

# Tax Revenue Drain and Its Policy Implications under the E-Commerce Environment

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**Abstract:** In the late 20th century, E-commerce has been developed rapidly in the world and driven an irreversible trend to direct the future development of trade. However, as a new pattern of trade, E-commerce has also put forward a serious impact and challenge to the traditional production and management as well as the trading and legal system. While E-commerce has become a greatly popular trading pattern, levying tax on it is still blank in many countries, including our country certainly. It inevitably leads to a huge loss of tax revenue, for this reason, the construction of E-commerce tax legislation cannot be delayed even a moment. This paper explores the defects in the current taxation system by analyzing the various manifestations of tax erosion in the E-commerce environment, and proposes suggestions on E-commerce taxation legislation at last. All in all, we should improve the legal framework of E-commerce taxation, by profiting from the overseas experience in E-commerce taxation legislation, to promote the healthy development of E-commerce.

**Keywords:** E-commerce; Tax Erosion; Legal Countermeasures

## I INTRODUCTION

E-commerce is a sort of commercial activities which makes use of network technology in B2B (Business To Business), B2C (Business to Consumer) and C2C (Consumer to Consumer) transactions for profit purposes. As a new type of trade transactions, E-commerce is paperless, universal, virtual and confidential, which are the significant characteristics that distinguish it from the traditional transactions. Due to the increasing turnover of E-commerce, tax source has been expanded widely, and the powerful developing potential that E-commerce has showed will certainly bring a huge increase in tax revenues. However, it is unable to regulate the rising E-commerce activities under the tax legal system. There are a few issues which are not clear in today's tax system, such as the tax subject, tax jurisdiction and tax categories. It has been an important task in our country's current tax legislation, that how to provide a fair and orderly law to guarantee the development of E-commerce and function the macro-economic control of tax revenue.

## II THE CURRENT SITUATION OF TAX EROSION UNDER THE E-COMMERCE ENVIRONMENT

It is reported in "The 25th Report of Internet Development in China", which is released by China Internet Network Information Center, that the number of Internet users in China has reached 384 million by the end of the year 2009, and the volume of business of online shopping market has reached 250 billion RMB.[1] According

to the relevant provisions, profit-oriented enterprises should pay value-added tax at the rate of 17%; if the sellers just buy and sell things only, they should pay the value-added tax of 4%. The taxable amount of Tao-Bao.com would reach 80 billion RMB in 2009 even just at the tax rate of 4%.[2] The development of E-commerce has vastly expanded the tax sources, but unfortunately most sellers have never paid taxes and actually none of the 80 billion has ever been levied. E-commerce transactions are the vacuum zone in tax collection.

### A. Self-employed sellers online avoid the supervision of tax authorities deliberately

"Interim Procedures for Online Commodity Trades and Service Management" (hereinafter referred to as interim procedures) was carried out by The State Administration for Industry and Commerce on July 1, 2010. It was ruled that the natural man who engages in commodity trading and related services through the network should provide the real name. Those who are qualified for registering should register with the Administrative Department for Industry and Commerce according to law. However, there is no specific provision in the interim procedures for what is the so-called "qualified for registering", and whether they should be taxed. In the trade pattern of C2C, the self-employed sellers rarely make the industrial and commercial registration, let alone reporting their income to tax authorities. Take selling goods in

Taobao.com for example, the sellers just need register a real name and then are able to trade commodities online with consumers. In order to reduce costs, they usually refuse to make an registration in industrial and commercial departments so as to avoid the supervision of tax departments and evade tax payments.

*B. E-commerce sellers do not give the consumers the invoices intentionally*

In the trading process of B2C, C2C business, consumers buy commodities or serves in personal name online. Owing to lack of tax-paying consciousness, the majority of individual consumers find it quite unnecessary to get the invoice. Moreover, some sellers even ask for extra cost if the buyer wants the invoice. Therefore, the individual consumers seldom require the invoices on self's own initiative. If the consumers do not ask for invoice, sellers would neither provide consumers with invoice initiatively in order to pursue the maximal profits, even though they have already made an industrial and commercial registration. Without the invoice as proof, it is difficult for the tax authorities to affirm the tax base of E-commerce trade, and to carry out effective supervision timely for the online trades.

*C. Overseas-funded enterprises make use of Internet transactions in attempt to evade tax*

With the development of technology, the trading objects can be converted to "digital information" in most cases and pass on the electronic information through Internet. Some overseas-funded enterprise import software to China through non-tangible medium. They use the overseas central servers to distribute and install the software to their branches through Internet all around China. So under such circumstances, it is difficult for tax authority to determine the transaction contents. So with the development of online-transactions, the tax erosion will be deteriorated. It is reported that only in 2000, 22532 overseas-funded enterprises have been approved in our country. Just estimates that the total number of overseas-funded enterprises which actually run the business is 20000, and each one installs and upgrades software products in average value of 10 million RMB, the income of the software import by the overseas-funded enterprise has already reached 20 billion. Under the software product tariff rate of 9%, value added tax rate of 17%, the number of tax revenue could be as high as 52 billion RMB.[3]

### III THE LACK OF E-COMMERCE TAX LEGISLATION IN OUR COUNTRY

Lack of tax legislation in our country is an important factor of tax erosion. As a new commercial model, E-commerce is characterized as privacy, rapidity, the

global participation of the transaction subjects, which makes the differences between E-commerce transactions and the traditional ones in taxation. There are many difficulties that cannot be coordinated between present tax system and the burgeoning E-commerce in aspects of taxpaying bodies, tax jurisdiction and tax categories.

*D. Too difficult to identify the tax subjects*

Taxpayers are the entities or individuals who are obligated to pay taxes prescribed in the tax laws. This definition specifies on whom should be the tax levied on, that is who should pay taxes.[4] The identification of tax subjects in our current tax system in China has sufficient and stable connection with the jurisdiction in physical space. However, the anonymity and globalization of E-commerce poses a new problem in identifying the tax subjects. In the case of direct E-commerce, tax authorities can only gather the available information of URLs (Uniform Resource Location) by utilizing the technology at present. But there is no inevitable and direct connection between taxpayers and the URLs, and tax subjects may register with virtual names, and change their names and their IP address frequently. Moreover, the owners of the web-sites and Internet service suppliers also make some profits in E-commerce. Should they also be included as the tax subjects? However, this question hasn't be addressed in current tax system. For these reasons, it is too difficult to identify the tax subjects. As concerned as the tax subject in E-commerce, who takes the characteristics of diversity, vagueness and marginalization, the current taxation laws and regulations cannot fit it anymore.

*E. It is difficult to define the ownership of the tax jurisdiction*

China implements the Regional Jurisdiction Principle, which is the main principle, while the Resident Jurisdiction Principle is supplementary. Regional Jurisdiction is the principle that levy tax standardized on the place that tax subjects gain the profit or where business activities take place. Resident Jurisdiction is the principle that levy tax standardized on whether the taxpayers have an ownership with their territorial sovereignty. That is to say, these two principles can only be applied on the premise that the income sources and the residential status can be identified effectively through the physical concepts, such as place of business, its standing body of the organizations, and residence. But the transactions occur under the E-commerce circumstances in virtual digitizing space, so any individual or organizations, regardless of its residence or operation place can set up websites for E-commerce in any type of tax jurisdiction. If the consumers purchase goods through Internet, the trade might be conducted in many kinds of different tax jurisdiction

regions. So, on the physical basis, it is obviously difficult to identify the jurisdiction. And the inability to identify makes levying on E-commerce more and more difficult.

*F. It is difficult to identify tax objects and tax categories*

The relevant taxes in E-commerce may involve value added tax, income tax, tariff and stamp tax. As it is stated in "Notice on Several Policies of Stamp tax", promulgated by Ministry of Finance and the State Administration of Taxation, taxpayers shall pay the stamp tax if they sign the taxable vouchers in electronic form. But other categories of taxes and related problems haven't been defined by law yet. According to the different phases in E-commerce of the logistic, information flow and capital flow, E-commerce can fall into direct and indirect E-commerce. Traded goods in indirect E-commerce are the object of value added tax. But in direct E-commerce, the logistic, information flow and capital flow are integrated through Internet, so the transaction process is fully networking. For instance, after buying the digital data, consumers can download and reload it, and they can also copy it at anytime. So should this kind of download be categorized as selling goods to consumers or supplying royalties?[5] Should we consider them as tangible products to levy value added tax, or think them as intangible products to levy sales tax? Take the download of E-books as an example, should we levy the value-added tax at a rate of 17%, or levy the sales tax at a tax rate of 5%? The rapid development of E-commerce has outraced the definition of goods, services and chartered rights in current tax laws. The tax authorities also have difficulties in judging the objects of transactions and the proper tax categories.

#### IV SUGGESTIONS ON E-COMMERCE TAXATION LEGISLATION IN CHINA

In order to better satisfy the legal requirements in our society, we should plan ahead to make laws regulating E-commerce. The current tax law should be amended and perfected. The tax subjects of E-commerce should be clarified, the principles of tax jurisdiction should be made clear, and the tax categories should be made complete. In this way, a fair tax environment can be guaranteed, and the development of E-commerce in China can be boosted.

*G. Too difficult to identify the tax subjects*

Compared with flexible site URLs, the location of server is more stable. But usually the ISP is just a network service provider mainly works for E-commerce subject to maintain and manage the normal operation of the site, who does not have the vested interests of E-commerce transactions. OECD have annotated and revised on the article 5 in "Agreement Model about Avoid-

ing Double Taxation on Income and Property of OECD"[6], and elaborates on whether the website, server and network service provider can be the permanent establishment. And we can use the experience of OECD for reference. Therefore, we should take the location of server as a general standard of permanent organization. In particular, 1) the sever is fixed, and in touch with a certain geographic location; 2) no matter loan or in possession, the server must be under control of the enterprise, and operated by it; 3) all the business or just part of the business of the sever should be done in the relative tax jurisdictions for enough long time; 4) the function of the sever is fundamental and critical to the foreign enterprises, far from auxiliary or preparative.

In particular cases, if the network service providers satisfy the following characteristics, they can also be identified as permanent establishment. 1) Internet service providers represent the E-commerce enterprises and sign the contract to others; 2) Internet service providers represent the E-commerce enterprises to take part in substantial business activities; 3) all or most of the content of network service is provided for the E-commerce enterprises.

*H. Make Clear the principles for the E-commerce tax jurisdiction*

Whether Chinese enterprises sell goods and services domestically through E-commerce, or foreign enterprises introduce the tangible commodity, transfer intangible goods or provide the services in our country, according to the current Regional Jurisdiction Principle, which is complementary with the Residents Jurisdiction Principle, we own the jurisdiction to tax the relevant subject. By implementing this principle, tax revenue can be well maintained the same as the principle of consumption tax revenue jurisdiction. Adhering to the principle of the existing tax jurisdiction will maintain our jurisdiction of E-commerce taxation.

According to the place where their transaction occurs, E-commerce transaction is divided into domestic trade and overseas trade.

● The Tax Jurisdiction of Domestic Transactions By Chinese Enterprise

When the Chinese domestic enterprise sells goods or services to consumers, regardless of its purchaser is other domestic enterprises or individual consumers, according to the principle of jurisdiction, the regional tax jurisdiction belongs to our country. However, when the Chinese enterprise sells goods overseas, the process of transaction doesn't happen in China, it is beyond the tax revenue jurisdiction of our country. In addition, it is explicitly ruled in article 3 of the Interim Regulation of the People's Republic of China on Value Added Tax that the rate of export goods shall be zero. No matter depends on

which principle, according to the tax revenue jurisdiction in China, the situations that Chinese enterprises provide service or transfer the intangible assets overseas are not within the scope of jurisdiction of our country. Therefore, on the basis of the existing tax revenue jurisdiction, the territory of the tax revenue jurisdiction of Chinese enterprise in E-commerce transactions still belongs to our country.

#### ● The Tax Jurisdiction of Domestic Transactions By Foreign Enterprise

Foreign enterprises in our country which are engaged in E-commerce transactions are mainly divided into selling tangible goods, intangible assets transfer and providing services according to the different contents of trade. When foreign enterprises sell the tangible commodities to our country, according to Article 1 of Interim Regulation of the People's Republic of China on Value Added Tax, value added taxpayer is the entity or individual who sells goods, provides processing, repairs or replacement services, and imports goods. Under the regulation, China has the authority to levy the value added tax. Consequently the tax revenue jurisdiction should belong to China. In the other hand, in accordance with Article 1 of Interim Regulation of the People's Republic of China on Business Tax, business tax payers is the entity or individual who provides labor ruled by this regulation, transfers intangible assets, or sells real property. China shall impose business tax on it under the regulation. Therefore, the tax revenue jurisdiction still belongs to China. Likewise, on the basis of the existing tax jurisdiction, China still have the tax revenue jurisdiction of overseas enterprises which making E-commerce transactions in our country.

#### 1. Clarify the E-commerce relevant tax categories and taxable behavior

According to the situation in our own country, we should make clear the legal characteristics of different subjects and behavior in E-commerce, and specific provisions shall be assessed. 1) Exempting the e-commerce of digital products from tariff. It is because that Internet is a universally virtual space, and digital products can be transferred in the virtual space freely, in non-physical forms. For example, in 1998, the European Union and the US came to an agreement in the tariffs exemption of E-commerce (sell electronic digital products on the Internet)[7] 2) "Off-line" business is the trade that uses the network platform to order goods and delivery to consumers by mail or express mail. All these above show no essential differences from the traditional mode of trade, so we can levy the tax as business tax. 3) "On-line" business is the trade that sells or buys digital products directly through the network. The object of "on-line" business is digital information, which should be levied busi-

ness tax as "the transfer of intangible assets", 4) the act of providing online teaching, medical consulting or others through the Internet belongs to service, which should be levied business tax according to "taxable services". Accordingly, goods sales include all tangible personal property, regardless of the transaction mood, should be clear ruled by value added tax law. In addition, it shall be clearly defined that online transactions should be regarded as "transfer of concessionary right" and levied as "transfer of intangible assets" in the business tax law, and Internet services are equivalent to the general services and should be levied tax as "service industry".[8]

#### V CONCLUSION

With the presenting economy age, the mode of E-commerce has become more and more popular all around the world. The tax source is also expanded widely due to the increasing turnover of E-commerce. And its powerful developing potential will certainly bring a huge increase in tax revenues. However, a few issues remain unclear under the present tax system, such as the tax subject, the tax jurisdiction and tax categories. Present tax legal system has already been outdated for regulating the rising E-commerce activities. A few issues are not clear in present tax system, such as the tax subjects, tax jurisdiction and tax categories. We should plan ahead to make laws regulating E-commerce to fully meet the requirements of rule of law in our society. Specific provisions in existing tax laws should be amended and reformed. We should clarify the tax subjects of E-commerce, make clear the principles of tax jurisdiction, and clarify the tax categories and taxable behavior. In this way, a fair tax environment can be guaranteed, and the development of E-commerce in China can be boosted.

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