Pergamon

PII: S0263-2373(01)00090-1

European Management Journal Vol. 19, No. 6, pp. 651–658, 2001

0263-2373/01 $20.00

Electronic Commerce and International Taxation: A Square Peg in a Round Hole?

JANE FRECKNALL HUGHES, *Leeds University Business School*
KEITH GLAISTER, *Leeds University Business School*

This paper examines the concept of the electronic commerce company (e-company) from a tax strategy perspective. E-company development is examined alongside traditional models of company growth and global expansion. The e-company is potentially multinational from genesis, operating without geographical constraints or even a physical presence. When transactions are grounded in different tax jurisdictions, however, this business form conflicts with regulations designed to deal with other forms of business. The paper considers whether this conflict can be resolved by integrating tax strategy more fully into e-company business operations to ensure conformity with existing tax regulations, or whether the new form needs new regulations. © 2001 Elsevier Science Ltd. All rights reserved.

Keywords: e-Commerce company, International business, International taxation

Introduction

It is now accepted that the Internet may facilitate a strategy of competing internationally. This paper discusses the taxation implications of following such a strategy. A key question is whether existing tax systems can cope with a trading mechanism which is perceived as achieving something very new, or whether different models are needed. The Internet is creating a unique global marketplace that has the potential to change profoundly the way international business is conceptualised and configured (Srirojanant and Thirkell, 1999; Bennett, 1997; Kedia and Harveston, 1999). The rapid commercialisation of the Internet calls into question many of the fundamental tenets of international business (Hamill and Gregory, 1997, p. 9). Issues such as the barriers to internationalisation faced by small and medium sized enterprises (SMEs); incremental, evolutionary internationalisation; the importance of overseas agents and distributors to export success; country screening; market concentration versus market spreading, etc., take on a new perspective.

The use of the Internet for global marketing 'enables firms to leap-frog the conventional stages of internationalisation, as it removes all geographical constraints, permits the instant establishment of virtual branches throughout the world, and allows direct and immediate foreign market entry to the smallest of businesses' (Bennett, 1997, p. 327). Kedia and Harveston (1999, p. 109) recall that the domain of international business has typically been dominated by large firms that have internationalized either incrementally or by progressing through a sequence of identifiable stages. Previous research has indicated that firms go through a process of evolutionary development in terms of depth of operational mode and product offerings (goods, know-how, services and systems). Probably the best-known model of the internationalisation process is that of the Uppsala school (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne 1977, 1990). This model describes a sequential progression from export through knowledge agreements, such as licensing or franchising, to foreign direct investment. These firms have been referred to as gradual globalisers. In contrast, a number of new ventures has recently appeared with a significant amount of international activities from inception (Cavusgil and Knight, 1997;

Oviatt and McDougall, 1995). These organisations have been referred to as 'born global' firms. There is a clear sense in which Internet-based strategies permit SMEs to be born global. Hamill and Gregory (1997) consider it is a legitimate question to ask whether the slow, evolutionary stages of development approach to internationalisation remains valid when Internet technology and the WWW provide SMEs with a low-cost 'gateway' to global markets.

In terms of taxation, the impact of this development and the speed at which it has occurred is significant. In the past, national revenue jurisdictions had time to react to slowly occurring changes and implement taxation policies and statutes to deal with them in a timely manner. Often any jurisdiction had only to consider its own needs. In a time of fast-developing technical changes, a revenue authority lags behind. It takes considerable time to formulate policy and establish it within a legal framework. By the time this has been done, the new law could have been overtaken by further innovations, which could require yet further statute to address their taxation implications. Moreover, e-commerce by nature is multi-jurisdictional, so a national taxing authority must necessarily consider its interfaces with other jurisdictions more prominently than before.

“In a time of fast-developing technical changes, a revenue authority lags behind”

The rest of the paper is organised as follows. The following section examines extant taxation theory within the context of e-commerce. The third section examines reasons for considering e-commerce as conceptually the same as trade by other means, together with current world-wide experiences. The fourth section looks at conceptual differences, going on to consider especially US perspectives and the potential for exploiting differences. Conclusions are in the final section.

Taxation – Extant Theory

Taxation theory as applied today stems ultimately from the four canons of taxation developed by Adam Smith in 1776 in *An Enquiry into the Nature and Causes of the Wealth of Nations*. In addition to certainty, convenience and efficiency, equity was fundamental. Later theorists have added neutrality, simplicity and flexibility. Equity in its basic meaning of fairness has two aspects. The first is that subjects of a State (which will now include companies, as these are legal persons) should contribute to the support of government as nearly as possible in proportion to the revenue they respectively enjoy under the protection of the State. Secondly, the individual circumstances of the person should be considered. The idea of *vertical equity* suggests that persons in different circumstances should be treated differently. For example, high wage earners should pay more tax than low wage earners (whether by proportional or progressive taxes). *Horizontal equity* on the other hand suggests that persons in similar circumstances should be treated similarly. A person who has acquired £35,000 is the same as another with the same amount of money, therefore they should be treated similarly. However, the vertical equity concept would suggest that treatment might need to be different if one person had £35,000 as earned income and the other as capital profits arising on the disposal of assets. There are differences even in the notion of 'person', which make a distinction in this context.

Corporations/companies arrived later as business entities than sole traders or partnerships. In the UK, for instance, no tax distinction was drawn between unincorporated and incorporated businesses, when the latter became increasingly used as means of doing business: both paid income tax (though companies had no personal reliefs and allowances and were not liable at graduated rates). Not until 1965 was there, in fact, a separate tax on company profits, although there had been some temporary forerunners in the form of excess profits taxes and national defence contributions levied on companies (Nightingale, 2000, pp. 29–30). The tax introduced in 1965 did not differentiate between distributed and retained profits, thus dividends were doubly taxed until the partial imputation system was introduced in 1973. Although both individuals and companies could make profits from being in business, it was the way in which companies rewarded their providers of capital from those business profits which helped bring about a fundamental difference in the way those profits are now both perceived and taxed. The point here is that an attempt to treat both in the same way for taxation purposes ultimately foundered not because the two entities were doing anything inherently different, but they had a different formal structure at law which dictated what could be done with profits.

In terms of e-commerce, the basic research question which needs to be asked is whether the form of doing business over the Internet is in itself different or brings about new outcomes or procedures, which require new or different tax policies or treatments. Sometimes differences are not immediately apparent: the case of taxation of company profits cited above underlines this. At present a great deal is being written about taxation and e-commerce from a practitioner or country standpoint. The debate basically hinges on whether e-commerce transactions can be fitted into existing national tax frameworks – with clarification on certain issues or extending definitions as and when required.