

TAXATION OF E-COMMERCE A TASK FOR JUGGLERS

by

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E-commerce presents a radical transformation of the nature of commercial activities; this creates significant challenges to regulations and tax formulas that are not specifically directed towards the “virtual” commercial world. A particular area of concern is the challenges posed by the growth of internet to current commercial and tax activities. This paper is going to identify the main challenges of assessing the taxing of e-commerce activities. It discusses the new challenge which faces governments as well as agencies such as the OECD and WTO regarding traditional tax concepts and their adjustment for an e-business environment. Contemporary tax legislation should be evaluated for applicability to the e-commerce platform. The paper will show the problems which may appear as consequence in the case of non-applicability; double-taxation, electronic fraud, jurisdictional issues, all complicating online commercial transactions. Ultimately these may prevent the internet growing to its full potential as a new virtual commercial world, even replacing the traditional way of conducting business. Slowly but surely, however, especially after Ottawa, where the OECD initially examined the issue of e-commerce and taxation, taxing online commercial activity is becoming an inescapable e-business reality. As a result the objective should be the realization of a formula of worldwide harmonized e-commercial regulations to achieve economic, legal and social efficiency. Thus, this presentation will draw upon some conclusions on the difficulties as well as preliminary thoughts on solutions.

Introduction [1]

Information technology advancements have been challenging many traditional concepts and approaches. More specifically world economies have been faced with a problematic, or rather challenging, scenario because

of the development of electronic commerce (e-commerce). That situation has proven difficult for tax policymakers.¹ The growth of e-commerce has altered the way business are conducted; shifted the basis from a physically-orientated commercial environment to an information-based environment.² This growth and proliferation of Internet and more specifically of e-commerce has made most of the policymakers, governments or organisations, to state that their aim is "...to encourage the vigorous growth of electronic commerce [in Europe]".³ Since it first appeared in mid-1990's, the online commercial activity has been constantly expanding.⁴ E-commerce entails new characteristics that challenge theories and well-grounded rules of existing tax systems, for example the concept of being able to locate all transactions in physical space.⁵ This paper will present the main issues arising about e-commerce and tax, as well as examine the approaches by certain bodies, either state or organisations. Before examining the difficulties e-commerce presents for tax authorities, it is important to assess the nature of e-commerce and its significance for present and future economic activities.

First of all we need to clarify what e-commerce is, what it entails. According to David LJ "Electronic Commerce could be said to comprise commercial transactions, whether between private individuals or commercial entities, which take place in or over electronic networks. The matters dealt with in the transactions could be intangibles, data products or tangible goods. The only important factor is that the communication transactions take place over an electronic medium".⁶ E-commerce transactions can be "business to business" (B2B) or "business to consumer" (B2C). The Organisation for Economic Co-Operation and Development (OECD) back in 1999 indicated a respectable development of e-commerce;

¹ Ivinson J, (2004) "Overstepping the Boundary – How the EU got it wrong on E-Commerce", *Computer and Telecommunications Law Review*, 2004, 10(1),(1-4)

² Subhajt Basu (2003) "Relevance of E-Commerce for Taxation: an Overview", *Global Jurist Topics*: Vol.3: No. 3, Article 2. <http://www.bepress.com/gj/topics/vol3/iss3/art2>

³ European Commission (1997, 15th April), "A European Initiative in Electronic Commerce (Green Paper)", COM(97) 157

⁴ OECD, Implementation of the Ottawa Taxation Framework Conditions – The 2003 Report, OECD 2003

⁵ Ronald Paris, "The globalisation of Taxation? Electronic Commerce and the transformation of the State" *International Studies Quarterly*, 2003 47, 154

⁶ Davies LJ (1998) "A Model for Internet Regulation", <http://www.scl.org>

they expected that e-commerce would reach a value of \$330 billion in 2001 and would rise up to £1 trillion by 2003-5.⁷

Is e-commerce different? [2]

The fact that e-commerce functions almost exclusively on the Internet platform makes e-commerce different from conventional commercial activities. E-commerce has no physical geographical boundaries, and thus within cyberspace any distance is eliminated, it is global. Physical presence is minimal in comparison to the “virtual” presence, something which is also applicable to the human intervention necessary for e-commerce, as well as the minimum documentation or complete lack of actual documentation regarding an online transaction. Also, in e-commerce there is evident the reduction of intermediaries, as well as the deficiency of actual physical control over it. Another significant difference is the fact that while conducting business online, the transactions are mostly anonymous; no face-to-face basis between seller and consumer.

So, if e-commerce is significantly different to conventional commercial activity there are questions of who is able or suitable to regulate it, and looking at it in a more narrow spectrum why should it be taxed? Internet libertarians have been arguing from the birth of the internet that it should be free of any regulation by governments.⁸ Internet by its character is not owned by anyone; so who has the right to collect taxes from any activity within the sphere of the internet? As has happened historically with any new development causing problems to the law and regulatory mechanisms, the view being followed is to apply current laws to the new development.⁹ But it is not always so easy or appropriate to take such an action. Saxby has commented that “The law is at a stage when it is trying to bed down a technology that has re-shaped society to its roots.”¹⁰

⁷ OECD,(October 1999) “Progress Report: Taxation and Electronic Commerce”, Paris Forum on Electronic Commerce

⁸ Lessig Lawrence, (1999) “Code and Other Laws of Cyberspace”, Basic Books

⁹ Rowland Rowland D, (1998) “Cyberspace - A Contemporary Utopia?”, The Journal of Information, Law and Technology (JILT), 1998 (3), http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/1998_3/rowland/

¹⁰ Saxby S, (1995) “A Jurisprudence for Information Technology”, <http://www2.echo.lu/legal/en/access/saxby/ch1/ch1.html>

One Set of Rules or “Real” & “Virtual” Rules Separately? [3]

In order to identify challenges to e-commerce taxation we have to look at the different types of taxes. First we have the indirect VAT sales and consumption taxes and secondly the direct income and corporation taxes. For instance, a very simple illustration is that when a resident of the city of Brno buys a product he or she will pay an X amount extra, which will be already inclusive in the price, to cover the tax of the product and the same would be the case for a resident of the city of London. But the difference is that residents of the Czech Republic pay 19% VAT, while residents of the United Kingdom pay 17,5%.¹¹ Within EU there is no actual harmonized tax system among its members; depending where a person resides will mean paying more or less for a product. So far we were referring to taxation in relation to traditional, if we can use the term, commercial activity and it is evident that even in that case tax authorities may face problems. What we also need to mention is the distinction between direct and indirect e-commerce. When talking about direct we refer to the supply of virtual goods, in other words electronic ordering and the subsequent electronic delivery of the ordered product or service. When on the other hand we mention indirect e-commerce we are referring to the electronic ordering and the subsequent physical delivery of the goods. Indirect e-commerce is much easier to identify and regulate, while direct e-commerce presents more challenges to regulation in general and specifically taxation.

So can the same rules simply be transferred and be applicable to the online commercial activity? Some academics believe that the existing tax rules should be applied to e-commerce.¹² They suggest that internet is simply a new stage where we can apply already existing law; a case presenting new facts which can be resolved with existing law.¹³ If someone rents a DVD to watch a movie, and if someone else downloads a DVD to watch the movie, what is the difference between the two? Is it a new

¹¹ EUROPA (2006, September), “VAT rates applicable in the EU Member States”, http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_2006_en.pdf

¹² Basu Subhjit (2004), 'To tax or not to tax? That is the question? Overview of Options in Consumption Taxation of E-Commerce ', 2004 (1) The Journal of Information, Law and Technology (JILT), http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2004_1/basu/

¹³ Orin S.Kerr, (February 2003) “Problem of perspective in internet law”, Georgetown Law Journal

product, or merely different channels of delivering the same product? We believe that it amounts to the same product, because the nature or character or use of the item is not altered; so, that may indicate existing tax rules could be applied to e-commerce activity, or it may also indicate that e-commerce presents a very radical change in the taxation perspective and completely new rules need to be devised.

We presented the idea that e-commerce is different than conventional/traditional commercial activities, and in this paper we are reviewing the challenges presented to the taxing authorities; Inland Revenue in UK, or the Central Financial and Tax Directorate (CFTD) in Czech Republic, or the Internal Revenue Service (IRS) for the United States are responsible for administering their tax system. These authorities will have to bear a significant degree of responsibility to adapt adequately to any potential adjustments in order to tackle the challenges in taxing e-commerce. Internet, in its commercial application as e-commerce, has been on the agenda for almost a decade.¹⁴

So what are the main challenges? [4]

First of all, the nature of Internet and more specifically its commercial part has shown rapid growth in the last few years. E-commerce has an international nature, it is inherently non-territorial. The lack of geographic boundaries has helped increased the amount of e-commerce activity; small-sized companies can become international players by using e-commerce. Because we are looking at what is a worldwide process, there is the issue of jurisdiction arising. Taxation is dependent upon, or rather is interrelated with the issue of residency, for a tax to be imposed on a transaction, the authority that has the role of collecting the taxes has to know where it took place and also to recognize the category in question, goods or services; if not clarified then there may be cases of double-taxation or even multiple-taxation. But the relevant and appropriate jurisdiction can not always easily be identified. The worldwide nature of e-commerce also creates another issue; that of anonymity. Business is not transacted on a face to face basis, customer can hide his identity easily, and this may eventually lead, or simply facilitate to an extent, fraud or even tax evasion. Internet Service

¹⁴ Smith Graham JH (editor) (1996), "Special Report: Internet Law and Regulation", FT Law & Tax (Division of Pearson Professional Limited)

Providers (ISPs), content providers, hosts, end users, they all may be located in one or more different jurisdictions. Thus, there is an ambiguity to the principle of origin and destination as well.

The issue on taxing e-commerce has initially been focused on physical products sold to businesses and consumers. Nonetheless, this specific way of commercial activity was not presenting any challenges to tax, because in destination-based consumption tax can be charged after the shipment passes through customs. On the other hand, if the payment method and the product itself are both digitized, then the origin and destination of these transactions is obscured and immense tax enforcement issues arise.¹⁵ To be able to effectively tax a consumption transaction under traditional taxation principles, tax collectors need to know where the transaction takes place and whether the transaction is regarding a good or service. Sellers of intangible products will usually conduct anonymous transactions, meaning they will be unaware of the physical location of their customers.

The fact that some goods have completely been altered in character is evident when examining the case of a book or a music cd. The traditional method would mean order the item and a few days later a parcel would be waiting for the person who ordered it. But now the most common form of an online purchase would be ordering the cd or book from an online bookstore-music store and instead of receiving the item in tangible form, the product ordered has been digitised and is downloaded in the consumer's laptop or even mobile phone. This example is basically illustrating the digitization of information. Any information we can find on the internet, such as music, books, videos they can all be automatically transmitted from the seller to the consumer in any part of the globe. The mere fact that the products will be in an intangible form does cause greater discomfort to the taxing authorities. It makes it very complicated to specify where and when the transaction began and where and when it came to an end; in other words the intangibility of products via e-commerce creates significant problems for the relevant authorities to identify origin and destination details.¹⁶

¹⁵ Basu Subhajt, (2002) 'European VAT on Digital Sales', *The Journal of Information, Law and Technology (JILT)* 2002 (3), http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2002_3/basu/

¹⁶ Basu Subhajt (2003) "Relevance of E-Commerce for Taxation: an Overview", *Global Jurist Topics*: Vol. 3: No. 3, Article 2., <http://www.bepress.com/gj/topics/vol3/iss3/art2>

Furthermore, because of how e-commerce is operating on the internet, meaning that is mostly virtual, it presents more difficulties to tax authorities. Examples of such difficulties can be the difficulties they are facing when trying to obtain the necessary records, or in setting up and trying to control audits requirements.¹⁷ Another result of e-commerce that may cause more difficulties to taxing authorities is the significant reduction in number of intermediaries, which is understandable considering that e-business requires less human intervention. By this reduction the eminent danger is the increase in tax avoidance and evasion.¹⁸

One of the major points of discussion in relation to e-commerce taxation is the theory of Permanent Establishment (PE). The notion of PE is very important in source taxation. Without PE, a country cannot claim jurisdiction to tax profits resulting where good or services are sold. A PE is a "fixed place of business through which the business of an enterprise is wholly or partly carried on".¹⁹ But the challenge of this definition is to fit within the e-commerce context. PE requires something "fixed", attached to a geographical place. Within the context of e-commerce there can not be bricks and walls. The permanent establishment guidelines were presented in the ones falling within the wording of Article 5 of the OECD model Convention, where they took the view that a website cannot constitute a PE, which means that countries cannot claim profits from website businesses but can only claim profits from enterprises which have a fixed establishment in that country. Thus, from the perspective of tax administration, the principal challenge remains how to implement geographically limited taxing systems in a technologically advanced environment that makes geographical borders and limitations essentially irrelevant.

Reacting to the Challenges [5]

The importance of e-commerce within the area of taxation has forced governments and other organisations to react to the challenges presented. One of the initial, and very important, reactions was by the Organisation of

¹⁷ Basu, Subhajit (2004) 'Implementing E-Commerce Tax Policy', British Tax Review, Number 1 pg 47

¹⁸ Basu Subhajit (2003) "Relevance of E-Commerce for Taxation: an Overview", Global Jurist Topics: Vol. 3: No. 3, Article 2., <http://www.bepress.com/gj/topics/vol3/iss3/art2>

¹⁹ OECD, Model Convention, Art.5

Economic Co-Operation and Development in a significant ministerial conference in 1998, which produced what is known as the “Ottawa Taxation Framework Conditions”.²⁰ The 5 taxation principles are presented in Box 2 of the 1998 Report and are Neutrality, Efficiency, Certainty and Simplicity, Effectiveness and Fairness, and Flexibility.²¹

These taxation principles may have only advisory character but the European Union has developed proposals for regulatory framework regarding taxation in accordance with these. The Ottawa principles tried to establish that consumption taxes should be levied where the consumption occurs, as well as that there should be a simple registration scheme for non-resident, in this case non-EU traders. The Council Directive 2002/38/EC²² was entered into effect July 2003, and by the Council Directive 2006/58/EC²³

²⁰ OECD (1998) “Electronic Commerce: Taxation Framework Conditions” (A Report by the Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference “A Borderless World: Realising the Potential of Electronic Commerce” on 8 October 1998)

²¹ OECD (1998) “Electronic Commerce: Taxation Framework Conditions” (A Report by the Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference “A Borderless World: Realising the Potential of Electronic Commerce” on 8 October 1998), Box 2, p.4

Box 2. Broad taxation principles which should apply to electronic commerce

Neutrality

(i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency

(ii) Compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.

Certainty and simplicity

(iii) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness

(iv) Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counter-acting measures proportionate to the risks involved.

Flexibility

(v) The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

²² Official Journal of the European Communities, (2002), “Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services”, L128/41 (15.5.2002)

²³ Official Journal of the European Communities, (2006), “Council Directive 2006/58/EC of June 2006 amending Council Directive 2002/38/EC as regards the period of application of the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services”, L174/5 (28.6.2006)

the VAT arrangements brought forward by the previous Directive were extended until the end of December 2006. Also, the EU has been rather proactive and been ensuring that steps are taken to ensure measures are in place to cover cases in the field of indirect taxation regarding electronic services that may occur in the next few years. Another very important Regulation brought forward is the Council Regulation (EC) 792/2002,²⁴ which introduces methods to register non-EU e-service traders for VAT purposes. The above mentioned new rules and regulations mean that EU suppliers are not required to charge tax when trading outside EU, a development quite useful for competition with the non-EU traders. On the same point, non-EU traders have to follow the same VAT rules as the EU ones. But a note is to be made here that this changes are only for B2C transactions-in B2B transactions the VAT will still be remunerated by the business who imports the products/services. These changes have been under a lot of criticism from academics and businesses from the United States, regarding them as not fair.²⁵ EU has taken the most sensible approach at this time to prefer that VAT to be charged where the item/service is consumed rather than where its supplier may be located. There is no discriminatory treatment towards non-EU traders, and the Directive has been approved by WTO.²⁶ Also, there are other directives and regulations in regard to personal taxation, VAT and excise duties and tax administration procedures, as well as European Commissions Reports on the activities within the tax field within specific year.²⁷

Besides the EU, other attempts have been made to tackle the issues presented to taxation by e-commerce. Although most of the countries will try to adopt an OECD-friendly approach, in some situations states would either take a step further or be rather deliberate to any proposals for

²⁴ Official Journal of the European Communities, (2002), "Council Regulation (EC) 792/2002, temporarily amending the Regulation (EEC) 218/92 on administrative co-operation in the field of indirect taxation", L128/1 (15.5.2002)

²⁵ The 2003 Regulations have been attacked by people claiming that they will produce unfair results between EU and non-EU traders. See Ivinson J, (2004) "Overstepping the Boundary – How the EU got it wrong on E-Commerce", *Computer and Telecommunications Law Review*, 2004, 10(1),(1-4)

²⁶ EUROPA (2006) "How VAT works?" – "FAQ", http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm

²⁷ European Commission Report, "Activities of the European Union (EU) in the tax field in 2005", February 2006, Brussels, http://ec.europa.eu/taxation_customs/resources/documents/report_activities_2005.pdf

regulation on this topic. The OECD continues after the Ottawa to publish working papers and advisory papers²⁸ on the topic. Also there has been a significant number of cases in the European Court of Justice,²⁹ showing that is something important to many people and not only corporate bodies.

The best approach to be taken for the problem of taxation in the stage of e-commerce to seize, is to devise a formula of a universal globalised tax system, which will follow the principles of OECD. By following these 5 rules and by all the different jurisdictions agreeing to a common solution then it will be possible to talk about an international harmonized tax system applicable to e-commerce. And because of the nature of e-commerce, its taxing has to be an internationally agreed plan; it doesn't have any boundaries, so why should it regulation only be made taking state's borders into account?

Conclusion [6]

According to folklore, Michael Faraday, who discovered the principle of electromagnetic induction, was asked by a British politician what use electricity might have. Faraday replied, "I do not know what it is good for. But of one thing I am quite certain--someday you will tax it." This quotation is, most probably a myth, but even so there is significant truth therein. Like electricity, that was eventually taxed, the e-commerce can and will be taxed – the important thing is that it be taxed fairly and efficiently (just like conventional commerce). There's no doubt that governments will e their tax revenues to evaporate. The truth is, governments are supposed to provide their citizens with services such as schools, hospitals, transport infrastructure, social security provisions, etc. and in practice taxation still holds a major role in securing the funds for those services exist. So we can think of taxation of e-commerce as a normal part of the way of how

²⁸ Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments, (February 2001) "Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs, - Tax Treaty Characterization Issues Arising from E-Commerce" (February 1, 2001). Also, OECD Working Party No. 9 on Consumption Taxes, "Consumption Tax Aspects of Electronic Commerce" (February 2001)

²⁹ Kerckhaert-Morres v Belgische Staat, Reference for a preliminary ruling from the Hoge Raad Der Nederlanden by order of that court of 2 December 2005 in *Investrand B.V. v Staatssecretaris van Financiën*. <http://curia.europa.eu/jurisp/cgi-bin/form.pl?Lang=EN&Submit=Rechercher&docrequire=alldocs&numaff=C-435/05&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100>, or http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c_074/c_07420060325en00020002.pdf

governments operate. What should be encouraged is for tax authorities internationally to make the most of the technology and infrastructure of Internet to improve, and to resolve to a common ground on e-commerce taxation. EU has taken some steps which seem rather promising, but it will require international consensus for such a big challenge to be met and resolved in an efficient manner.

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