Will the GST be Effective in the Information Age?

Michael Hekimian, Law Student, University of New South Wales

PART ONE: INTRODUCTION

The advent of the information age has brought about an entirely new way of doing business. The Internet has connected buyers to sellers all across the world - transcending the traditional geographic boundaries of nations. In many ways the Internet has become a world within itself. A world where apparently the legitimacy and enforceability of national laws is undermined, whilst the dictates of e-commerce[1] reign supreme.

It would be foolish to assume that e-commerce is a passing fad. Large corporations world wide have adapted to it as readily as they did to telephones, photocopiers and fax machines. Domestically, 1.5 million Australian households (22% of all households) had Internet access as of May 1999.[2] They made about 3 million purchases, over two thirds of which were offshore.[3] Some conservative estimates predict that global e-commerce sales will exceed $470 billion world wide by 2002[4]—a significant amount of which will be spent on goods and services. If spending patterns do in fact match these predictions (with Australians buying mostly from overseas), the Australian Tax Office might find themselves out of pocket sooner than they realise. As one tax haven website boasts: "taxes are an option in e-commerce."[5]

The ATO have not been oblivious to the potential impact of e-commerce. Last December, they released *Tax and the Internet: Second Report.*[6] However the general gist of the 211 page report was that although e-commerce had potential to have significant impact on Australia's tax base, current tax rules and administration, as it is still in its infancy they will adopt a "wait and see" approach.[7] They concluded that "... at least for the next few years, electronic commerce is unlikely to have significant impact on taxation revenues."[8]

Considering that the taxation climate in Australia is about to shift focus this attitude is dangerous. As of July this year Australia will adopt a Goods and Services Tax to replace the Wholesale Sales Tax and various other sales taxes.[9] As this paper will demonstrate, consumption taxes are undermined considerably by the dynamics of e-commerce and steps need to be taken immediately to ensure that Australia is not caught flat-footed if market trends match current predictions. To this end, this paper will, demonstrate why e-commerce undermines the GST, and discuss what the international position is in regard to these problems. Finally, the paper will proffer possible remedies to these problems.

PART TWO: E-COMMERCE AND THE GST

The Internet is bringing markets closer to the assumption of perfect competition (lowering transaction costs and barriers to entry; improving product information and quality of service),[10] indirectly, it is simultaneously facilitating greater opportunities for tax avoidance and tax evasion.[11] This is because consumption style taxes (like the GST) are particularly susceptible to the three norms of e-commerce transactions. They are:

- Low cost cross-border transactions;
- Disintermediation; and
- Trade in intangibe products. [12]

Each of these issues will be examined in turn to illustrate what their ramifications will be on the operation of an effective GST.

Part 2.1: Low Cost Cross Border Transactions

On the Internet, it makes little difference where the location of parties to a transaction actually are. Small and medium enterprises have been able to capitalise on this phenomenon and are now entering markets that were traditionally inaccessible due to the distances involved. At the other end, consumers too, are becoming increasingly aware of, and are more comfortable with, shopping on-line. The inevitable consequence is that distance is no longer the economic barrier it once was, thus small scale commerce (retail) is becoming increasingly global.[13]

This situation exposes the shortcomings in consumption tax law regarding jurisdictional issues. Consumption taxes (which are primarily transaction based) are imposed on the basis of a physical nexus to, or presence in, the taxing jurisdiction.[14] As such, e-commerce with its cross-border transactions as common place undermines this base. Consumers do not necessarily consider jurisdiction a factor when making purchases. They will buy from the cheapest sites instead of their domestic retail markets.[15] This results in GSTs not paid into the coffer of the consumer's country. The only way then currently available to make the consumer pay tax is to get them to pay an import duty. However, this creates its own problems especially for low cost transactions.

As e-commerce leads to an increase in consumers making retail purchases from other jurisdictions it inevitably results in an increase in volume of imported goods that benefit from the low value concessions granted through Customs legislation (currently in place for items less than $50 in value). There seems to be no practical method to tax this form of cross-border consumption.

The OECD[16] has indicated that a review of the low value concessions is appropriate in this context.[17] In light of this, the ATO has decided to assist Customs in monitoring low value consignments to establish seasonal profiles and trends through a pilot survey. The ultimate aim of this survey will be to assess the appropriateness of the existing thresholds in a GST environment.[18] However, if the volume of such imports does indeed increase according to market estimates, Customs may not have the resources to intercept, value and impose taxes and or duties on such items. Consequently the consumer avoids paying tax again.

If one considers that it is becoming less important to consumers where a business is actually located, then logically, business will make conscious decisions as to where they establish themselves, informed by this awareness. Heightened competition will force businesses to seek more favorable places of residence.[19] In effect this will mean that businesses will move to jurisdictions that grant tax concessions because they will then be able to supply consumers with cheaper goods.[20]

This means that countries lose out again on collecting tax revenue because the company which was previously in residence has moved away thus depriving the country of that company's income tax as well.[21]

Part 2.2: Disintermediation

The above factors are compounded when one considers that e-commerce directly facilitates access between the producer and consumer without the need for intermediaries like wholesalers, brokers, distributors and retailers.[22] This process coined "disintermediation" deprives the tax office of one of its more convenient and traditional collection points for consumption taxes.[23] As such, it will become increasingly important for the tax office to be able to tax either the producer or the consumer as there will be fewer entities on which to impose a tax.

Part 2.3: Intangible Products

Lastly, the necessity of many types of "information" goods[24] to have an actual corporeal presence is diminishing. This poses real problems for the ATO. It is one thing to identify and then tax an item purchased over the Internet and shipped to your house by conventional means, but it is another thing altogether when the same item is downloaded directly into your PC.[25] Physically auditing the seller becomes an exercise in futility. For example, many software programs are now just as easily downloaded rather than installed from diskette. Consequently, auditing the boxes of software sold may not be a very accurate reflection on how much software the company is selling if it is also trading on the Internet.[26]

Another example can be found in the music industry. Due to technological advancements, music stored in a computer file is now equal in quality to music stored on CD for domestic purposes. New technology like the "MP3 player" can then be used to directly interface with a PC and extract and store downloaded music files.[27] The MP3 player is then used like a Walkman or connected to a household stereo system to play the music. Furthermore, it is expected that within three years, data compression technology will similarly make current video and DVD technology redundant.

Current ABS figures indicate that software represents 34% of goods currently purchased over the Internet and music represents 14%.[28] The market for intangible goods will only increase as more and more forms of information goods become available on-line. However, the OECD has recommended that digitised products should not be clasified as 'goods' for the purposes of consumption taxes. The Australian government has supported this position.[29] Essentially, this means that incorporeal or digitised products will not be subject to a GST even though they make up a significant percentage of e-commerce trade.[30] Despite this, the ATO's stance is to merely continue to monitor the production and marketing strategies adopted by industries likely to be impacted.[31]

Thus, the consumer avoids paying tax on these items—through no fault of their own. The government at least should enact legislation to identify intangible information as a good, service or perhaps even give it a unique classification. Failure to make a choice now may give rise to an inconsistent approach later that could lead to double taxation or to no taxation of intangibles.[32]

PART THREE: INTERNATIONAL DEVELOPMENTS

Clearly, the global nature of e-commerce problems require global solutions. This should leave it beyond any one country to dictate policy in this area.[33] However, on the global stage some players are more equal than others. Therefore it is prudent to consider the positions of particularly the US, EU and the OECD in regard to e-commerce issues before attempting to find a national solution to taxation problems.

There is common consensus among nations that, in particular, there is a need for: continued international cooperation; a need to establish a coordinated strategy to deal with the many issues within an appropriate framework; and a need for coherent and clear rules that are consistent with technology.[34]

In 1998 the US government passed its e-commerce initiative - *A Framework for Global Electronic Commerce*. Essentially, this framework set up a non-interference policy in regard to e-commerce with an eye to lending the US market a hand in global expansion.[35] To complement this framework Bill Clinton passed the *Internet Tax Freedom Act* in October of that same year. The act placed a three year moratorium on taxing the Internet.[36] By and large, the Europeans have taken a similar approach.[37]

At the time, John Howard condoned the US position and stated further that he believed that e-commerce would fuel Australia's economic and social development. But he has had his critics who argue that unregulated trade in goods and services over the Internet could seriously damage the economy, and that by copying the US position, the Australian government is failing to protect Australia's interests.[38] Indeed, the US chooses not to tax the Internet because it is in its best interest not to do so. After all, Australians along with many other non-US countries make a significant percentage of their purchases on US websites to the detriment of their own retailers.

Some of Howard's critics are already doom-saying that the three year moratorium (which will end next year) will have given the industry in the US time to settle into ways of doing business based on the absence of any requirement to collect state sales taxes on Internet sales. This means that monetary transfer software is not currently being developed to incorporate taxation collection mechanisms. They further their argument by saying that when the time is up, the industry will have mustered enough lobbing power in the US to ensure that Clinton's moratorium continues.[39]

Given that the rapid rise of e-commerce has spawned a new generation of powerful business people - most notably Bill Gates (America's richest man) and Steve Bazos (the CEO of Amazon.com and *Time* "Man of the Year" in 1999), the doom-sayers may have a valid point.

In the international forum, the OECD has for quite some time been actively addressing e-commerce taxation issues both internally and with other relevant international bodies such as: the EU; the Commonwealth Association of Tax Administrators; the World Customs Organisation; and over 30 other economies outside the OECD.[40] As noted above they have recommended that countries examine their import duty thresholds. In addition, they have suggested that in cross-border trade, taxation should occur in the jurisdiction where consumption takes place.

To deal with taxation problems arising from e-commerce the OECD has set up five TAGs (Technical Advisory Groups) comprised of business and government members to assist in developing solutions.[41] Australia has representatives in all of the TAGs who have been active in presenting Australia's views. True to the spirit of the OECD, the ATO report complements the work done by the OECD.[42]

However, not all countries adhere as closely to the OECD as Australia does. In many ways this leaves Australia between a rock and a hard place. We must resist trying to assert our own rules in isolation to other countries because this could lead to fragmentation and uncertainty in regard to international tax laws and trade practice - making us a less viable place for consumers to spend their dollars.[43] On the other hand if we follow the practices of the larger players we may also lose out because the nature of our economy means that our businesses are not in a good position to compete internationally. The priority then should be to find some middle ground that is not in conflict with international norms and does not undermine our businesses.

PART FOUR: POSSIBLE SOLUTIONS

It may be possible for Australia to overcome this dilemma by pioneering innovative, practical developments in regard to e-commerce taxation issues. As discussed above the biggest concern with e-commerce stems from the way the technology associated with it has changed market habits. Considering that one of the key principles of an efficient tax system is that taxes should be as easy as possible to collect, an effective tax system should feed on the way the economy generates income.[44] From this perspective, it seems that the best way to implement a consumption tax on e-commerce transactions would be to use the technology required to facilitate the transactions for taxation purposes.

Transactions over the Internet generally require two things. A credit card (or some other form of digital cash) to make the purchase, and an ISP (Internet Service Provider) to access the Internet itself.

From this, two possible options present themselves. The first is to impose tax on credit card use for Internet purchases or on the digital cash cards themselves. The second could be to establish ISPs as new intermediaries for taxation purposes.

ISPs know the identity of each user (and usually operate in the same jurisdiction), theoretically this means that they could be made responsible for keeping track of each consumers financial transactions. Currently, however, there are problems in regard to setting up ISP's as consumption tax collectors. The major problem is that the sheer volume of transactions would require intensive resources which may make ISP's economically unviable.[45] Despite this the premise is still quite solid. For the foreseeable future there will need to be some kind of ISP technology to mediate between a PC and the Internet. Adapting the use of such technology now, whilst it is still in its infancy, would lead to later technology more readily available for public benefit in the future.

There is also a less popular solution in the form of a "bit tax". Although the Australian government has already followed the US example and ruled this option out,[46] a "bit tax" would essentially impose a small rate of tax on every bit (which is the basic unit of information) that is sent across the net. It is a tax therefore on the volume of information traded. As such, it would be particularly useful for taxing intangible goods. Such a tax is relatively easy to collect, unfortunately this tax taxes volume rather than quantity. This means that if a person was to download a music file they would be taxed regardless of whether they paid for it or not. Consequently the real economy of such tax collection is inherently distorted.[47]

PART 5: CONCLUSIONS

Regardless of what solution is ultimately pursued, if any, the bottom line remains that e-commerce is here to stay and will only become more significant each year. Despite this, the ATO maintains that because e-commerce is not yet a significant economic factor the best approach is to "wait and see." At the least, such an attitude is unresponsive and does nothing to stem the flow of what will be an increasing amount of lost revenue each year. At worst, it will leave Australian businesses trying to play catch up in an almost exponentially increasing market place - depriving the government of a major revenue source that is necessary to maintain the standard of living Australians have come to expect. The option is still open for Australia to take a leading role in regard to finding solutions to these problems. It would be a shame to let another such opportunity slip.

1 Electronic Commerce.
2 ATO. *Tax and the Internet: Second Report.* December 1999, 56.
3 Australian Bureau of Statistics figure as quoted in 16-17 January 2000 *Australian Financial Review*, 25.
4 *Ibid.* Currency refers to AUD.
5 See www.hansa.net/ecom.htm
6 Note 2 above.
7 *Ibid*, 4.
8 *Ibid*, 59.
9 *A New Tax System (Goods and Services Tax) Act 1999* (Cth)
10 J Pooley. "Tax Reform, Competition Policy and Electronic Money" *Economic Papers (Sydney)* v.17 no.4 Dec 1998: 86-94 at 87.
11 D Pinto. "Taxation Issues in a World of Electronic Commerce" *Journal of Australian Taxation* v.2 no.4 July-Aug 1999: 227-280 at 227.
12 D Watson. "Taxing E-commerce: which way to go?" *Australian CPA* v. 69 no.6 July 1999: 44-45 at 44.
13 Note 11 above at 231.
14 Note 10 above at 93.
15 Note 2 above at 26.
16 Organisation for Economic Cooperation and Development.
17 Note 11 above at 236.
18 Note 2 above at 185. Draft Recommendation no.26.
19 U Kohl. "The Horror-scope for the Taxation Office: the Internet and its Impact on Residence" *University of New South Wales Law Journal* v.21 no.2 1998: 436-451 at 436.
20 Note 3 above.
21 M D'Ascenzo. "Current Issues facing the ATO." *Tax Institute of Australia: Convention Papers* v.1 1998-1999: 104-108 at 105. Please note that this is a very simple set of examples. For more detail see note 2 above 78-99.
22 Note 10 above at 87.
23 Note 11 above at 237.
24 Computer software, music, video, magazines and other print media, etc.
25 Note 12 above at 44.
26 Note 10 above at 233.
27 *Ibid*, 234.
28 Australian Bureau of Statistics catalogue no 8147.0 *'use of the Internet by householders, Australia,'* May 1999.
29 Note 2 above at 45.
30 Note 11 above at 234.
31 Note 2 above at 127. Draft recommendation 27.
32 Note 19 above.
33 Note 11 above at 247.
34 *Ibid*, 245.
35 *Ibid.*
36 Note 12 above at 45. The moratorium does not extend to tangible products ordered and paid for on-line but delivered conventionally. See M De Zwart. "Electronic Commerce: Promises, Potential and Proposals" *University of New South Wales Law Journal* v.21 no.2 1998: 305-322 at 312.
37 Note 11 above.
38 Note 3 above.
39 Note 12 above at 45.
40 Note 2 above at 43.
41 *Ibid*, 43.
42 *Ibid*, 7.
43 Note 11 above at 247.
44 *Ibid*, 230.
45 *Ibid*, 271.
46 *Ibid*, 270.
47 Note 12 above at 45.

IN OUR NEXT ISSUE...

Our next issue looks at

e-business

Contributions from members of all Societies are welcome. Although this is the central theme of the issue, contributions can be on any topic relating to computers and law and can take the form of an article, product or book review, abstract or press release.

Please send your contributions to the Editors no later than September 2000.