sources of domestic tax laws generally include tax statutes, cases and rulings of the tax administrators. Domestic tax laws generally provide for rules on determining who is liable to tax in a particular jurisdiction, how income earned by nonresidents is taxed and how foreign taxes paid by residents on foreign source income are recognized.[35]

The tax treaties, on the other hand, are entered into by countries with their trading partners. These treaties are generally based on the OECD Model Tax Convention. The main objective of tax treaties is to facilitate international trade and investment by removing tax barriers to the cross-border flow of goods and services and by reducing the risk of double taxation.[36]

### B. NEXUS AND JURISDICTION

Jurisdiction to tax the income of an individual or an entity may be divided into two kinds, namely domiciliary jurisdiction and source jurisdiction. The first type is based on the personal status of that individual, such as residence, domicile or citizenship (for individuals) and place of incorporation or effective management (for corporations). It includes the right to tax the worldwide income of the individual involved. The second type is based on the source of the income being situated within the territory

---

[34] RICHARD DOERNBERG *ET. AL*, ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION 71-72 (2001).

[35] *Id.*

[36] *Id.*

of that state. It is usually restricted to the income that arises from sources within the state. Source jurisdiction usually takes precedence over domiciliary jurisdiction; hence domiciliary states which tax worldwide income will usually take reasonably drastic action to remove the double taxation that results from the concurring tax claims on income arising outside the domiciliary state.[37]

### 1. Domiciliary Jurisdiction

*a. Individuals*

States usually exercise domiciliary jurisdiction over an individual's worldwide income on the basis of the individual's residence, domicile, and/or citizenship. On the one hand, citizenship refers to one's political ties with the state. Residence on the other hand reflects one's factual ties with a particular territory. A person's domicile is where he or she has a permanent home to which he or she always intends to return. Countries usually employ residence or domicile of individuals as a basis for tax liability with respect to worldwide income.[38]

*b. Corporations*

Countries generally tax corporations based on their residence, which is determined by the place of incorporation or the place of central or effective management of the corporation. The place of incorporation refers to the state under whose laws a company is created, which is akin to the concept of citizenship of individuals. In some countries, the corporate equivalent of an individual's residence is the place where the company is managed.[39]

### 2. Source Jurisdiction

Source jurisdiction in taxation is usually acquired with respect to the nature of the income, which has a reasonable nexus with the territory of the state concerned. This refers to economic activities and capital interest that are substantively connected with that state.[40] The types of income most

---

[37] *Id.* at 74.
[38] *Id.* at 79.
[39] *Id.*
[40] *Id.*

commonly affected by electronic commerce transactions are the business income, services income and capital income.

*a. Business Income*

The source rule for business income under domestic tax laws on the one hand is usually defined to be the place of carrying on a business, place of contract, the location of certain business activities, and activities of a dependent agent.[41]

Tax treaties, on the other hand, use the concept of "permanent establishment" to determine the source of business income. It is defined to be a fixed place of business through which a business is conducted[42]. While the meaning of "permanent establishment" has remained unchanged over the past 70 years, in recent decades however, it has been observed that the term has been extended by deeming any business activity carried on during a minimum period of time to have been carried on through a permanent establishment.[43]

*b. Services Income*

Source of services income, according to domestic law and treaty law, is based generally on the location where services are performed. Tax treaties however, often provide more limitations on source taxation. Article 15 (2) of the OECD Model Tax Convention for example disallows the source country from taxing employment income earned by a resident of a treaty partner even if the services are exercised in that country, unless 1) the taxpayer is present in the source country for a period exceeding 183 days, 2) the remuneration is paid by a resident of that country, or 3) where the remuneration is borne by a permanent establishment.[44]

*c. Capital Income*

Under the domestic laws of most countries, the source of dividends is based on the residence of the corporation that pays the dividends. The source of interests and royalties is also based on the residence of the payer.

---

[41] *Id.*
[42] art. 5, *OECD Model Tax Convention.*
[43] Doenberg, *supra* note 37, at 79.
[44] *Id.*

In some countries, the source of royalties is based on the place of use of the intangible property.[45]

Under tax treaties, the source of dividends, interest, and royalties is usually determined by the residence of the payer. In the case of interest and royalties, the location of a permanent establishment that bears the cost of payment may also determine the source of these two types of income.[46]

## VI. PHILIPPINE INCOME TAX LAW

### A. GENERAL PRINCIPLES OF TAXATION IN THE NIRC

Taxation is the process or means by which the sovereign, through its law-making body, raises income to defray the necessary expenses of government. It is a method of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must, therefore, bear its burdens.

The power of taxation proceeds upon the theory that the existence of government is a necessity and that it cannot continue without the means to pay its expenses. As such, it has the right to compel all citizens and property within its limits to contribute. The basis of taxation is found in the reciprocal duties of protection and support between the State and its inhabitants[47].

Income, on the other hand, is defined as "*the amount of money coming to a person or corporation, within a specified time, whether as payment for services, interest, or profits from investment.*" It imports something distinct from the principal or capital.[48] For income to be taxable, there must be (1) gain or profit, (2) such gain or profit must be realized, accrued or received during the taxable year, (3) and such gain or profit must not be excluded by law from taxation.

Under the Tax Code,[49] there are four types of taxpayers, namely, individuals, corporations, general professional partnerships and estates and trusts. Individuals may be classified as either (1) citizens of the Philippines who may be further classified as either (a) resident citizens or (b) nonresident citizens, and (2) Aliens or foreigners who are either (a) resident

---

[45] *Id.*
[46] *Id.*
[47] HECTOR DE LEON & BENJAMIN TEODORO, THE LAW ON INCOME TAXATION 1-2 (2001).
[48] Fisher v. Trinidad, 43 Phil. 973 (1922).
[49] TAX CODE, § 22. The National Internal Revenue Code is Rep. Act No. 8424 (1997).

aliens, or (b) nonresident aliens, the latter may further be divided into (i) those engaged in trade or business in the Philippines and (ii) those not engaged in trade or business in the Philippines. Corporations on the other hand may be divided into (1) domestic corporations and (2) foreign corporations, the latter being further divided into (a) resident foreign corporations and (b) nonresident foreign corporation.

### B. DEFINING THE CONCEPT OF "DOING BUSINESS"

To engage in business is to "follow the employment or occupation which occupies the time, attention and labor or the purpose of a livelihood or profit.[50] Under the Tax Code, the term "trade or business" includes the performance of the functions of a public office[51] and the term "trade, business or profession" does not include the performance of services by the taxpayer as an employee.[52] A nonresident alien who owns real properties in the Philippines, pays the real estate dealer's tax for renting houses and collects rentals from such properties is engaged in trade or business in the Philippines[53]. However, a nonresident alien who receives dividends from a Philippine corporation is not necessarily engaged in business in the Philippines[54].

Furthermore, the Tax Code provides that a nonresident alien who comes to the Philippines and stays therein for an aggregate period of more than 180 days during any calendar year shall be considered a nonresident alien doing business in the Philippines[55]. This provision creates a presumption of engaging in business. It must be understood as an exception to the generally accepted meaning of the phrase "engaged in trade or business".

While the Corporation Code does not define the term "transacting business in the Philippines", the Omnibus Investments Code does enumerate certain acts which are deemed included in the phrase "doing business". Article 44 of the said Code provides that "doing business" shall include "soliciting orders, purchases, service contracts, opening of offices, whether called "liaison" offices or branches; appointing representatives or

---

[50] Semple v. Guenther, 96 N.W. 895, 896.
[51] § 22 (C).
[52] § 22 (CC).
[53] Bureau of Internal Revenue, Oct. 13, 1961.
[54] Hospital de San Juan de Dios, Inc. v. Comm., CTA Case No. 1693, Aug. 29, 1969.
[55] § 22 (A).

distributors who are domiciled in the Philippines or who in any calendar year stay in the Philippine for a period or periods totaling one hundred eighty (180) days or more; participating in the management, supervision or control of any domestic business firm, entity or corporation in the Philippines, and any other act or acts that imply a continuity of commercial dealings or arrangements and contemplate to that extent the performance of acts or works, or the exercise of some of the functions normally incident to, and in progressive prosecution of, commercial gain or of the purpose and object, of the business corporation".

The Board of Investments, pursuant to its power to promulgate rules and regulations, enumerates in more detail the acts which constitute "doing business" in the Philippines, and those which are not deemed "doing business". Section 1 of the Rules and Regulations implementing the Omnibus Investments Code provides in part:

> The following acts by themselves shall not be deemed doing business in the Philippines:
>
> (1) The publication of a general advertisement through newspapers, brochures, or other publication media or through radio or television
>
> (2) Maintaining a stock of goods in the Philippines solely for the purpose of having the same processed by another entity in the Philippines
>
> (3) Collecting information in the Philippines. Thus, sending a roving correspondent to gather news in the Philippines does not of itself constitute doing business therein.
>
> (4) Performing services auxiliary to an existing isolated contract of sale which are not on a continuing basis, such as installing in the Philippines machinery it has manufactured or exported to the Philippines, servicing the same, training domestic workers to operate it, and similar incidental services.

The Supreme Court has repeatedly stated that no general rule can be laid down as to what constitutes doing business and that each case must be decided in the light of its peculiar circumstances. In the case of *Mentholatum Co. Inc. vs. Mangaliman*[56], however, it attempted to lay down a test which has been cited frequently in subsequent cases, and which was later incorporated in the law. Briefly stated, such test is *whether there is continuity of transactions*

[56] 72 Phil. 524 (1941).

*which are in pursuance of the normal business of the corporation*[57]. Thus, an isolated transaction, even if in pursuance of such business, cannot constitute "doing business."[58]

In some cases, the Supreme Court has considered the place of perfection and consummation of the contract as the determining factor. Thus, although a foreign corporation had entered into similar export transactions in the past, since all these contracts were negotiated, perfected and the goods contracted were delivered outside Philippine territory, it was considered not doing business in the Philippines.[59]

It should be noted however, that under the BOI rules promulgated in pursuance of the Omnibus Investments Code, the place of delivery or of the signing of the contract is immaterial if solicitation or negotiation were made in the Philippines.[60] According to the BOI rules, mere investment in a domestic enterprise which has a distinct legal personality and duly licensed to transact business in the Philippines does not constitute doing business therein.

Under the Tax Code, foreign corporations are subject to income tax on all income from sources within the Philippines. On the one hand, if said corporation is doing business in the Philippines, it may claim deductions from gross income to the extent connected with income from Philippine sources.[61] It is thus taxed on its net income. On the other hand, a foreign corporation not doing business in the Philippines is taxed on all its gross receipts, without any qualifications or exceptions.[62] Thus, where a foreign corporation had loaded cargoes in the Philippines on two separate, isolated occasions, it was deemed not to be doing business in the Philippines and so liable to pay taxes on its gross receipts, without allowing any deductions for commissions paid by it to its agents.[63]

---

[57] *Id.*

[58] Eastboard Navigation Ltd. v. Juan Ismael & Co., 102 Phil. 1 (1957)

[59] Pacific Vegetable Oil Corp. v. Singzon, G.R. No. 7917, Apr. 29, 1955.

[60] INVESTMENTS CODE Implementing Rules and Regulations, § 1(f)(1). The Omnibus Investments Code is E.O. 226 (1987).

[61] TAX CODE, §§ 24 (b)(2), 37.

[62] § 24 (b)(1).

[63] N.V. Reedertij Amsterdam v. Commissioner of Internal Revenue (hereinafter "Reedertij"), 162 SCRA 87.

### C. KINDS OF TAXABLE INCOME

Income includes gain, profits, and income of whatever form derived from any source, whether legal or illegal, such as those derived from the exercise of professions and vocations, or from trade, business, commerce, sales or from dealing in property or growing out of the ownership or use of property or any interest therein, as well as from interest, rents, dividends, securities or the transactions of any business carried on for gain or profit.[64]

Taxable income may be grouped into three categories, namely (a) passive investment income subject to final tax, (b) compensation income and (c) non-compensation income.[65] Income subject to final tax is no longer included in the taxpayer's taxable income. Income subject to final tax includes royalties, interest from Philippine currency bank deposits, dividends from domestic corporations and shares of individual partners in the net profits of taxable partnerships.

Royalties, are "payments of any kind received as a consideration for the use of, or right to use, any copyright of literary, artistic or scientific work including cinematographic film, any patent, trademark, design or model, plain, secret formula or process, or for information concerning industrial, commercial, or scientific experience"[66] and are considered as passive investment income subject to final tax. The final tax rate in the case of citizens, resident aliens and of nonresident aliens engaged in trade or business in the Philippines is twenty percent (20%) of the royalty amount. In the case of nonresident aliens not engaged in trade or business in the Philippines, the amount received by them in royalties from sources within the Philippines shall form part of their gross income subject to a flat rate of twenty-five percent (25%).

Compensation income and gross compensation income refer to all income payments, in money or in kind, "arising from personal (not corporate) services under an employer-employee relationship."[67] In order that an income can be so considered compensation income, (a) it must arise from personal services under an employer-employee relationship, and (b) is in the nature of income given to the recipient employee.

---

[64] JOSE VITUG & ERNESTO ACOSTA, TAX LAW AND JURISPRUDENCE 106 (2000).
[65] *Id.* at 96.
[66] art. 12, *OECD Model Treaty*.
[67] TAX CODE, § 34.

On the one hand, compensation income of resident citizens within and without the Philippines, unlike royalties, is taxed on gross (deductions other than exemptions and premium payments on health and/or hospitalization insurance, not being allowed). On the other hand, nonresident citizens, resident aliens and nonresident aliens engaged in trade or business in the Philippines, are taxed only on compensation derived from sources within the Philippines.[68] Non-compensation income is any other income that is not derived from personal services or not related to an employer-employee relationship and is generally subject to tax on net income basis.

### D. SOURCES OF INCOME

Section 42 of the NIRC sets the rules in determining the situs of income. Sources of income may be generally divided into three, namely, income from sources within the Philippines, income from sources without the Philippines, and income from sources partly within and partly without the Philippines.

For royalties to be considered as income from within the Philippines, such royalties must be derived from property located in the Philippines or from any interest in such property. However, for compensation to be considered as income from within the Philippines, such compensation must be for labor or personal service performed within the Philippines regardless of (1) the residence of the payor, (2) the place in which the contract for service was made and (3) the place of payment.[69]

Income derived from the purchase and sale of personal property is considered entirely earned from the country where it is sold. The exception to this rule concerns gains from sales of shares of stock of domestic corporations, which are treated as being derived entirely from sources within the Philippines regardless of where the shares are sold. It is the prevailing view that in ascertaining the place of sale, the determination of when and where title to the goods passes from the seller to the buyer is decisive. This is sometimes called the "passage of title test."[70]

---

[68] TAX CODE, §§ 24-25, 27-28.
[69] § 42 (A)(3). § 155, Revenue Regulations 2.
[70] Vitug, *supra* note 64.

Conversely, royalties from property located outside the Philippines, or from any interest in such property, including royalties for the use or the privilege of using the same outside the Philippines (i.e., patents), are considered income from sources outside the Philippines. Compensation for labor or personal services performed outside the Philippines as well as gain, profits and income from the sale of personal property located outside the Philippines and income from the purchase of personal property within and its subsequent sale outside the Philippines, are considered as income from sources outside the Philippines.[71]

### F. NEXUS AND PERMANENT ESTABLISHMENT

Under the United States tax system, the Commerce Clause and the Due Process Clause of the United States Constitution provides the limits to the state's taxing power.[72] Under the Due Process Clause, there must be some minimum connection between a state and the person, property or transaction it seeks to tax. This clause ensures that states do not unfairly impose tax collection requirements on companies that have no connection with them.

The Due Process Clause states, "No State shall make or enforce any law which shall... deprive any person of life, liberty, or property, without due process of law." The standards of fairness set forth by the clause govern the imposition of taxes and are used to decide whether a given tax burden is fair.

Of particular importance under the Due Process Clause is whether the company has minimum contacts with the state that is levying the tax. Companies based in the taxing state that enjoy the benefits of operating in that state should be required to collect and pay taxes. However, allowing a taxing state to impose a tax requirement on out-of-state companies that do not enjoy the benefits of operating in that state would be an unfair burden on those companies.[73]

Under the Commerce Clause, a tax is valid only if it is applied to an activity having a substantial nexus with the taxing state.[74] The Commerce

---

[71] TAX CODE, § 42 (E).

[72] Andersen, *supra* note 3.

[73] http://www.ksg.harvard.edu/project1/law.html (September 26, 2003).

[74] Complete Auto Transit v. Brady, 430 U.S. 274 (1976). *Complete Auto Transit* established a four-prong test for deciding whether a state tax violates the Commerce Clause. In order to pass muster under the Commerce Clause, a state tax must (1) apply to an activity with a substantial nexus with the taxing state, (2) be

Clause balances the right of states to tax residents with the right of Congress to regulate interstate commerce. The Commerce Clause states that "Congress shall have power to lay and collect taxes and to regulate commerce with foreign nations, and among the several states, and with the Indian Tribes." Under the clause, states may impose taxes as long as these taxes do not burden interstate commerce.[75]

Generally, the rules for determining nexus for purposes of sales and use tax and corporate income tax are the same. For both types of taxes, physical presence of the taxpayers' (or its agents') employees or property will typically create a taxable connection with the state. Corporate income tax nexus rules however provide certain limited protection for sellers of tangible personal property (unlike sales and use tax rules that afford no such protection).

In 1959, the U.S. Congress enacted Public Law 86-272, which created a safe harbor from state income taxation for multi-state companies that meet certain criteria. Under said law, a state may not subject a foreign corporation to a tax on or measured by net income derived within the state from interstate commerce if the "only business activities within such State by or on behalf of such foreign corporation" are the solicitation of orders for sales of tangible personal property, where the orders are sent outside the state for approval or rejection and are filled by shipment or delivery from a point outside the state.[76]

Nexus issues as they relate to electronic commerce, will undoubtedly be a major topic of discussion in taxation as the application of nexus standards to electronic commerce transactions raises a host of uniquely difficult questions.

The US Supreme Court has ruled that state tax statutes must satisfy two different tests under the Due Process Clause and the Commerce Clause. The relationship between permanent establishment and taxation has been addressed by the US Supreme Court when it rendered its decision in *National Bellas Hess v. Department of Revenue of the State of Illinois*.[77] In this case, National Bellas Hess, a Missouri mail-order company, that sold goods in Illinois but

---

fairly apportioned (3) not discriminate against interstate commerce, and (4) be fairly related to the services provided by the state.

[75] Reedertij.

[76] 15 U.S.C. 381 (a). See also William Wrigley, Jr. Co v. Wis. Dept. of Revenue, 112 S.Ct. 2447 (1992).

[77] 386 U.S. 753 (1967).

had no physical presence or any sales representatives in Illinois. When the state of Illinois attempted to collect sales taxes imposed by Illinois on consumers who purchase goods for use within the state, National Bellas Hess objected. The case eventually reached the Supreme Court, which ruled in favor of National Bellas Hess on the grounds that a company must have a "minimum link" between the state and the consumer in order to be required to collect taxes. The reasoning in this case sets forth taxation principles that depend on the physical location of a vendor relative to a purchaser.[78]

Twenty-five years after *Bellas Hess*, the Court decided *Quill Corporation v. North Dakota.*[79] According to the facts of the case, Quill Corporation sells office equipment and supplies, soliciting orders through catalogues and flyers, ads in national periodicals, and telemarketing. It delivers all of its merchandise to its North Dakota customers from out-of-state locations. None of its employees work or live in North Dakota, and its ownership of property in the state is insignificant. Under its laws, North Dakota requires mail-order companies to collect sales and use taxes from its North Dakota customers and to remit the amounts to the state. When Quill refused to pay the use tax, North Dakota filed suit in a state court against Quill. Quill asserted however that the state did not have the power to compel Quill to collect use taxes from its North Dakota customers. The Supreme Court ruled in Quill's favor and reasoned that the bright-line rule in the area of state use taxes and the doctrine of *stare decisis* in *Bellas Hess* was still good law.

In *Quill*, the Court revisited the question of whether or not states were allowed under the Constitution to tax out-of-state mail order companies. The ruling in *Quill* is particularly important with respect to digital products both because of what it succeeded and failed to address. While the Court explained how mail order companies selling tangible goods across state borders should be taxed, it did not address the problem of when states may tax the sales of intangible or tangible goods over the Internet.[80]

In the Philippines, a parallel case dealing with the same issues is the decision of the Philippine Supreme Court in "*Commissioner v. British Overseas Airways Corporation.*"[81] In this case the Court ruled, "The source of an income is the property, activity or service that produces the income. For the source of income to be considered as coming from the Philippines, it is

---

[78] 430 U.S. 274 (1976).
[79] 504 U.S. 298 (1992).
[80] 430 U.S. 274 (1976).
[81] 149 SCRA 395.

sufficient that the income is derived from activity within the Philippines. In BOAC's case, the sale of tickets in the Philippines is the activity that produces the income. The ticket exchanged hands here and payments for fares were also made here in the Philippine currency. The flow of wealth proceeded from, and occurred within, Philippine territory, enjoying the protection accorded by the Philippine government. In consideration of such protection, the flow of wealth should share the burden of supporting the government."[82] It further ruled "the absence of flight operations to and from the Philippines is not determinative of the source of income or the situs of income taxation. Admittedly, BOAC was an off-line international airline at the time pertinent to this case. The test of taxability is the 'source' and the source of an income is that activity which produced the income."[83]

## VII. PHILIPPINE VALUE ADDED TAX LAW

### A. CONCEPT AND GENERAL PRINCIPLES

The value-added tax is a tax levied on a wide range of goods and services and is a tax on the *value added* by every seller with aggregate annual sales of articles and/or services exceeding Php 550,000.00 to his purchase of goods reported and services. VAT is computed at the rate of 0% or 12% of the gross selling price of goods or gross receipts realized from the sale of services.

The VAT is an indirect tax, the amount of which may be shifted to or passed on to the buyer, transferee, or lessee of the goods, properties or services. It is a business or percentage tax and is likewise an excise tax.

The transactions subject to VAT are the following: a) any sale, barter, or exchange of goods and properties, or similar transactions, in the course of trade or business; b) any sale of services or similar transactions, in the course of trade or business; c) any lease of goods and properties or similar transactions, in the course of trade or business; and d) any importation of goods whether in the course of trade or business or not.

---

[82] *Id.*
[83] *Id.*

### B. TRANSACTIONS EXEMPT FROM VAT

The NIRC enumerates certain transactions, which are exempt from VAT. The individual making an exempt sale of goods, properties, or services shall not bill any output tax to his customers because the said transaction is not subject to VAT. On the other hand, a VAT registered purchaser of VAT-exempt goods/properties or services which are exempt from VAT is not entitled to any input tax on such purchase despite the issuance of a VAT invoice or receipt.

Of special interest to the discussion in this paper is the exemption on books, magazines and newspapers, as well as works of art, literary works and musical compositions. On the one hand, Section 109 (y) of the NIRC provides that the sale, importation or publication of books and any newspaper, magazine, review or bulletin which (a) appears at regular intervals (b) with fixed prices for subscription and sale and (c) which is not devoted principally to the publication of advertisements, are exempt from VAT. Section 109 (o) on the other hand provides that sales of works of art, literary works and musical compositions and similar creations, or services performed for the production of such works, if sold by the artist himself, are exempt from VAT. However, if the same are sold by other persons in the course of business, they shall be subject to VAT.

In VAT Ruling No. 047-03 dated 25 November 2003 addressed to Mr. Abelardo Leano, the BIR had the occasion to rule that the importation of journals and periodicals through the Internet is exempt from VAT.

In the aforementioned case, Info-Ed Marketing Corporation is engaged in the sale of educational materials such as books, CDs, software. They also provide journals and periodicals, which can only be accessed by the librarians or students in their library through the Internet, the client schools not having a hard copy of said journals. The Bureau of Internal Revenue (BIR) therein, citing R.A. 8792 or the Electronic Commerce Act of 2000, ruled thus:

> In this light, this Office is of the opinion that while journals and periodicals can be accessed through the Internet, they are basically print media. Absence of hard copy (print format) does not negate the fact that every electronic data message or document electronically written is capable of being sent, received, recorded, stored, downloaded, transmitted, retrieved and finally reduced into printed form. Such being the case, although the aforesaid journals and

periodicals can be accessed only through the web, they are nonetheless considered written publications.[84]

The BIR further set forth the criteria for exemption from VAT for the importation of journals and periodicals over the Internet, thus:

> Accordingly, such importation of journals and periodicals which can be accessed only through the Internet may be exempt from VAT as provided for under Section 109(y) of the Tax Code of 1997, if (1) their publication in the Internet appears at regular intervals; (2) they are available for subscription and sale at fixed prices; and (3) they are not principally devoted to the publication of paid advertisements.[85]

The above reasoning was reiterated in the more recent ruling of the BIR in VAT Ruling No. 002-08 dated 19 March 2008 addressed to Franklin Naig. Therein CE-Logic Inc., which is engaged in the distribution of online academic library resources, e-Books, and e-Journals of various foreign publishers, requested a ruling that the sale of the foregoing educational products in digital or electronic format is not subject to VAT since these products are: a) merely computerized versions of printed media; that b) appear at regular intervals; and are c) available for subscription and sale at fixed prices; and are d) not principally devoted to the publication of paid advertisements.

The BIR, citing VAT Ruling No. 047-03 as well as Section 109 (R) of the Tax Code of 1997 (as amended by R.A. 9337) and Sections 5 (f) and 7 of the Electronic Commerce Act of 2000 (RA 8792) ruled thus:

> From the above provisions, it can be seen that entities engaged in the importation and sale of printed material as stated in Section 109 (R) of the Tax Code of 1997, as amended, may avail of VAT exemption on such printed material. In this regard, RA 8792 clearly allows for documents/messages/information which are electronically written, capable of being sent, received, recorded, stored, downloaded, transmitted, retrieved and finally reduced into printed form to be considered as equivalent to print media.
>
> ...
>
> Accordingly, since the e-books, e-journals and online library resources of CE-Logic are considered as equivalent to printed media; appears at regular intervals; available for subscription and sale at fixed prices; and are not principally devoted to the publication of paid

---

[84] Bureau of Internal Revenue, VAT Ruling No. 047-2003 (2003).
[85] *Id.*

advertisements, CE-Logic's sales of such products are exempted from VAT in accordance with Section 109 (R) of the Tax Code of 1997, as amended.[86]

## CHAPTER III

## PROBLEMS

## VIII. INCOME TAX LAW AND DIGITAL TRADE

### A. DIGITAL GOODS AND SERVICES VS. TRADITIONAL GOODS AND SERVICES

Digitized goods and services blur the concept of geographical boundaries, (i.e., place of supply or residence). While an e-commerce sale of tangible goods entails their shipment to the buyer, thereby establishing a basis for ascertaining the situs for taxation purposes, there is no such "bright line test" for electronic delivery.

The term "digital products" or "virtual goods" refers to information-based products that can be digitized and delivered via electronic networks, such as software, stream video, and MP3, etc. These products are unique to e-commerce. Virtual goods, now free of the physical forms that formerly carried content, allow a much greater degree of product customization and differentiation.[87] Furthermore, the Internet has made it possible to sell goods and services without either the buyer or seller being identified.

Many vendors need only credit card numbers to complete transactions. For instance, where software is downloaded from a website, the vendor does not need to know the identity or location of the buyer to complete the transaction. Where information is not needed to complete a transaction, the vendor need not request that information, even if the information is necessary for proper tax compliance.[88]

Businesses dealing in goods or services, which can be digitized or otherwise transferred electronically, will find electronic commerce to be a

---

[86] *Id.*

[87] http://www.ksg.harvard.edu/project1/tech.html (September 26, 2003).

[88] David Hardesty, *Tax Issues in Electronic Commerce*, *at* http://www.smartpros.com/x15734.xml (last visited Sept. 26, 2003).

very fast and cost effective way to reach their consumers. While the distribution of automobiles and refrigerators will not occur electronically, other major business and personal consumer items lend themselves to the digital age including computer software, telecommunications, movies, magazines, books, customer service, music albums, financial transactions, medical services, video conferencing, newspapers, educational and training materials, electronic bulletin boards, E-mail, games, business databases and miscellaneous information services.[89]

These "virtual goods" defy the traditional image of a good or service in that these goods and services are not "captured" in a tangible medium. Digital products such as software, music or electronic versions of printed materials are intangible and do not exist physically outside Internet space. Some digital products have physical analogues, such as CDs or books, while new forms of commerce such as web searches have no such analogue. As more businesses adapt E-commerce strategies, digital products have begun to emerge in industries such as publishing, travel, insurance and banking. The possibilities for new forms of digital products are unpredictable.[90] As Nicholas Negroponte, author of *Being Digital*, aptly puts it "we are, at least partially, in the transition from an economy based on the movement of "atoms" to one based on "bits"...the information superhighway is about the global movement of weightless bits at the speed of light."[91]

## B. SOME SAMPLE TRANSACTIONS[92]

SITUATION 1: SALES OF TANGIBLE GOODS ONLINE

"www.usedbooks.com", a United States corporation, is an online bookseller. It features a large used-book collection, selling books that have gone out of print. On the Internet, consumers purchase books by credit card, and the books are shipped to their homes. Its servers are located in the United States. A Filipino customer who wishes to purchase a rare collection of books from usedbooks.com simply enters his credit card number on the order form found on the website and he is automatically billed by his credit card company for his purchase. The books are then shipped from the

---

[89] Andersen, *supra* note 3.
[90] McLure, *supra* note 18.
[91] Andersen, *supra* note 3.
[92] *International Taxation of Electronic Commerce: Classification of Income Issue*, Conference and Research Papers, 2001 WTD 82-15.

United States to the Philippines. Situation 1 provides the least controversial position among the situations discussed in this paper.

SITUATION 2: SALE OF SHRINK-WRAP SOFTWARE ONLINE

Software.com, a United States corporation is an online retailer of software. Consumers and businesses purchase software online, payment being made via credit card. The software is then physically "shrink-wrapped" and shipped to the consumers. The servers are located only in the United States. A Filipino purchases computer games from Software.com because of its low prices. The software is shipped from the United States to the Philippines.

The neutrality concept dictates that Situation 1 be treated in the same manner as Situation 2. However, many countries will deem Situation 2 as a payment of Royalty (while Situation 1 is treated as Business Profits) The United States may still source that transaction in the United States and deny a foreign tax credit for the royalty taxes.

SITUATION 3: SALE OF SOFTWARE DOWNLOADED ONLINE (1 COPY)

Software.com now begins a service allowing customers to download software from their servers located in the United States. Juan Dela Cruz, a Filipino who resides in the Philippines, purchases games online from Software.com. He pays for the software with his credit card. If the Philippines were to treat this transaction like the one in Situation 2, Software.com will not have to pay tax in the Philippines. The Philippines could however deem that payment as a payment of royalty and require the withholding of taxes by Juan Dela Cruz.

SITUATION 4: SALE OF SOFTWARE ONLINE (MULTIPLE COPIES FOR ONE ENTERPRISE)

Software.com also allows businesses to download software to be installed at offices on many workstations. Although only one copy is downloaded, the purchase agreement stipulates that a certain number of copies may be made for all the computers in an office. The server is located in the United States. ABC Company, a Filipino company purchases one copy of a spreadsheet program from Software.com with permission to copy that program onto all its 18 computers.

This transaction may be treated by the Philippines as generating either Business Profits or Royalties. If it is a business profit, the question arises as to where the "sale" was consummated. If it treated as a royalty payment on the other hand, withholding tax on royalty income may be required of ABC Company.

SITUATION 5: SALE OF SOFTWARE ONLINE (FOR REPRODUCTION AND RESALE)

Softwarehouse.com, a United States corporation, is an online distributor of software to other online software retailers. It generally purchases software from the manufacturer, converts it to a downloadable file, and sells it to online retailers for reproduction. Its servers are located in the United States.

ABC operates a web site in the Philippines and sells a variety of software to both consumers and businesses. It purchases the right to sell 30,000 copies of a spreadsheet program from Softwarehouse.com

Nearly all nations could classify the payment as a Royalty because the contract stipulates that ABC has a "right to sell" a certain number of copies. Since the income involved here is Royalty income, the Philippines could demand withholding tax on the Royalty by ABC.

SITUATION 6: ONLINE SUBSCRIPTION SERVICE

WestLaw, Inc., a United States corporation, operates an online service, where for US$150.00 a month users can log on and use its database of US laws and cases. WestLaw, Inc.'s servers are located in the United States. The UP College of Law Library subscribes to the services provided by WestLaw, Inc. The Philippines may deem the payment as a Business Profit (payment for services). The question again arises however as to where the service is rendered and where the income is earned.

The six (6) transactions described above are not intended to provide for every possible tax scheme with respect to electronic transactions. However the situations are the most common circumstances occurring online today.[93]

---

[93] *Id.*

## C. PROBLEMS AND ISSUES IN INCOME TAXATION

States are attempting to use a mid-twentieth century tax system—designed largely for manufacturers and vendors of tangible personal property—to tax a technologically advanced 21st century industry. The Internet is exploding with new concepts and terminologies such as TCP/IP, digital assistants, packet switching, webcrawlers, routers, hyperlinks, and encryption. Will these old tax rules suit to tax electronic commerce? Can old dogs learn new tricks?

### 1. Payments: Royalty or Business Income?

There are generally two ways in which electronic commerce income may be characterized for income taxation purposes: either Business Profits or Royalties. How a transaction is characterized is crucial for determining how it is treated for tax purposes and which jurisdiction can levy a tax on it. As discussed in the previous section, different categories of payments will carry different tax consequences under our tax code. To further compound the problem, e-commerce is blurring the line between goods and services, and the incidence of taxation may change because goods or services are delivered electronically[94] For example, is the payment made for searching an electronic database and downloading a document to be considered as one for provision of a service and thus classed as business profits and taxable only in the recipients' home country? Or should it rather be considered as payment of a royalty to which withholding tax will apply in the country of the payer?

Should sales of software or other "content" online be considered as a sale of tangible personal property or the sale of services/intangible property? To the extent that such sales are considered sales of tangible personal property, they will be sourced according to where the sale is consummated. It is likely, however, that such products may be treated as a sale of services or intangibles, since such electronic content cannot be "seen, measured or touched". To the extent that such sales are considered sales of services/intangibles, the settled rule in our jurisdiction provides that the source of the income is determined by the situs or place of the performance of the service.

---

[94] *OECD Nears Consensus on Tax Treaties and e-Business Issues, at* http://www.kpmg.ca/english/services/tax/publications/ctl/ctl01021.html (last visited Sept. 26, 2003).

Going back to Situation 3 mentioned above, it may not be clear whether the payment constitutes a royalty for the use of intellectual property, in which case the payment would be subject to national and treaty royalty rules. Alternatively, the fee may constitute payment for the performance of services. Still, a customer may be paying for the right to use tangible property (i.e., a hard drive or server) in which case the payment might constitute rental payment. Finally, if the customer acquires all the rights to property (tangible and intangible), the fee paid may constitute sales proceeds.

### 2. "Doing Business in the Philippines": Establishing Physical Presence in a Virtual Market

A corollary issue to the question of characterization of income from an Internet transaction is the question of the source of income. The source of income in Internet transactions becomes problematic because the principle of traditional physical business presence in terms of assets, personnel or both becomes diluted.[95] Foreign merchants can exploit the domestic market without even having to establish physical presence.[96] Is a website or server a permanent establishment for establishing nexus?

The committee on Fiscal Affairs of the OECD has adopted amendments to the Model Tax Convention which provide that an Internet website alone does not constitute a permanent establishment. The amendments further provide that a website hosting arrangement does not result in a physical establishment and that, except in very unusual circumstances, an Internet Service Provider (ISP) does not constitute a dependent agent of another enterprise and thereby result in a physical establishment.[97]

In the Philippines, the Supreme Court held in *Philippine Guaranty v. CIR* that "*business* implies continuity and progression of transactions, while *activity* may consist only of a single transaction."[98] Section 24 of the NIRC does not require a foreign corporation to engage in business in the Philippine to subject it to income tax. It suffices that the activity creating the income is performed or done in the Philippines. What is controlling,

---

[95] Welson Chu & Nicolas Nangit Jr., *http://www.taxinginternettransactions.com*, 75 PHIL. L. J. 351 (2000).

[96] Cabreros, *E-Commerce: Its Implications on Tax Treaties*, 36 PHIL. REVENUE J. 3, 36 (2000).

[97] *Supra* note 82.

[98] Philippine Guaranty Co., Inc. v. Commissioner of Internal Revenue, G.R. No. 22074, Apr. 30, 1965. Emphasis supplied.

therefore, is not the place of business but the place of activity that creates an income in order to establish the nexus. The abandonment of the "physical establishment" requirement as in U.S. tax law apparently made it easier to determine when a taxable event has occurred. So long as income is derived from a transaction done within the Philippines, it may safely be concluded that such income is sourced from within the Philippines and hence is taxable.

However, this brings us back to the question—in the digital world, when is a transaction considered as being transacted or perfected in the Philippines? When a consumer downloads a digital copy of a book from the website as illustrated in the situations in the previous section, where was the sale perfected? The website is hosted by a server in the United States but the product is being purchased by a resident of the Philippines. Where is the sale perfected for purposes of taxation? It may be difficult to determine where a contract is perfected in an online digital transaction, and the place of contract in any event may be subject to easy manipulation. Furthermore, is the payment made a business income or royalty? The nagging question remains.

### 3. Tax Enforcement and Administration

Some of the most difficult issues that electronic commerce has thrust into the tax debate involve administration and enforcement of tax rules. For example, questions concerning how to determine when a taxable event has occurred; whether a system based on voluntary compliance is still viable, how to establish audit trails; and the proper level of information exchange and efficient tax collection are of great importance in implementing a tax system.[99]

The use of credit cards in an ordinary online purchase, for instance, raises a lot of issues. Imagine a scenario wherein the consumer decides to make a purchase from a web merchant's store. The transaction information provided by the merchant may be considered at most as a mere offer and does not give rise to an obligation without an absolute acceptance communicated to the merchant. In other jurisdictions, however, a public offer already constitutes a source of obligation.

The consumer in our scenario then clicks on the pay button, prompting the input for the choice of credit card and other data.

---

[99] Andersen, *supra* note 3.

Subsequently, the transaction information is digitally signed by the consumer, encrypted, and sent to the merchant server which signs, encrypts, and forwards the transaction information to a third party server. Credit card numbers are encrypted with the third party's public key, so merchants never have to handle them directly. The third party server then decrypts and certifies the transaction data and forwards it through a private network to the merchant's bank for authorization. The merchant's bank processes the charge automatically. It then returns an approval or denial to the third party server, which passes it on to the merchant. The merchant then passes it on to the consumer.

While the whole process may take fewer than twenty seconds, the Bureau of Internal Revenue (BIR) in this simple scenario, would have to deal with the following issues 1) the perfection of the contract, 2) the situs of the transaction, 3) the provider of the service, 4) the encryption/decryption technology, and 5) the collection, not to mention 6) the exemptions allowed under tax treaties.[100]

There are additional enforcement problems arising out of new payment methods. In commercial transactions today, cash businesses pose special enforcement problems because there may be no external record of a company's income. However, commercial payments often are made by check or by credit card, creating a paper record of the transaction. Electronic cash, however, offers the opportunity for completely anonymous transactions in large denominations. A consumer can download electronic tokens from an online bank; use those tokens to consummate a transaction and leave no paper (or electronic) trail whatsoever.[101]

## IX. VAT LAW AND DIGITAL TRADE

### A. TAXING INCOME V. TAXING CONSUMPTION

In contrast to taxing income, while taxing consumption presents less conceptual and theoretical complications, the problems and issues related to administration and compliance are generally similar to income taxation. First, the nexus problem does not arise. The VAT rule for goods is the destination principle so that vendors are taxed when they import goods into

---

[100] Hardesty, *supra* note 88, at 357-358.
[101] Andersen, *supra* note 3, at 175-176.

a destination (and pass the tax on to their consumers).[102] No physical presence in the destination country is required.[103] Interestingly, this means that countries give up on taxing value added within their borders when they zero rate exports.[104]

The situation for services is, however, more complicated. Services are included in the VAT tax base; the liability to tax is determined based on the place of supply, which traditionally has been defined as the residence of the supplier.[105] This rule is problematic for electronic commerce because the supplier can be a resident in a country that is a tax haven from a VAT perspective. Recently, there has been a growing tendency to use a so-called "reverse charge" rule, in which the place of supply is the location of the consumer. As such, it appears likely that electronic commerce can be taxed for VAT purposes under a reverse charge regime, similar to the destination rule applicable to goods.[106]

Finally, VAT avoids the cascading problem faced by other forms of consumption taxes in other jurisdictions (i.e., retail sales tax) by either allowing an input tax credit for taxes paid by suppliers to registered VAT taxpayers or allowing the supplies to be deducted from taxable outputs. This rule allows for matching wherein deductions are permitted only when the party on the other side has paid the appropriate tax. Matching makes tax avoidance much more difficult and also enables the tax to be collected on a substitute basis. The absence of such matching in the income tax means that the tax must be collected from all taxpayers separately with generally no substitution, which leads to huge administrative difficulties.[107]

### B. SOME SAMPLE TRANSACTIONS

CASE 1: BUSINESS TO CONSUMER (B2C) SUPPLY OF DIGITAL SERVICES

Lex Libris Corp. (Lex Corp.) is a Philippine based company. It maintains a proprietary database containing valuable information. Its physical presence (mainframe computers, employees, and corporate offices) is confined to the Philippines (RP). It sells and delivers its information over the Internet through an online service provider (OSP), or through an

---

[102] *Tax Reform for Fairness, Simplicity, and Economic Growth: Value Added Tax*, 3 Treasury Department 7-8 (1984).
[103] *Id.* at 12.
[104] *Id.* at 41.
[105] *Id.* at 45-46.
[106] ADRIAN OGLEY, PRINCIPLES OF VALUE ADDED TAX: A EUROPEAN PERSPECTIVE 80-82 (1998).
[107] Reuven S. Avi-yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997).

Internet service provider (ISP). OSPs and ISPs charge customers either a flat fee or a fee based on usage for Internet access and related services.

The customers are foreign law schools and law libraries in Europe and the United States. When the European law school wishes to access Lex Corp's database, the customer (i.e. foreign student) logs onto a personal computer and dials up an OSP or ISP. The call is typically a local call. Once in communication with the Internet, the customer can log on to Lex Corp.'s services, where, after providing a password or credit information, the customer will be able to search the data base and download information. The customer will then be charged for Lex Corp's service based on such factors as duration of the connection. The customer will be billed through a credit card or by a separate statement sent by Lex Corp.

CASE 2: BUSINESS TO CONSUMER (B2C) SUPPLY OF TANGIBLE GOODS

SM Appliance Center (SM) is established in the Philippines. It maintains a website where the public (locals and foreigners) can view a catalogue of its products and purchase them online. A customer orders the furniture through SM's website hosted on servers located in the U.S. The customer pays for the furniture by credit card, submitting the requisite information electronically as part of the ordering process.

SM establishes a distribution center, including a warehouse and related facilities, in Hong Kong to handle its Internet sales, to facilitate the order fulfillment process, and to provide greater proximity to its customers. The foreign customer's orders are then processed and fulfilled through the distribution center that SM uses for facilitating its Internet sales.

CASE 3: BUSINESS TO BUSINESS (B2B) SUPPLY OF DIGITAL AND TANGIBLE PRODUCTS.

Kamiseta Inc. (Kamiseta) is in the business of designing as well as supplying clothes for customers who are mostly manufacturers of women's apparel. Kamiseta advertises its services on a website hosted on the server of independent ISPs and located in the market of potential customers. Kamiseta uses its website to communicate with its customers and to deliver the final design to them. It also maintains a distribution center to handle the sale and worldwide distribution of its products.

### C. PROBLEMS AND ISSUES

The transactions in Case 1 & 3 involve the electronic delivery of information products and services. In general, since the Philippine corporation therein has no physical presence in the foreign country where the customer is located, it is unlikely that the Philippine corporation is liable to charge and collect VAT in the foreign country. The customer may be required to self-assess the tax in some jurisdictions in certain circumstances.

The VAT treatment of online transactions depends on 1) how the transaction is characterized for VAT purposes, 2) whether the supply is considered to be a domestic supply, and 3) whether the customer is a private consumer or a VAT registered entity.

The characterization of services provided online is generally unproblematic. However, digitized products may be characterized as either services or intangible property. Since the application of VAT at the point of importation pertains only to tangible goods, the purchase of digitized goods or services online is not taxable at the border. In this sense, the distinction between "services" and "intangible property" is irrelevant. This distinction however, becomes relevant where different rules apply to services and intangible property.

In electronic commerce, the key element of the definition of "property" is that it includes "a right or interest of any kind". Thus a digital transaction involving the transfer of any right to the recipient may be considered a supply of intangible personal property. In distinguishing "services" and "intangible personal property", taxing authorities often look to the amount of human intervention on the part of a supplier in making the supply as the deciding factor.

VAT is a tax on domestic consumption of goods or services. As such, domestic supplies (unless zero rated or exempted) are always taxable. The importation of intangible property or services is free of VAT in some countries but taxable in others. An importation generally occurs when a supply is made to a domestic recipient, but the place of supply is outside the jurisdiction. The place of supply rules is therefore significant in that they determine whether a supply is domestic or an importation.

In an electronic commerce environment, the location of a server in the customer's country may be relevant to the determination of the place of supply in cases where the place of supply is linked to a "permanent establishment" and where the server constitutes a permanent establishment.

In cases 1 & 3, the place of supply of the digital goods or services is outside the customer's country. Thus where a supply is considered to be outside the jurisdiction, the acquisition of digital goods or services by a domestic customer may be considered to be an importation.

While registration is required of resident suppliers, it is not always required of nonresident suppliers as non-resident suppliers are required to register only in limited circumstances. Some of these instances include: 1) the nonresident supplier is considered to be carrying on business in the customer's country; 2) the nonresident supplier has a permanent establishment; 3) the nonresident supplier has a resident agent; or 4) the nonresident supplier provides telecommunications services to recipients who are residents of the jurisdiction.

### 1. Non-digital deliveries

Goods and services that are ordered online but delivered by traditional means are treated in the same manner as goods and services ordered offline. The method of ordering (i.e. online, phone, or mail) is largely irrelevant in terms of the application of VAT. Where a supplier is a non-resident, tangible goods imported, unless zero rated or exempted from VAT, are taxable at the point of importation.

The importation of tangible goods is often treated differently from the importation of intangible property or services. Characterization of a transaction, though crucial, is unfortunately yet uncertain. The transaction may be characterized as a purchase of tangible goods, a license of intangible property, or services. Software transactions, for example, may be characterized as 1) a sale of "software products" including the storage media, or 2) a transfer of registered software, or 3) a transfer of the copyright or title to the software where the software is not registered. An importation of software products is subject to VAT, while the other two characterizations (i.e., importation of tangible goods and services) are subject to Income Tax.

In BIR Ruling No. 009-05 dated 2 August 2005 addressed to Atty. Miguel Armovit, the BIR had the occasion to distinguish between a sale of goods and a sale of services. In this case, Domain Merchandising Services, Inc. (DMSI), a domestic corporation, is engaged in the business of collecting PH domain name service fees in the Philippines as an agent for and in behalf of Dot Phone, Inc. (DPI) from resellers located outside the

Philippines who in turn collect PH domain name service fees from PH domain name holders located inside, as well as outside the Philippines, for domain name services performed outside of the Philippines by DPI.

DPI is a foreign corporation registered under the laws of the British Virgin Islands and is a domain name service company for Philippine (PH) domain names. It is engaged in the business of performing PH domain name services outside of the Philippines for PH domain name holders located inside of, as well as outside of the Philippines, through PH domain name servers/web servers also located outside of the Philippines.

On the issue of determining whether a transaction is a sale of goods or a sale of service, the BIR ruled thus:

> *DPI, as a domain name service company is engaged in the sale of services, not goods.* In order to determine whether a certain transaction is a service transaction or a property transaction, it is imperative that a characterization of the same shall be made. A distinction between transactions in goods and transactions in services is important for purposes of characterization of the revenue/income derived from a particular transaction.
>
> The basic distinction between a transaction in goods versus a transaction in services is *whether the customer acquires property from the provider.* Implicit in the concept of services income is the notion that the value conferred on the purchaser does not take the form of a cognizable property interest. Therefore, generally speaking, *if the seller transfers possession of property rights to the purchaser, the transaction should be characterized as a transfer of property rather than the provision of a service. On the other hand, if the customer does not receive an interest in property, then the revenue should be characterized as revenue or income from services (Taylor S. Reid, ESQ., Tax Characterization of Electronic Commerce Revenue, E-Commerce Tax Report, Vol. 1, No. 5, BNA Tax, 2000).*
>
> Thus, when a customer receives property in connection with the rendition of services by the vendor, it will often be necessary to determine whether the income from the transaction should be characterized as services income or income from the sale of goods. *If the customer owns the property after the transaction, but beneficial ownership of the property was not transferred from the vendor to the customer, then the transaction generally should be treated as a services transaction.* For example, if the customer engages the vendor to create an item of property that the customer will own from the moment of its creation, then no property will have been transferred from the vendor to the customer, and the transaction should be characterized as the provision of services *(Boulez v. Commissioner, 83 T.C. 584 (1984)).*

> *In this regard and since DPI, being a domain name service company, merely renders administrative functions that do not involve any transfer of technology, equipment or property to its subscribers, nor does its rendition of services to its subscribers effectively transfer ownership of the technology it used in the transaction, DPI, therefore, is classified to be engaged in the sale of services, not of goods.*
>
> *If, however, the customer receives a valuable report or other property that was not created specifically for that customer, then the transaction could give rise to income from the sale of goods. (Taylor S. Reid, ESQ., Tax Characterization of Electronic Commerce Revenue, E-Commerce Tax Report, Vol. 1, No. 5, BNA Tax, 2000)*"[108]

On the issue of the situs of taxation of service income derived from registration and maintenance of PH domain names performed outside the Philippines, the BIR, reiterating the rule in the oft-cited case of *CIR v. BOAC*, stated thus:

> The rule in this jurisdiction regarding tax situs is that the source of income is the property, activity or service that produced the income; the *test of taxability is the "source" and the source of income is that activity which produced the income (CIR v. British Overseas Airways Corporation, G.R. Nos. 65773-74, Apr. 30, 1987)*. With regard to compensation for labor or personal services, services performed within the Philippines, regardless of the residence of the payor, or of the place in which the contract for services was made, or of the place of payment, is gross income from sources within the Philippines (Section 155, Revenue Regulations No. 2). Stated differently, *the situs of the income derived from labor or personal services is determined solely by the place where service is rendered (CIR v. Japan Air Lines, Inc., G.R. No. 60714, Oct. 4, 1991)*. Compensation from services performed abroad is considered income from sources without the Philippines. (BIR Ruling No. 464-93 dated November 19, 1993)
>
> In this particular case, the sources of DPI's income are the contracts between DPI and the various resellers. Under these contracts, DPI has contracted outside of the Philippines with various resellers located inside, as well as outside, of the Philippines for the latter to offer for sale PH domain name services to be performed by DPI outside of the Philippines for potential PH domain name holders located inside, as well as outside, of the Philippines. *Considering that the services that produce the income (i.e., registration and maintenance of PH domain*

---

[108] Emphasis supplied.

*names) are performed outside of the Philippines, it follows that the income derived from the performance of such services is not taxable in the Philippines.*"[109]

### D. DIGITAL GOODS AND DIGITAL SERVICES: WHERE DO WE DRAW THE LINE?

In the modern world, the solicitation of a customer, the conclusion of a contract, or the payment of the consideration often involves means of electronic communication. The use of the Internet as a communications link or as a payment tool does not give rise to many problems if physical goods are delivered to the customer or if services are physically performed.

These transactions can be dealt with under the existing rules under which the place of supply for an "offline" delivery of goods is generally the place where the shipping of the goods begins. Like the physical delivery of goods, the physical performance of services is easily dealt with even though use of the Internet may somehow have contributed to the supply of said service. This supply of service will be categorized as an "offline transaction".

Things become difficult, however, if a taxable person delivers "digital goods" or performs "online services" via the Internet. Typical "online transactions" include: a) the purchase and download of software or electronic books; b) fee-based subscription to online databases and periodicals; c) online banking and brokerage; d) point-to-point streaming of audio and video; e) online advertising (i.e., banner ads); and f) Internet-based distance learning. These do not fit readily into the traditional categories of goods and services.

One could argue that these transactions should be characterized in accordance with their physical equivalents so that the purchase of an electronic book would be considered a sale of goods and sourced at the place where the shipping begins, whereas the place of supply of banking services would be the place where the supplier has been established.

New technologies are challenging the traditional boundaries between goods and services, and between tangible and intangible (digital) goods. For example, computer software can be viewed as a good, a service, or intellectual property, thereby creating a characterization problem while

---

[109] Emphasis supplied.

attempting to determine the type of tax to be applied to its sale over the Internet.[110]

A key issue for properly taxing e-commerce transactions is how to categorize certain e-commerce transactions in which the end-product is received on-line (i.e., software, online information services, digitized images, and film and video output).[111] Many goods once sold in physical format are now available in digital format online. Such classification issues are critical because of the possibility of a differential tax impact. A product, for example, imported into a country as a "good" may be subject to the VAT, rather than withholding taxes or income taxes, as long as the destination country does not have a permanent establishment in the country. An "intangible" however, may be subject to withholding taxes on its royalty payments, but not subject to the VAT. Finally, a "service" many not be subject to any taxes at all, as long as the services are provided by a foreign company and are performed outside the country[112].

### E. CROSS BORDER DOCTRINE: WHERE IS THE BORDER?

VAT is essentially based on the destination principle; imports are subject to tax and exports enter international trade free of tax. (Exports are taxed at a zero rate, or zero-rated, and credit is allowed for tax paid before the export stage; refunds are commonly paid if credits exceed liability for tax on sales, as is often the case for exporters). A destination-based VAT thus can be useful if seen as a tax levied where consumption occurs, instead of where production occurs.

Direct imports by households create problems of detection and valuation under the VAT system. These are potentially more serious in the case of electronic content than in the case of imports of tangible products, which easily can be required to pass through customs. The problem is aggravated by the development of unaccounted and encrypted payments.[113]

---

[110] Reimar Pinkernell, APPLICATION OF THE EU VALUE ADDED TAX TO E-COMMERCE TRANSACTIONS, *at* http://www.pinkernell.de/euvat.htm.

[111] Edward Morse, *State Taxation of Internet Commerce: Something New Under the Sun?*, 30 CREIGHTON L. REV. 1113, 1113-1118 (1997).

[112] James Cigler et. al., *Cyberspace: The Final Frontier For International Tax Concepts*, 7 J. INT'L TAX'N 340 (1996).

[113] Charles McLure Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints and Tax Laws*, 52 TAX L. REV. 269 (1997).

### F. ADMINISTRATION AND COMPLIANCE

The advent of electronic commerce and progress in information technology brought about several ways in which tax administrations may stand to benefit. Intranet-type networks, for example, may open up new possibilities for tax authorities to exchange information in a more timely and secure way, and to improve the quality of their dealings with taxpayers.

Unfortunately, these same advances are a cause for worry by the tax authorities. It allows the emergence of public and private global communication systems, which are secure and inexpensive to operate. As a result, a huge range of small and medium-sized enterprises will be able to engage in international commerce for the first time. Tax authorities will thus be faced with a rapid expansion in cross-border activities.

The process of "disintermediation" via the Internet will, as the word suggests, substantially reduce the role of intermediaries. Financial and other forms of information, for example, may become available without the intervention of banks and similar institutions, resulting in tax authorities no longer being able to rely upon them to collect withholding taxes.

Furthermore, the development of encrypted information may mean that the government will no longer have access to the content of messages sent on the net. They will neither know what type of transaction is taking place nor be able to assess its value for taxation.

Trade in cyberspace raises a number of problems for VAT as well. The concept of "place of supply" is important in VAT systems. In broad terms, places of supply rules fall into two categories: 1) those, which depend upon the identification of a relevant establishment (the suppliers' in some cases, the customer's in others), and 2) those, which are based on the place of performance or enjoyment. Since electronic commerce makes the link between the place of supply, the place where the enterprise is located and the place where the service is used or consumed, more opaque, the Internet offers business consumers new opportunities to evade or avoid VAT by turning to suppliers who are not registered for it.

The Internet has also changed the environment within which tax administrations operate. Traditional paper audit trails may disappear, and tax administrations will encounter difficulties tracing transactions because of the lack of links between electronic entities and their physical counterparts. Verification of identity of taxpayers will also become practically impossible. Individuals and entities engaging in electronic commerce will be able to establish an Internet address in almost any taxing jurisdiction regardless of the location of their residence or the source of their activities[114]

# CHAPTER IV

# SOLUTIONS

## X. CURRENT RESPONSES TO PROBLEMS ON JURISDICTION

### A. INTERNET JURISDICTION

Jurisdiction is a term used in several senses: 1) it most generally refers to a political entity, a nation, state, or local subdivision; 2) it may also refer to the power and authority of a government or subdivision to regulate activities of its citizens or businesses; and in a narrow sense, 3) it may refer to the constitutionally permissible exercise of governmental power by a tribunal to render verdicts over particular matters.[115]

The law of jurisdiction has been fairly well settled for many years. The Internet however, may have made it much more likely that the activities of a person in one political subdivision would fall within the regulatory powers of another jurisdiction.

Jurisdiction while generally existing over the citizens, businesses, and other activities conducted within a political subdivision, is however not always exercisable over the activities of foreigners who reside outside a state or in another nation.

#### 1. Nexus

A sale of "virtual goods" (i.e., digital downloads) over the Internet presents two distinct issues for any taxing authority that imposes a sales tax: 1) where the buyer is located, and, corollary to this, if the buyer is located within the authority's taxing jurisdiction; and 2) presence of sufficient nexus by the seller in that jurisdiction to compel the collection of tax owed to that taxing authority. Tax administrators have approached the issue of taxation of Internet transactions by relying on nexus case law relating to mail order

[114] Jeffrey Owen, *What Chance for the Virtual Taxman?*, THE OECD OBSERVER No. 208, Oct 1997.
[115] JOHN W. BAGBY, E-COMMERCE LAW: ISSUES FOR BUSINESS 29 (2003).

sales, most notably the U.S. Supreme Court's rulings in the *Bellas Hess* and *Quill*[116] earlier discussed.

The power to regulate or adjudicate must generally be based on some close connection, often called a nexus, between the political entity and the regulated entity. A business must have "nexus" with a particular jurisdiction for that jurisdiction to collect income, sales, or other taxes from the business, or to require the business to collect sales and use taxes on its behalf. The concept of nexus has been developed through the U.S. Supreme Court's interpretation of the Due Process Clause and the Commerce Clause of the U.S. Constitution, and has been interpreted to require a substantial physical presence of the business within the taxing jurisdiction.[117]

On the one hand, a Nexus exists when the firm has substantial physical presence in the state. On the other hand, physical presence arises when said firm has offices, warehouses, and physical inventories within the taxing state. Moreover, presence may also arise with the firm's deployment of sales staff calling on clients in the state, or firm's attendance in trade shows therein, or its use of a web server in the taxing state, or its licensing of software in the state, or its hiring of agents in the state.

A physical presence in the state or nation clearly confers jurisdiction. Stated differently, if a person or business against, whom suit is brought has had some minimum contacts in the state then jurisdiction may be validly acquired.[118] Governments can regulate activities if the person or business has made a "purposeful availment"—that is, said person or business has taken the "privilege of conducting activities within the forum State, thus invoking the benefit and protection of its laws."[119] This means that because of their activities, a reasonable person would "anticipate being haled into court" in the foreign state or nation.[120]

In terms of finding "purposeful availment," courts have grouped Internet cases into three categories. In the first category, purposeful availment exists when a person does business over the Internet with clients from a particular jurisdiction. An example of this is the offering for download of a digital good or file into another jurisdiction in exchange for a stated fee. The second group consists of those involving interactive

---

[116] VICENTE AMADOR, CYBERLAW 474 (2000).
[117] *Id.* at 477.
[118] International Shoe v. Washington, 326 U.S. 310 (1945).
[119] Hanson v. Denckla, 357 U.S. 235 (1958).
[120] World-wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980).

websites, where a user can exchange information with the host computer. The third group comprises of passive websites where a person simply posts information on the Internet, which is accessible to users in a foreign jurisdictions.

Jurisdiction is often asserted for activity encompassed by the first category, occasionally for the second and rarely for the third. Whether the exercise of jurisdiction is appropriate largely depends upon the level of interactivity and commercial nature of the exchange of information that occurs on the website.[121]

## 2. Models of Jurisdiction

In 1997, the American Bar Association (ABA) undertook the ABA Jurisdiction Project to create a uniform model of jurisdictional power. More particularly, the federal district court for western Pennsylvania in the case of *Zippo Mfg. Co. v. Zippo Dot Com, Inc.*[122], categorized jurisdiction over three different types of websites.

*a. Passive Websites*

A passive website simply posts information that becomes accessible to anyone from nearly anywhere over the Internet. The content is generally informational. Many operators of such websites make no intentional decision to direct their content to particular jurisdictions. Most decided cases hold that passive websites that have either none or very limited interactivity generally do not trigger jurisdiction in a foreign state or nation.

*b. Highly Interactive or Commercial Websites*

These websites purposefully direct activity into a foreign jurisdiction, which makes sufficient minimum contacts thereby purposefully availing itself of the foreign jurisdiction's protection. Highly interactive or commercial websites can be subjected to jurisdiction in a foreign state or

---

[121] *Supra* note 109, at p. 495.
[122] 952 F.Supp. 1119 (W.D.Pa. 1997).

nation. The foreign jurisdiction's long arm statute could be validly used to subject the alien to regulation and liability.[123]

*c. Interactive Web Sites*

Interactive websites occupy the middle ground between the two extremes of passive websites and highly interactive or commercial ones. Websites belonging to this category risk some assertion of jurisdiction. Where the level of website interactivity is more than *de minimis* or passive accessibility, courts may be asked to exercise jurisdiction over the nonresidents operating these websites.[124]

In the case of *Complete Auto Transit v. Brady*[125], the court had the occasion to set forth constitutional principles for imposing tax collection and remittance duties on out-of-state businesses. The court therein held that sufficient nexus exists to impose these duties when 1) the activity taxed has substantial nexus to the taxing state; 2) the tax is apportioned fairly; 3) the tax does not discriminate against interstate commerce; and 4) the tax fairly relates to services provided by the taxing state. *Complete Auto Transit* is still the leading case exempting many out-of-state businesses from the tax collection and remittance duty.

### 3. Servers as Nexus

Online businesses sometimes use the servers of an application service provider (ASP) whose servers are located in another state. Some have argued that anyone in the world using a server located in the United States should be treated as generating income in the United States. The difficulty there is that a server can be located anywhere in the world. The user is indifferent to its location; it is simply an instrument for business. Any time U.S. tax authorities attempt to assess taxes on income generated by the use of servers within the United States, foreigners will simply use servers located outside the United States. There is no consistent law on whether the use of a server in another state passes the physical presence nexus test for

---

[123] BLACK'S LAW DICTIONARY, 485 (Abridged 5th ed) 1983. Long arm statutes are various state legislative acts, which provide for personal jurisdiction, via substituted service of process, over persons or corporations, which are nonresidents of the state and which voluntarily go into the state, directly or by agent, or communicate with persons in the state for limited purposes, in actions which concern claims relating to the performance or execution of those purposes, e.g. transacting business in the state, contracting to supply services or goods in the state, or selling goods outside the state when the seller knows that the goods will be used or consumed in the state.

[124] *Supra* note 108, at p.31.

[125] 430 U.S. 274 (1977).

taxing purposes. Nevertheless, to the extent that a web-based company's servers are also located in the same state in which orders are fulfilled, the physical presence nexus requirement may be met. In any event, the law on the issue remains unsettled.[126]

## XI. CURRENT RESPONSES TO THE INCOME TAX LAW PROBLEM

### A. OECD MODEL TREATY

#### 1. Introduction to OECD

The Organization for Economic Co-operation and Development (OECD) is an international association created pursuant to a Convention signed in Paris on December 14, 1960. It seeks 1) to promote policies designed to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus contributing to the development of world economy; 2) to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and 3) to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.[127]

The Technical Advisory Group (TAG) on Treaty Characterization Issues arising from E-Commerce was set up by the OECD Committee on Fiscal Affairs with the mandate "to examine the characterization of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary."[128] The TAG has identified a number of typical e-commerce transactions and analyzed the various treaty characterization issues that may arise from such. The result of that work was a document, which described twenty six (26) categories of transactions together with the analysis and preliminary conclusions of the TAG (See Appendix A).

---

[126] ROGER LEROY MILLER AND GAYLORD A. JENTZ, LAW FOR E-COMMERCE 372-375 (2002).

[127] Organization for Economic Cooperation and Development, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs Progress in Identifying and Eliminating Harmful Tax Practice* (June 26, 2000), *at* http://www.oecd.org/daf/fa/harm_tax/Report_En.pdf (last visited Feb. 19, 2001).

[128] Organization for Economic Cooperation and Development Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments, *Tax Treaty Characterization Issues Arising from E-Commerce* (Feb. 1, 2001), at http://www.oecd.org/dataoecd/46/34/1923396.pdf (last visited Feb. 19, 2001).

In general, the majority of the TAG has chosen to classify most transactions as business profits as opposed to royalties in order to preserve the neutrality principle. The OECD has classified transactions as subject to royalty treatment if the transaction showed evidence of "commercial exploitation". Commercial exploitation is where the purchaser of a copyright "exploits" a copyright. In that case, a royalty is generated.[129]

Most of the developed world has turned to the OECD to interpret the "permanent establishment" concept with respect to electronic commerce. The OECD has held numerous meetings and studies concerning electronic commerce and has developed certain core principles regarding worldwide taxation of electronic commerce. In its interpretation, the OECD believes that the presence of a server or web page by itself generally will *not* satisfy the requirements for permanent establishment.[130]

## 2. OECD MODEL TREATY

The OECD Model Tax Convention is a sample tax treaty which many countries follow when negotiating tax treaties. The OECD Model Tax Convention is accompanied by a Commentary, which is used in interpreting the provisions of tax treaties that follow the OECD Model. In October 2001, the OECD issued a first draft of various changes to be made to the OECD Model Tax Convention and Commentary. The pertinent provisions in the treaty relating to E-commerce are Articles 5, 7 and 12.

*a. Permanent Establishment*

Article 5 defines "permanent establishment" as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." This definition is often difficult to apply in the real world, and even more difficult to apply in the virtual world of electronic commerce.

According to the TAG, computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed[131] and if the function performed through the equipment exceeds the preparatory or auxiliary threshold.[132] In other words, no permanent

---

[129] http://www.ksg.harvard.edu/project1/tech.html (September 26, 2003).
[130] *Id.*
[131] OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, ¶ 42.4 (Dec. 22, 2000), *at* http://www.oecd.org/dataoecd/46/32/1923380.pdf (last visited Feb. 19, 2001).
[132] *Id.* at ¶ 14.

establishment may be considered to exist where the electronic commerce operations carried on through the computer equipment at a given location in a country are restricted only to the preparatory or auxiliary activities.[133]

Hence, there is a need to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet, for instance, the mere operation of a server to host a website used exclusively for advertising or providing information to prospective customers, the location will not constitute a permanent establishment. If, however, typical functions related to a sale are performed at that location, for example the conclusion of a contract or the processing of the payment and the delivery of the products, these activities cannot be considered merely preparatory or auxiliary.[134]

In addition, the distinction between a website and the server, on which the website is stored and used, is important since the enterprise that operates the server may be different from the enterprise that carries on business through the website.[135] In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become "fixed".[136]

Furthermore, human intervention is not a requirement for the existence of a permanent establishment.[137] Neither is the presence of personnel necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This rule applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically.[138]

*b. Business Profits*

Article 7 of the Model Treaty provides that "the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a

---

[133] *Id.* at ¶ 42.7.
[134] *Id.* at ¶ 42.9.
[135] *Id.* at ¶ 42.3.
[136] *Id.* at ¶ 42.4.
[137] *Id.* at ¶ 9.
[138] *Id.* at ¶ 42.6.

permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as may attributable to that permanent establishment." It provides further that "where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

*c. Royalties*

Article 12 of the Model Treaty on the other hand defines the term "royalties" as "payments of any kind received as a consideration for the use of, or right to use, any copyright of literary, artistic or scientific work including cinematograph film, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience." Article 12 of the Model Treaty also provides that "royalties arising in a contracting state and beneficially owned by a resident of another contracting state shall only be taxable in that other state."

The TAG, in its proposed revisions to the Commentary, distinguished Business Profits from Royalties. According to the TAG, payments for transactions that permit the customer to electronically download digital products for his own use or enjoyment (i.e., software, images, sounds or texts) is made to acquire data transmitted in the form of a digital signal for the purchaser's own use or enjoyment. This constitutes the essential consideration for the payment and falls under Article 7 (Business Profits) or Article 13 (Capital Gains) of the Model Treaty. On the other hand, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This is illustrated in the case of a book publisher who would pay to acquire the right to reproduce a copyrighted picture to include the same on the cover of a book it is producing. In this transaction, the essential consideration for the payment is the acquisition of the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.[139]

## B. E-COMMERCE ACT

In June 2000, Republic Act No. 8792, otherwise known as the Electronic Commerce Act, was passed and promptly signed by President Joseph Estrada in the wake of the "I Love You" virus, which was believed to have originated in the Philippines. Its main importance is the accordance of legal weight to electronic documents. There is however no specific provision that directly provides for the taxation of Internet transactions. There are some sectors who opine that this is probably because the drafters of the law recognize that existing tax laws suffice and should still apply in the case of electronic commerce.

However, a possible loophole may be found in Section 23 of the E-Commerce Act in relation to taxation. Section 23 provides

> *Unless otherwise agreed between the originator and the addressee,* an electronic data message or electronic document is deemed to be dispatched at the place where the originator has its place of business and received at the place where the addressee has its place of business. This rule shall apply even if the originator or addressee had used a laptop or other portable device to transmit or receive his electronic data message or electronic document. *This rule shall also apply to determine the tax situs of such transaction.*[140]

As worded, the section would seem to allow the parties to specify a place of dispatch and/or receipt that would allow tax liability to be circumvented or minimized. The Implementing Rules and Regulations (IRR) of the E-Commerce Act makes mention of and emphasizes that the principle of neutrality should apply to e-commerce transactions. Chapter II Section 3 (d) of the IRR provides that "transactions conducted using electronic commerce should receive *neutral tax treatment* in comparison to transactions using non-electronic means and taxation of electronic commerce *shall be administered in the least burdensome manner.*"[141]

Professor Jesus M. Disini reports that Senate Bill 1902, the bill proposing the enactment of the E-Commerce Act, originally contained the

---

139 OECD Technical, *supra* note 129, at ¶ 16.
140 Emphasis Supplied.
141 Emphasis Supplied.

following provision: "Section 27 Taxes on E-Commerce Transactions—Value-added, sales and other appropriate taxes shall be collected on E-Commerce transactions by the central and local governments concerned.". He notes that apparently it was determined that "since tax laws do apply with equal force upon electronic transactions, the above-quoted provisions was unnecessary and was therefore abandoned during the Bicameral Conference Committee meeting."[142] This however still implies at the very least that the authors of the abovementioned law believe that e-commerce transactions should be subject to tax, in much the same way as other business transactions are subject to tax.

To date, there are no Philippine tax laws explicitly covering electronic commerce transactions. It appears that no law will be passed on the subject in the near future. However it cannot be denied that many electronic transactions Internet-based entities are subject to existing tax laws.[143]

### C. BUREAU OF INTERNAL REVENUE

All matters pertaining to Philippine income taxation are under the administration of the Bureau of Internal Revenue. It is headed by a chief known as the Commissioner of Internal Revenue and four assistants known as Deputy Commissioners. For administrative purposes, the Bureau is under the executive supervision and control of the Department of Finance.[144]

The BIR at present has not issued any regulations regarding e-commerce. Without any set of guidelines and a clear-cut understanding of the matter, it is difficult to predict how the BIR will manage to enforce the relevant tax provisions with respect to e-commerce.[145] Interestingly, the BIR in a draft revenue regulation at one time considered explicitly making the purchase of intangible goods over the Internet subject to 10% VAT (See Appendix B). The BIR contemplated having the Filipino purchaser withhold the tax and remit it to the BIR. This indeed is difficult to implement. Even if the Filipino buyer is able to and actually withholds the tax, it is not clear whether there are sufficient incentives for him to report the same and remit the tax.

---

[142] JOSE JESUS DISINI, ANNOTATIONS ON THE ELECTRONIC COMMERCE ACT AND ITS IMPLEMENTING RULES AND REGULATIONS (2000).

[143] Andersen, *supra* note 3, at 327.

[144] TAX CODE, § 3.

[145] Andersen, *supra* note 3, at 327.

## XII. CURRENT RESPONSE TO THE VAT LAW PROBLEM: A STUDY OF CONTRASTS

### A. THE US MORATORIUM ON INTERNET TAXATION

In early 1997, Senator Ron Wyden and Representative Chris Cox announced that they would introduce legislation to preempt any new taxes on the Internet by state or local taxing authorities in order to prevent "cybertaxes" from stopping the growth of the Internet. After a lengthy period of debate and review, the "Internet Tax Freedom Act" was signed into law on October 21, 1998, as part of an omnibus spending bill. The bill did two things, namely, a) it imposed a three (3) year moratorium on Internet taxes, and b) it created an advisory commission, which will examine Internet taxation issues and report back to Congress. The Act specifically restricted Internet access taxes and multiple or discriminatory taxes on electronic commerce.

It bears noting that under the aforementioned Act, Internet retailers in the U.S. are largely exempt from collecting state and local sales taxes.[146]

In allowing this exemption, Congress agreed to give out-of-state businesses a 5 to 7 percent price advantage over local stores. Proponents of the exemption argue that Internet-based suppliers would stagger under the administrative burden of collecting thousands of different state and local sales taxes. Opponents of the exemption on the other hand argue that the electronic commerce companies do not need help siphoning business away from already struggling downtowns.[147]

### B. THE EU VAT DIRECTIVE

In stark contrast to the United States, the European Union never considered making the Internet a tax-free zone. In 1998 for example, E.U. tax authorities voiced their concerns that it would be essential to be able to apply VAT to trade over networks in order to avoid distortion of competition with conventionally traded products.

---

[146] Internet Tax Freedom Act, Pub. L. 105–277, title XI, 112 Stat. 2681-719 (1998) (codified at 47 U.S.C. 151).

[147] Simona Fuma Shapiro, *Think Locally, Tax Globally: The New Rules*, (2000), *at* http://www.newrules.org/journal/nrsum00itax.html.

### 1. The Dilemma

Member countries of the European Union (EU) adhere to the basic rule set forth in Article 9 of the Sixth EU VAT Directive which provides that the place of supply of services is where the supplier is located or has a fixed establishment from where the supply is made.

There are a number of exceptions to this general rule however. For instance, under Article 9(2)(c), the place of supply of services relating to the supply of cultural, artistic, sporting, scientific, educational, entertainment type services is where the service is usually carried out. Services supplied under Article 9(2)(e) on the other hand, such as those given by consultants, engineers, lawyers, accountants and other similar services are deemed supplied where the customer is located and are subject to the reverse charge mechanism. These existing VAT rules regarding supply of services create difficulties for EU operators where services are delivered by electronic means.[148]

Supplies of electronic services by third country-based operators to non-taxable persons in the EU are not required to charge VAT, since the place of supply of such services is located outside the EU. This results in a tax based advantage for such suppliers. While European businesses are required to charge VAT, these (third country) suppliers can legally supply markets VAT-free within the EU. In addition, EU taxable persons supplying electronically delivered services to customers in third countries are also required to charge VAT since the place of supply is within the EU, thus putting such companies at a price disadvantage compared to their other non-EU competitors.[149]

The resulting uneven playing field, caused by the existence of low and no-VAT jurisdictions within the EU, attracted Internet businesses wishing to sell goods or services in countries with higher VAT rates. Hence, while these non-EU providers of electronically supplied services (i.e., Internet access and digital downloads) were not obliged to account for the VAT in the member states, their EU competitors had to do so and were thus significantly disadvantaged. This harmful tax competition between EU

---

[148] Organization for Economic Cooperation and Development Tax Strategy Group, *Discussion Paper on Electronic Commerce Budget 2001* (2001), *at* www.finance.gov.ie/documents/tsg/2001/tsg11.doc (last visited Oct. 22, 2008).

[149] *Id.*

member states and the consequent distortions to economic competition and resultant tax leakages was recognized by the European Commission.[150]

### 2. The Solution

In June 2000, the European Commission brought forward a proposal to amend the existing VAT arrangements under the Sixth VAT Directive (particularly Article 9 thereof) with respect to delivery of services by electronic means.[151] In 2002, a special directive[152] was adopted in order to ensure that the EU VAT regime no longer provided an unjust competitive advantage to non-EU businesses over their EU counterparts and that electronic services consumed within the member states were duly taxed. Towards this end, new legislation was required in each of the then fifteen (15) member states to implement the new rules by July 1, 2003. The Directive was initially set to expire after three (3) years. On June 27, 2006 however, the Directive was extended until December 31, 2006.[153]

Under the Directive, which principally affects electronic services,[154] the place of supply of electronic services is determined by reference to the place where the customer is located. The non-EU supplier is required to account for the VAT at the rate prevailing in the EU country in which the customer is located. The Directive does not affect the existing VAT treatment of supply of service between a non-EU supplier and an EU business customer (i.e., B2B commerce) since the latter is required to self-assess local VAT under the "reverse charge" mechanism. Non-business customers include private individuals, local authorities, government organizations, schools and colleges.[155]

---

[150] Oleksandr Pastukhov, *The E-VAT Directive: Mitigating Tax Competition or Spurring It?*, 2 J. INT'L COMM. LAW & TECH (2007).

[151] OECD Tax, *supra* note 149.

[152] Directive 2002/38/EC (2002).

[153] Pastukhov, *supra* note 151.

[154] Examples of these "electronic services" include:
website supply, web hosting, distance maintenance of programs and equipment;
supply of software;
supply of images, texts and information;
supply of music, films and games; and
supply of distance teaching (Directive, *supra* note 153, at 44).

[155] Pastukhov, *supra* note 151.

### 3. Criticism of the Directive

Critics point out some of the drawbacks of the Directive. The first scenario contemplates a situation wherein, upon registering under the new Directive, non-EU businesses need to charge a higher VAT rate in some countries than their EU competitors. For instance, while a non-EU VAT-registered business needs to charge the VAT at 25% to individuals in Sweden or Denmark, a competitor from Luxembourg supplying to individuals in Sweden or Denmark would only need to charge Luxembourg VAT of only 15% thereby allowing Luxembourg-based businesses to set their prices lower by 10%. As critics have pointed out, this became possible because EU suppliers of electronic services are not affected by the Directive. Hence, the place of supply of their services is determined by where they are established rather than by where their customers are located.[156]

The second scenario contemplates the possibility of going around the Directive by the simple expedient of creating an establishment in one of the EU member states. It must be remembered that the question of what constitutes a "fixed establishment" for VAT purposes has not been definitely resolved by neither the members states' national laws nor by any EU instruments. It is clear however that an EU-established supplier is only required to register in the country in which it is established and charge only the prevailing rate of VAT of that country to all its non-business customers throughout the EU.[157] Both these scenarios have lead Internet based businesses to establish and set up their businesses in the lowest VAT jurisdictions in the EU. This has lead critics to conclude that the EU VAT Directive was based on the fundamentally flawed logic of trying to tax things that cannot possibly be taxed and not trying to find things that can be taxed instead. [158]

---

[156] Pastukhov, *supra* note 151.
[157] Pastukhov, *supra* note 151.
[158] NEIL WARREN, INTERNET CHALLENGE DO THE TAX SYSTEM DESIGN 89, *in* The International Tax System (Andrew Lymer & John Hasseldine eds., 2002).

## CHAPTER V

## PERSPECTIVES

### XIII. PROPOSED SOLUTIONS TO THE INCOME TAX PROBLEM

The mere adaptation of existing tax concepts and rules to e-commerce may not be the final answer in all cases. It pays to consider alternative solutions for cases where yesterday's tax rules would turn out to be incapable of dealing adequately with the tax challenges of tomorrow's economy. In this section, we shall examine proposed solutions to the puzzle discussed above. The discussion shall be divided into two parts, the first part shall attempt to solve the dilemma on the classification of income as to whether the same is business income or royalty. The second part shall propose a technical solution to the problem of taxing the trade of digital goods over the Internet.

#### A. CATEGORIZATION OF INCOME

In an economic sense, income is income. Vendors rarely concern themselves with the categorization of income before transferring their wares or services for compensation. Distinctions between different types of income are artificial. However, these categories, artificial as they may be, are essential for purposes of taxation.

There are different approaches to the categorization issues that electronic commerce poses. One approach is to apply existing rules and characterize income from electronic commerce as business profits, royalties, or service fees. This is the approach of the OECD TAG. Another approach is to create a new category of income for electronic commerce. Defining this new category would require international consensus. Another suggestion is to categorize income from electronic commerce into "digital income" and "non-digital income"[159].

On the issue of whether payment should be considered as business income or royalty, it is suggested that the "main reason" (i.e. consideration) for the payment be identified. This is known as the subjective test. Where a person downloads information electronically for his own use, the fact that a

---

[159] Andersen, *supra* note 3, at 377.

copyright is used in the process of downloading the information is an incidental part of capturing and storing the data and hence not relevant for categorization/characterization purposes. Such payments are not royalties and are, for tax treaty purposes, treated as business profits.[160] Where the purpose of the payment is to obtain a right to use a copyright in a digital product that is downloaded for that purpose, payments should be regarded as royalties.[161]

Payments for "know-how" are regarded as royalties, whereas payments for services rendered are regarded as business profits. In a know-how contract, the grantor of the know-how agrees to impart to the recipient, for his own use, the grantor's specialist knowledge and experience. The grantor is not required to play any part himself in applying the information made available and does not guarantee the result thereof. Generally the grantor also incurs little cost in making the information available as the information is in a pre-prepared format (i.e. standard formulas, packaged information etc.). On the other hand in a contract for the provision of services, the service provider undertakes to execute work for the recipient normally incurring a much higher level of expenses in executing his work.[162]

### B. LECHNOLOGICAL SOLUTION

The e-commerce of digital products can be categorized into three "layers" as shown in the figure below: a) the end user (consumer), b) the information medium (third party) and c) the provider (business), thus:

| End-Users | Intermediaries | Providers |
|---|---|---|
| Consumers<br><br>(Including individuals and businesses purchasing from other | Third parties<br><br>(Digital Cash, Verification Certificates for Legal and Financial Status, such as | Businesses providing digital products<br><br>(Stream Video Developer, Software Companies, Publishers, |

[160] Bernanrd du Plessis, *E-Commerce Adds a New Dimension*, *at* http://www.accountancysa.org.za/archives/2001aug/features/ecommerce.htm (last visited Sept. 17, 2003).

[161] *Id.*

[162] Andersen, *supra* note 3. Payments for the following are generally regarded as payments for services, rather than royalties: after sales services, services rendered by a seller to a purchaser under guarantee, technical assistance, an opinion given by an engineer, advocate or an accountant, and advice provided electronically for electronic communications with technicians or for accessing, through computer networks, a trouble shooting database.

| | | |
|---|---|---|
| businesses) | Provision of Credit History ) | etc.) |

The intermediary layer performs several functions, including credibility verification, such as a digital certificate provider, and payment intermediary, such as a digital cash bank. Under any scheme to tax the sale of digital products, it is at this intermediary layer where a "taxation function" would most easily occur.[163]

The first layer in e-commerce transactions comprises the consumers, whether individuals or businesses purchasing from other businesses. It can be difficult to identify the location of the end-user of digital products because of the ease with which the routing process can disguise the final destination or server. This difficulty is a key area where traditional tax statutes, which are based on geographically-determined concept of "nexus" fail to provide adequate guidance in the e-commerce environment. Digital commerce at this layer includes both Internet access and the purchase of goods or services.

The intermediaries or the second layer mediates the transaction between provider and consumer through credit provision and verification. As such, the intermediary serves as a third party that interfaces with both the end user as well as the provider of digital products. This requires that third party entities maintain identity information for both parties, which enable this layer to serve a monitoring function.

The product providers comprise the third layer. They are the providers of digital products. In contrast to their counterparts that sell tangible products, they enjoy lower marginal costs of production because of the extremely low costs of replication that technology enables.[164]

Since the intermediary has the interface of both the user and provider and is also generally less in number, taxation of digital goods at the intermediary level has the greatest potential. The technological infrastructure of third party intermediaries, such as digital cash and credit verification,

---

[163] http://www.ksg.harvard.edu/project1/tech.html. (September 26, 2003).
[164] Andersen, *supra* note 3.

facilitates tax collection and monitoring. For instance, taxes can be collected when digital cash is purchased. Alternatively, each time an Internet certificate is used; proof of taxation can be monitored. Since third party intermediaries already maintain party identification for credibility purposes, keeping track of such transactions for tax purpose would not require much additional work. There are however, certain limits in current software development, which prevent such taxation mechanisms from being readily available. Moreover taxation at the intermediary level may render an online micro payment system virtually impossible because auditing requirements would delay the process and would severely limit the efficiency of an online payment system.[165]

## XIV. PROPOSED SOLUTIONS TO THE VAT LAW PROBLEM

### A. THE BIT TAX PROPOSAL

The "bit tax" is perhaps the most controversial among the proposed e-commerce taxation schemes. It is a tax on the interactive digital traffic on the Internet. In general, a bit tax levies a consumption tax or tariff on the transmission of digital information. This tax applies to all digital "bits" of interactive digital information that flows through telecommunication lines. The taxation scheme proposes to tax the volume of data to be collected by telecommunication carriers and transfer all such revenue collections to their respective governments. However, in order to eliminate double taxation, the bit tax would have to apply to value added portions of interactive digital transactions.[166]

The main appeal of the bit tax is brought about by its ostensible simplicity—a specified tax rate is applied to the volume of interactive cyberspace "traffic" traveling over lines run by telecommunications carrier companies, and the resulting tax revenues then flow directly to national governments. However, such simplicity may be more apparent than real, for the bit tax presents vexing problems of how to accurately measure the volume of data flow and how to precisely separate which data is taxable and which is not. Consequently, tax collection could either be inflated or deflated, bringing unintended distortions in the tax base and instabilities in the tax system. Additionally, taxing business transactions in a different

---

[165] Andersen, *supra* note 3.
[166] Arthur Cordell, *New Taxes for a New Economy*, 2 GOV'T INFO IN CANADA 4, 1996.

manner specifically because they are conducted by means of electronic commerce violates the principle of tax neutrality.[167]

It is observed that a distinguishing characteristic of the bit tax is that the entire burden of collecting and remitting the tax is borne by the carrier company. While carrier companies arguably possess the necessary technical and labor resources to effectively perform such a function, it is uncertain who, in the final analysis, would shoulder the bulk of the tax burden or incidence. Would carriers absorb the cost, or would they pass it unto consumers? If carriers choose to pass the costs to consumers, they would have to do so in a non-neutral manner because carriers lack the means to accurately separate e-commerce from non-e-commerce data flows.[168]

Moreover, a bit tax could bring about problems in enforcing compliance on the part of carrier companies. The absence of a central international regulatory agency to oversee the carriers may bring about difficulties in ensuring that companies collect the correct amount of tax and accurately allocate the funds to the designated governments. Even if such an agency were created by international treaty or agreement, it seems doubtful that sovereign governments would accede to international jurisdiction and oversight over the activities of their key telecommunications corporations.[169]

### B. THE E-CARD PROPOSAL

The Clinton Administration had proposed a variant of the traditional VAT taxing scheme. Under this proposal, 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 where the purchase was made. 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[170].

---

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

[168] *Id.*

[169] *Id.*

[170] *See* Department of Treasury, *Selected Tax Policy Implications of Global Electronic Commerce*. Also John K. Sweet, *Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-based Taxation in an Era of Eroding Traditional Income Tax Principles*, 146 U. Pa. L. Rev. 1949, 2006 (1998). *See also* Kerry Lynn Macintosh, *How to Encourage Global Electronic Commerce: The Case for Private Currencies on the Internet*, 11 Harv. J. L. & Tech 733, 734-735 (1998).

Several distinct advantages can be identified with this proposal. First, the e-card is tax neutral. As opposed to the bit tax, e-commerce transactions under the e-card proposal would not be taxed differently than other business transactions. And, since the e-card proposal is a VAT consumption tax, the EU countries could maintain tax consistency, and the United States and Australia could tax e-commerce transactions as they currently tax sales transactions.

Another advantage of the e-card proposal involves the creation of an escrow agency. By centralizing the "funneling" of tax revenues to appropriate governments through an escrow agent, the plan provides for greater consistency and predictability than calling for an indeterminate number of private banks to perform the same task. Also, governments can deal with one centralized body in case any disputes, concerns, or queries arise over the processing of tax transactions. Governments can readily learn one agency's dispute and query protocols, instead of dealing with a disparate number of banks.

A third advantage of the e-card proposal is that it does not call for a source-based approach to taxing e-commerce tax revenues. This should ease the concerns of developing countries, since the e-card proposal is a residence-based plan and rewards developing countries when its residents conduct business with residents of other countries.

Finally, the e-card helps preserve the privacy of consumers, a thorny issue with the EU countries, and a weakness of the aforementioned EU VAT Directive. The e-card's only "identifier" is the country of origin of the purchase. Otherwise, it appears the e-card is much more like cash, and much less conspicuous than a check or credit card.[171]

Under the e-card proposal, consumers would be required to purchase the e-card from banks; a legitimate concern is thus raised as to whether this inconvenience would hamper consumers' appetites for e-commerce transactions. It is believed however that in the long run, such a requirement would not retard the development of e-commerce. Once a "critical mass" evolves on the Internet, where significant products, goods, and services are conveniently available on-line, it is not difficult to envision consumers purchasing e-cards as a matter of routine. Another area of

---

[171] *Id.*

concern could be the integrity and security of the e-cards themselves, and whether the cards would be subject to possible fraud and abuse.[172]

### C. OTHER PROPOSALS

#### 1. Creative Borrowing Proposal

The rise of electronic commerce does not require the abandoning of traditional taxes and substitution of new taxes.[173] Traditional taxes can be applied to electronic commerce. In fact, some of them, like the VAT, are quite suitable for adaptation to an electronic commerce environment.[174] The answer to the challenge of electronic commerce is not to substitute one tax for another; the traditional taxes have strong normative foundations and are based on a well-developed international consensus, which it would be unfortunate to lose.

The answer instead, is the "creative borrowing" of the methods of one tax regime into another.[175] The following may be adopted to achieve this objective: a) abandonment of the permanent establishment rule and replacing it with a threshold of *de minimis* amount of sales into a jurisdiction; b) abolition of the distinction among sales, services, and royalties and including all of them in the threshold amount; and c) dealing with transfer pricing by adopting global profit splits that take into account the interests of all source jurisdictions. The income tax can also benefit from some of the methods of the VAT, like disallowing deductions for inputs (including cost of goods sold) unless the party of the other side can demonstrate that it is subject to tax (i.e. a matching requirement).

Whether any of this is possible remains to be seen, and much of it requires multilateral approaches. However, "it would be unfortunate if a premature decision was taken to abandon the traditional taxes for a bit tax, or even abandon the income tax for a consumption tax, before undertaking a serious study of the possibility of meeting the challenge of electronic commerce."[176]

---

[172] *Id.*
[173] Avi-yonah, *supra* note 108.
[174] *Id.*
[175] *Id.*
[176] *Id.*

### 2. Creation of an International Monitoring Bureau

The Clinton Administration's VAT e-card proposal may be used as a starting point, with some modifications.[177] For instance, an international e-commerce "taxation agency" may be created in order to oversee the proposed e-card taxation regime, and perhaps, report to an international economic organization, such as the WTO, OECD or UNCITRAL. It is important, however, that the agency be under the aegis of a respected international body, to lend credibility and influence to the new agency.

Said agency will manage and implement the new e-card and other e-commerce technologies that could improve the system and coordinate and manage the individual consumption taxing schedules of the various countries, to ensure that each country receives its proper and correct share of e-commerce tax revenues from the escrow agent. Furthermore, it will monitor and audit the activities of the escrow agent—especially in regards to the accurate and timely allocation of tax funds to their appropriate countries. The agency will also help to decrease the likelihood of abuse and fraud on the part of the escrow agent and oversee and manage the wholesale distribution of e-cards.[178]

Agreements between national governments should include provisions requiring each government to pass local regulations designed to enforce and monitor compliance of sellers that are residents of the country. Such regulations should outline the requirements of the sellers in collecting and withholding tax funds from the e-commerce transactions in which it participates, and also detail the domestic agency that would be responsible for domestic compliance issues. Additionally, a fund may be set up, with contributions from the wealthiest countries, to help all Internet retailers defray the costs of compliance.[179]

Finally, further research should be done to find ways to more widely distribute the e-cards, in addition to having them available for purchase from banks. Also software should be researched and developed that is embedded with anti-fraud and anti-tampering capabilities to reduce incidents of seller fraud and non-compliance.[180]

---

[177] Chan, supra note 168.
[178] *Id.*
[179] *Id.*
[180] *Id.*

### 3. Designing Internet Solutions

Arthur J. Cockfield, Assistant Professor at the Thomas Jefferson School of Law, suggests three (3) possible approaches in the taxation of e-commerce transactions: a) the establishment of a secure extranet, b) identification of the location of taxpayers, and c) the establishment of an international online tax clearinghouse.[181]

*a. Secure Extranet*

According to Cockfield, an effective exchange of information among tax authorities would help to reduce a number of problems that currently plague the international tax arena. As a practical matter, however, tax authorities do not engage in an ongoing exchange of information that includes taxpayer identification numbers and cross-border flows.

He suggests that tax authorities could set up a secure extranet (sometimes referred to as Virtual Private Network or VPN) among themselves to enable a far more comprehensive and efficient exchange of taxpayer information. An extranet is a portion of the Internet that has been secured from outside access. Through this extranet, participating countries could share information concerning cross-border transactions and nonresident taxpayer information. A secure extranet, accessible only by national tax authorities, would greatly assist these multilateral efforts. This extranet would build on one of the major strengths of the Internet by creating networked linkages among partners for sharing data. The implementation of the secure extranet does not require any architectural changes to the Internet, and the use of extranets is already commonplace in the business-to-business e-commerce market. The scale of the project should also be manageable, as Internet technologies along with improved database storage capabilities ensure the feasibility of this proposal.[182]

*b. Identifying the Location of Taxpayers*

Regulators must develop technologies that can identify web users. A necessary prerequisite to any tax effort is the identification and geographic location of taxpayers participating in international transactions. The

---

[181] Arthur J. Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation*, 85 MINN. LAW REV. 1171 (2001).

[182] *Id.*

decentralized nature of the Internet, however, frustrates attempts by e-commerce businesses to identify the location of these parties. Tax authorities could encourage the implementation of technologies that identify the country (or local jurisdiction) where an Internet producer or consumer is located.[183]

Digital certificates have been suggested as one mechanism that could assist in the process. A digital certificate acts similarly to a passport, revealing certain aspects of the computer user's identity such as age or location. The digital certificate could be registered with a so-called "trusted third party" such as a government agency or a private company. The trusted third party would act like a bonding agency to ensure the veracity and accuracy of information given out by the digital certificates.

The identification technologies could be developed to preserve a desired amount of privacy on behalf of individuals who use the Internet. For international transactions, it will be sufficient if the digital certificates identify the country where the consumer is located. For taxation in federal countries like the US, it may be necessary to identify more closely the location of customers to enable the imposition of state and local sales taxes on Internet transactions. Still it may be sufficient to resort to a zip code instead of a street address of the customer.[184]

*c. International Online Tax Clearinghouse*

The extranet and identification technologies could also function in combination with an online tax clearinghouse in order to a) reduce compliance costs for online companies, b) protect the source state's ability to tax online transactions, and c) reduce harmful tax competition.[185]

The international online tax clearinghouse could work as follows: Governments would first determine, through multilateral negotiations, an appropriate online intermediary that could be licensed to act as the collector of revenues. While retailers have generally acted as the traditional intermediaries in tax collection, Internet technologies—and the arrival of new online intermediaries as a part of the re-intermediation process presents a number of possibilities. Web browsers such as Netscape's Navigator or Microsoft's Internet Explorer could act as intermediaries because consumers

---

[183] *Id.*
[184] *Id.*
[185] *Id.*

and businesses have to use a browser to navigate that web. Alternatively online billing companies such as MasterCard, Visa or Digitcash could also act as the intermediaries.

Regulators could compensate these intermediaries for the collection and remittance of taxes by permitting the intermediaries to keep a portion of the taxes that have been collected. The intermediaries would maintain electronic records of the transaction in order to provide an audit trail for tax authorities, should any dispute arise.[186].

The new online intermediary would, in conjunction with the international online clearinghouse, enable automatic billing and collection of taxes. First, the intermediary would scan the consumer's digital certificate, or similar identification technology, to determine the physical location of the consumer along with other required information. The intermediary would then access a government-maintained international online tax clearinghouse that maintains a database containing worldwide tax bases and rates.

For sales tax or VAT purposes, the intermediary would then adjust the retail price on the online vendor's website to show the amount of sales tax or VAT owed. If a purchase were made, the intermediary would unbundle the sales tax or VAT payment and remit this payment to the online clearinghouse. For income tax purposes, the intermediary could simply record the transaction with the online clearinghouse, which would forward the information through the proposed secure extranet to the appropriate national or sub national tax authority.

It may prove more efficient for tax authorities, however, to mandate a gross withholding tax (which would be automatically removed and remitted to the online clearinghouse), which serves as a proxy for income tax liabilities. This technological development would permit countries to enforce *de minimis* threshold requirement for indirect taxes as well as direct taxes. This solution would also allow source countries to impose income taxes on transactions that exceed a specified monetary threshold in order to approximate the impact of existing international tax principles, such as the permanent establishment principle.[187]

A clearinghouse would have the added benefit of permitting countries to maintain distinct tax rates and preserve competition among tax

---

[186] *Id.*
[187] *Id.*

systems. The ability to impose different rates would preserve fiscal sovereignty among participating countries. Identification of a taxpayer's location, along with the maintenance of a record of cross-border transactions in a central clearinghouse would permit the sharing of revenues associated with the taxation of profits derived from international e-commerce transactions. In addition, the approach may hinder harmful tax competition by permitting states to focus taxation on the jurisdiction of consumption instead of the jurisdiction where a company resides.[188]

## XV. PERSPECTIVES

### A. REQUISITES FOR A SOUND TAX REGIME

Seven criteria may be used to evaluate proposals to tax the Internet.[189] They are as follows: a) an equitable system-- taxpayers in similar situations which carry out similar transactions should be taxed in the same way; b) a simple system--administrative costs for the tax authorities and compliance costs for the taxpayers should be minimized as far as possible; c) certainty in the rules-- taxpayers should know what is to be taxed, when and where the tax collected is to be accounted for; d) an effective system--it should produce the right amount of tax at the right time and minimize the potential for tax evasion and avoidance; e) a system which avoids economic distortion-- corporate decision makers should be motivated by commercial rather than tax considerations; f) a flexible and dynamic system--to ensure that the tax rules keep pace with technological and commercial developments; and g) a system which ensures fair sharing between countries-- any tax arrangements adopted domestically and any changes to existing international taxation principles should be structured to ensure a fair sharing of the Internet tax base between countries.[190]

Neutrality, certainty, and administrative ease are three relevant tax policy principles which should not be ignored.[191] One goal of a tax policy is to establish taxing systems that are neutral. A neutral tax system treats economically similar income equally, regardless of whether earned through electronic means or through more conventional channels of commerce. The goal of certainty on the other hand is to ensure a full and complete understanding of tax systems and the application thereof, without any

---

[188] Avi-yonah, *supra* note 108.
[189] Jeffrey Owens, *What Chance for the Virtual Taxman*, 208 THE OECD OBSERVER (Oct. 1997).
[190] *Id.*
[191] Michael Fang, *International E-commerce Source Taxation*, 3 OREGON REV. OF INT'L LAW 104 (2001).

ambiguities. Finally, a tax policy must aim to establish taxation schemes that are neither complicated to apply nor too complex to comprehend, especially on a global scale. Not all countries have the economic or technological resources to meet the costs of administering and maintaining a complex tax system. A tax treaty for e-commerce taxation should also consider simplicity in order to accommodate all signatory countries.[192]

## B. TO TAX OR NOT TO TAX?

While the current architecture of cyberspace rejects the concept of geographic borders, the power to tax, however, is geographically based. If the Internet's architecture somehow imposed the geographical borders that exist in the physical world onto cyberspace and e-commerce, ascertaining tax jurisdiction would simply involve applying familiar concepts. Hence, there would be no incentive to tax transactions in digitized products differently from their physical analogs.

In the absence of a geographically-based Internet architecture or international agreement of e-commerce tax rules, however, taxing international e-commerce transactions in digitized products will present certain difficulties. Thus, a question arises as to whether these transactions should be taxed at all.[193] As Warren puts it: "if tax laws are not enforceable and taxpayers use the Internet to play a *catch-us-if-you-can* game of tax avoidance and evasion, then the resulting tax system is neither efficient, nor equitable nor sustainable."[194]

On the one hand, some sectors posit that setting up an international body to monitor and tax the various Internet transactions is almost impossible as the logistics involved would be too complicated. There are tens of millions of websites in the world today, not all are even involved in e-commerce, and these are increasing by the hundreds of thousands per day. Instead they propose that a reasonable and consistent tax system that conforms to generally accepted Internet standards must be developed in each jurisdiction which must neither be restrictive nor over-expansive.[195]

---

[192] *Id.*

[193] Neal Harold Luna, *Implications of Singapore's Income and Consumption Tax Policies on International E-Commerce Transactions of Digitized Products*,,10 Pac. Rim L. & Pol'y J. 717 (2001).

[194] Warren, *supra* note 159.

[195] Andersen, *supra* note 3, at 359

On the other hand, other sectors posit that rather than a piecemeal, country-by-country approach, a thoughtful and efficient approach to the global challenges of e-commerce taxation requires international cooperation and consensus. This international consensus is essential to achieving the common objective of establishing a stable tax environment that will enable e-commerce to develop its full potential, while at the same time enabling governments to protect their revenue bases.[196]

## EPILOGUE

The issue of Internet taxation is in its infancy and there are many unresolved issues and statutory and regulatory ambiguities. There are already stark differences in approaches taken by various jurisdictions that are creating considerable confusion and lack of uniformity.

In many cases, states are attempting to adapt a mid-twentieth century tax regime to a technologically advanced 21st century industry. Ironically, in drafting tax policies, the states are caught between two conflicting forces—one prodding them toward avoiding or delaying the taxation of electronic commerce, the other compelling them to continue or expand the taxation of cyberspace.[197]

The debate over the taxation of cyberspace promises to be one of the defining state policy issues of the next decade. While the complexity, novelty and economic importance of electronic commerce may inhibit states from enacting new laws to tax the Internet, the vast expansion of electronic commerce will create strong countervailing pressures on the states to broaden and clarify their state laws to encompass electronic services.[198]

- o0o -

---

[196] Andersen, *supra* note 3, at 593

[197] Andersen, *supra* note 3.

[198] Andersen, *supra* note 3 at 359.

## APPENDIX A

| The OECD Technical Advisory Group's Recommendations on the Character of E-Commerce Payments for Tax Treaty Purposes | | |
|---|---|---|
| **Transaction Type** | **Description of Transaction** | **Character of Payment** |
| *Advertising* | Advertisers pay to have ads (for example, banner ads) displayed to users of a given web site. | Business profits |
| *Application hosting— Separate license* | The customer has a perpetual license to use software (for example, financial management, inventory control) and contracts a host entity for accessing software applications and providing technical support. | Business profits |
| *Application hosting— Bundled Contract* | The user enters into a contract that provides use of one or more applications, plus hardware and software support. The contract renewable annually for an additional fee. | Business profits |
| *Application service— Provider (ASP)* | The ASP licenses a software application and makes it available to the customer. For the customer the software automates a particular back-office function such as automatic sourcing, ordering, payment and delivery of goods and services from third parties. | Business profits |
| *ASP license fees* | Same as above, except the ASP pays the software application provider a fee based on revenue from its customers and the contract is for a one-year term. | Business profits |
| *Carriage fees* | Payments made by a content provider to a web site | Business profits |

| | | |
|---|---|---|
| | operator to have its content displayed on the operator's web site. | |
| *Content Acquisition—Existing Material* | A web site operator says content providers for existing copyrighted news stories, information or other content to attract users to the site. | Royalty |
| *Content acquisition—Newly-created Material* | A web site operator pays for the creation of new content to attract users to the site and becomes owner of the copyright of the new content. | Business profits |
| *Customer support over a Computer network* | Online support can take the form of online technical documentation, a trouble-shooting database and e-mail communication with technicians. | Business profits |
| *Data Retrieval* | The provider sells access to a searchable repository of information. | Business profits |
| *Delivery of exclusive or Other high-value data* | As in data retrieval above, the provider sells access to a searchable repository of information; in this case the value of the data is greater than the search and retrieval of functions and provider adds significant value in terms of content (for example, by adding analysis of raw data). | Business profits |
| *Electronic access to professional advice (e.g. consultancy)* | A consultant, lawyer, doctor or other professional advises customers remotely (for example, through e-mail, video conferencing). | Business profits |
| *Electronic ordering and downloading of digital products* | Digital product is ordered online and downloaded onto the customer's hard disk. | Business profits |
| *Electronic ordering and downloading of digital products for purposes of* | A digital product is ordered online and downloaded onto the customer's hard disk; the customer acquires the right to commercially | Royalty |

| | | |
|---|---|---|
| *copyright exploitation* | exploit the copyright in the digital product (for example, a book publisher acquires a copyrighted picture for use in a book that it is producing). | |
| *Electronic order processing of tangible goods* | A tangible product that is ordered online from an electronic catalogue and physically delivered via common carrier (with no separate charge for use of the online catalogue). | Business profits |
| *Information delivery* | The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. | Business profits |
| *Interactive web site access* | Subscribers pay a fixed fee for access to a site featuring digital content (for example, video, music, games). | Business profits |
| *Limited duration software and other digital information licenses provided on a tangible medium or downloaded electronically* | Right to use software or other digital products for a period of time that is less that the product's useful life; all copies of the digital product are deleted or become unusable on termination of the license. | Business profits |
| *Online shopping portals* | A web site operator hosts electronic catalogues of multiple vendors or displays many items for purchase from multiple vendors. Providers are compensated either through commissions or flat fees. | Business profits |
| *Online auctions* | Same as above, only items are purchased by auction. | Business profits |
| *Sales referral programs* | An online provider pays a sales commission to the operator of a web site that refers sales leads to the | Business profits |

| | | |
|---|---|---|
| | provider (for example, through links to the provider on the operator's web site). | |
| *Single-use software or other digital product* | The customer obtains the right to use software or other digital product once only, with no right to make copies other than as required to use the product for its intended use. | Business profits |
| *Software maintenance* | Under a bundled contract, a single annual fee is charged for software updates and technical support. Software updates are the principal object of the contract. Though the contract covers different elements, the TAG agreed that the treatment applicable to the principle part should apply to the whole consideration. | Business profits |
| *Streamed (real time) web based broadcasting* | The user accesses a content database of copyrighted audio and/or visual material; the broadcaster receives subscription or advertising revenues. | Business profits |
| *Subscription to a web site allowing the downloading of digital products* | Subscribers pay a fixed, periodic fee for access to a web site featuring copyrighted digital content (e.g. music). Unlike the "Interactive web site" category, the site's principle value is the possibility to download these digital products. | Business profits |
| *Technical information* | The customer is provided with undivulged technical data on a product or process (for example, description or diagrams of a secret manufacturing process). | Royalty |
| *Updates and add-ons of software and other digital products* | The provider of software or other goods agrees to provide the customer with updates and add-ons to the digital product; there is no agreement to produce updates and | Business profits |

| | | |
|---|---|---|
| | add-ons specifically for a given customer. | |
| *Web site hosting/ Data warehousing* | The provider offers space on its server to customers for creating and maintaining web sites or for storing computer data that the customer can access and manipulate remotely. | Business profits |

## APPENDIX B

Draft Revenue Regulation
(Only Section 2 par. 2.3 reproduced here)
Exposure Draft
December 17, 2000
Republic of the Philippines
Department of Finance
BUREAU OF INTERNAL REVENUE
Quezon City

REVENUE REGULATIONS NO. ______
SUBJECT: Electronic Commerce Transactions
TO: All Internal Revenue Officers and Others Concerned.

Section 2. Electronic Commercial Activities.

2.3. Treatment of Digitized Information Products for VAT Purposes—Digitized information products shall be treated as intangible personal property right. Any payment to a nonresident of the Philippines as a consideration for any digitized information product such as, but not limited to, music, computer software, graphics programs, books, movies, or data bases which the said nonresident owner downloads to the personal computer of a resident of the Philippines, whether a VAT or non-VAT registered person, for the latter's use shall be imposed with the creditable 10% VAT withholding, pursuant to the provision of Section 113 C of the Code, as follows:

"xxx Provided, further, That the payment for lease or use of properties or property rights to nonresident owners shall be subject to ten percent (10%)withholding tax at the time of payment. For this purpose, the payor or person in control of the payment shall be considered as the withholding agent.

"The value-added tax withheld under this section shall be remitted within ten (10) days following the end of the month the withholding was made"

The digitized information product shall be treated as the intellectual property or property right of the aforesaid nonresident person. The aforementioned resident person shall, in turn, be treated as the lessee or licensee with respect to the lease or use of the said intellectual property or property right of the said nonresident who shall, accordingly, be considered as a withholding agent in respect of the 10% VAT due from the said nonresident. The aforesaid resident person shall, before making payment, withhold and remit the 10% VAT due thereon by filing a VAT return in his capacity as a withholding agent, for and in behalf of the said nonresident-payee.

If VAT Withholding Agent is a VAT Registered Person.—The 10% VAT so withheld and remitted to the BIR shall be treated as the said withholding agent's input tax which shall be available for credit against his output taxes.

If VAT Withholding Agent is a Non-VAT Registered Person—The 10% VAT so withheld and remitted to the BIR shall be treated as the said withholding agent's cost or expenditure for income tax purposes; Provided, however, that whether or not he may be allowed to claim the same as deduction for income tax purposes shall depend on whether or not the corresponding requisites for its deductibility, under the income tax law and regulations, have been complied with.