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Bits or Balloons? The Need to Rethink Tax Concepts and Principles on the Internet

Those who will benefit least from this new invention will be the tax-collectors, who henceforth will never be able to prevent the passage of contraband. The walls of our towns will prove no obstacle, and it will require an army of officials to walk round the districts, day and night, to inspect newly-arrived machines.¹

1 Introduction

The above comment was made in 1784 following the invention of hot air balloons. But air balloons, boats, cars or aeroplanes, were not destined to fundamentally challenge the tax system, which today is fundamentally the same as it was in 1784.

The impact on the tax system of electronic commerce and other uses of information and communication technologies is not likely to be less significant than that of air balloons. Nonetheless there seems to be little doubt among tax authorities and tax lawyers that the new forms of commerce can be dealt with within the current tax system. Most seem to have full confidence in the system itself.

As I see it, the tax system will be confronted with major challenges in the not too distant future. The economy consists to a growing extent of transactions in digital networks, whereas the tax system is still founded on manufacturing and distribution of physical products. In this paper, I will make some comments on the tax system of today and its chances of survival in the digital economy.² I will argue that in order to provide for a smooth-running tax system, it is necessary to rethink some of the fundamental assumptions underlying the tax system.

The basis of my discussion will be the general debate on taxation of electronic commerce, which has been going on for several years among legislators, practitioners and academics. I will outline some problems that have been identified in the debate: enforcement, classification, and localisation problems. I will then offer some concluding remarks concerning the lines along which further work in this area could be carried out.

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¹ *Lettre à M. De Saint-Just sur le globe aérostatique de M.M. Montgolfier, Paris 1784*, quote from *The Romance of ballooning: The Story of the Early Aeronauts*, New York: The Viking Press 1971, p. 53.

² Below manufacturing and transactions of information in digital networks will be labelled e-commerce for short.

The IT Law Observatory has issued two reports concerning taxation, one dealing with VAT, and one dealing with general matters. This paper is to some extent founded on both reports.³

2 Enforcement problems

There are considerable problems for tax enforcers in the digital environment. The possibilities of hiding transactions are vast and the possibilities of identifying parties to a transaction are in many cases virtually non-existent. The opportunities for tax evasion seem endless.

The debate so far has been mainly concerned with enforcement problems. The general opinion seems to be that existing tax rules are applicable and should be applied in a digital environment. The problems caused by new forms of communication are not seen as new problems, only as bigger ones. From this perspective, problems with control and enforcement outweigh more fundamental problems.

Discouraging as the enforcement problems may be to tax authorities worldwide, it is my conviction that these problems are trivial compared to the more fundamental problems concerning the basic concepts and principles of today's tax system.

3 Classification problems

The problem of classifying digital products has been a subject of attention for several decades, and has become more important with the arrival of e-commerce.

In taxation, it is often necessary to classify a transaction or the object of a transaction.

Transactions are classified, for example, as income from employment or from royalties, and the objects of the transactions are classified, e.g. as products or services. I will focus here on the classification of products and services.

Traditionally, distribution of information has depended on the distribution of the media. When the information has been fixed, e.g. on a CD, the information has been distributed in fixed form. These transactions have traditionally been taxed as transactions in goods, without regard to the fact that the actual object of the transaction is the information contained in the physical product. In these cases the information product is an object that exists and can be observed in the physical world.

The classification problems connected to e-commerce are primarily related to the principle of neutrality. An information product, e.g. a music album, can be delivered either physically, in the form of a record, or digitally. According to current tax law, the same information product will be taxed differently depending on how it is delivered. It is hard to find a way to classify information deliveries within the framework of current tax law, which at the same time satisfies fundamental taxation principles and considers the characteristics of information.

Classification problems occurred in the traditional physical environment. As long as information was distributed mainly in physical form, these problems were of little importance. As production and distribution move out into the networks, the problems grow more pressing.

³ Philip Hallenborg, *Elektronisk handel och indirekt skatt* (IT Law Observatory Report 14/2000), Gustaf Johnssén, *e-skatt? i-skatt? o-skatt?* (IT Law Observatory Report 18/2000). References to sources and further reading relevant to this paper can be found in the latter report.

In the end, the neutrality problem may seriously endanger the legitimacy of the tax system. The dominant view among the tax subjects is or will be that the two forms of delivery are just that: different forms of delivery of the same product. The law, which treats them as different products, will then seem out of touch with the real world.

These problems may to some extent be problems of terminology. But underlying them are more fundamental assumptions of tax law. These assumptions are deeply rooted in the history of tax law and its connection to trade in goods. The discussion regarding classification can contribute to the discussion of information taxation mainly by highlighting the fact that products in networks are neither goods nor services in a traditional sense. Information simply does not fit into tax law, because tax law is rooted in the production and distribution of physical products, and not services, still less information.

This is even more evident from the discussion of localisation problems.

4 The problems of localisation

Much of the debate has concerned international taxation. In fact many argue that international issues are the only problems related to electronic commerce. A representative position could sound like this:

The expression [Cyberspace] risks overshooting. A person, transaction, income or other fiscal fact, whether physical or digital, is situated in a country (or in two or three etc. countries, or in a country that does not impose tax), not in some extraterrestrial realm. As a tax concept the expression can only highlight the jurisdictional problem of determining in which specific country or countries electronic commerce and its players are situated and how much profit must be allocated to that country.⁴

In my view, this is a flawed approach.

Several taxation concepts relate to the physical or geographical location of a person, a company, or a transaction. This is due to the fact that taxes are national. It is therefore always necessary to attribute a transaction to a certain geographic location. The aim is always that the creation of value should be taxed where the value is actually created. The connection can be formal, e.g. connected to where an organisation is registered. It can also be based on where a transaction is regarded as taking place.

One instrument for allocating a transaction is the concept of permanent establishment. In one of the most influential tax documents, the OECD Model Treaty, permanent establishment is defined in the following way:

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
 - a) a place of management;
 - b) a branch;
 - c) an office;
 - d) a factory;
 - e) a workshop, and

⁴ Luc Hinnekens, *The Challenges of Applying VAT and Income Tax Territoriality Concepts and Rules to International Electronic Commerce*, in *Intertax*, vol. 26, 1998, p. 54.

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

The application of this provision to e-commerce is one of the main themes in the debate.

It goes without saying that the definition primarily refers to traditional manufacture of and trade in physical products. This does not mean that the provisions cannot be applied to new phenomena, but it seems far-fetched to apply it to non-physical objects. The discussion of this provision has been mainly concerned with how transactions in computer networks can be connected to physical objects and thereby to states where those objects are located. This calls for a method of unambiguously connecting the transactions in the networks with physical locations.

In the debate, many more or less elaborate attempts have been made to find a connection between physical and logical infrastructure. In these attempts it often seems as if the networks are perceived merely as the means of delivery. Information is treated as if it were transported through the networks. One is looking for information factories and information shops in the networks. The server is seen as an information-tap, where information flowing through the network can be drawn off.

In some sense this is correct, since the information is in fact transmitted from one physical point to another through the physical network in the form of electromagnetic impulses. The problem is that this view sees distribution of information as distribution of physical goods.

In the case of physical distribution, an object is transported by physical persons and delivered to other physical persons. The transactions comprise distinct physical components: the object, the persons involved, and the place where the transaction takes place. The relations between the object, the persons and the place are self-evident and uncomplicated. The reason for this is that the transaction involves distinct, physical phenomena, such as human beings.

In e-commerce the relations between the parties involved are less clear. The physical infrastructure, computers and cables, is as tangible as the physical infrastructure for distribution of goods. The information “is” in some sense in the networks, but it forms its own infrastructure, which does not follow the physical infrastructure. Information is not matter that can be pumped through the networks like oil being pumped through a pipeline. The server is not a warehouse where information is stored on a shelf. It would be more correct to say that if information is a good, then information is the warehouse as well as the transport workers. Information is the logical infrastructure’s equivalent of trains and railways, ships and the sea, balloons and the air.

One possible strategy from the enforcement point of view is to trace the transaction back to the persons and companies involved, thereby bypassing the several middlemen and ambiguous constellations. The problem with that strategy is that it overlooks the specific character of e-commerce, that it blurs traditional structures and makes legal categories irrelevant. The risk is that the taxation will be alienated from the economic reality. You may solve one problem by finding a tax subject, but at the same time create a new one. The purpose of the international tax rules is to mirror the transaction and tax it where it takes place. By connecting taxation to traditional tax subjects, the opposite is accomplished. The parts of the transaction where value is created are bypassed.

5 Conclusion – The need for a new approach

As I have outlined, the discussion so far has been carried on mainly within the current legal framework. The main concern is how to enforce taxes in the digital environment. Some

attention is given to the problems of application of traditional concepts to new phenomena. But there is hardly anyone who questions the concepts or the fundamental principles of tax law.

The problems I have outlined are of three kinds:

- Enforcement problems.
- Application problems.
- Principal problems.

The enforcement problems are obvious. These are the problems that have been most thoroughly analysed. They are also the problems most urgently needing to be solved. The application problems have also been recognised, and received their due share of attention. The principal problems, those concerning the fundamental principles and assumptions of tax law, have not been thoroughly analysed. In fact they are not recognised as problems. I have tried to show that these problems are more alarming than the problems of enforcement and the problems of application, but that they tend to be overshadowed by these more easily grasped problems.

This conservative approach may be justified from the point of view that one should not jump to conclusions. In the long run, however, it will not be tenable. The strain on traditional tax concepts will eventually result in the breakdown of the tax system. If we do not address the fundamental questions, but wait and see, we may wake up one day and find that the tax system has been so alienated from the economic and technological reality, that applying the rules is not just hard but downright impossible. The tax system will lose its legitimacy, which will benefit nobody.

Such a breakdown could be avoided if the problems are recognised as problems and included in discussions among legislators.

The questions that should be addressed include:

- Can information be a relevant category in tax law?
- If so, how can it be defined in a way that is adequate from a legal, as well as an economic, and technological perspective?
- Should traditional taxation-principles be abandoned?
- Should the tax system of the future be developed at a national or an international level?

In what ways is the design of tax law dependent on other areas of law?