GLOBAL ELECTRONIC COMMERCE: TAX ISSUES

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ABSTRACT

The sudden surge in the use of electronic commerce has facilitated the communication and exchange of information at an unprecedented level. Although the brisk development of e-commerce is more apparent in developed countries, Malaysia is not far behind. E-commerce is the symbiotic integration of communications, data management, and security capabilities to allow business applications within different organizations to automatically exchange information related to the sale of goods and services. E-commerce, therefore, combines the advantages of computer-based processing (speed, reliability, and relatively high volumes of data) with the advantages of people-based insight (creativity, flexibility and adaptability). E-commerce also enables entrepreneurs to review, analyze, add value, and sell a variety of products that are represented electronically, such as reference material, textbooks and training materials, and computer software. The World Trade Organization (WTO) has reported that 51 percent of global trade was transacted through facsimile and telephone while 17 percent was conducted through the Internet and the balance by other means. The WTO further estimated that global revenues from Internet commerce could be US$200 billion a year by the turn of the century and grow briskly after that. By the year 2005, one billion people are expected to be on-line (NST, 1998). A preliminary survey conducted by the authors in the northern region of West Malaysia shows that most consumers and retailers are aware of the use of Internet for the purposes of commerce. About 60 percent of the consumers expressed their concern regarding the Internet security issue such as possible fraud, security infraction, counterfeiting, and privacy issues. This paper examines how electronic commerce would have an impact on the Malaysian income tax system. Since e-commerce would be an important 'trade route' in the next millenium, tax administrators need to be concerned of the possible loss of revenue due to competition among countries. Moreover, electronic forms of money would provide opportunities and even loopholes for tax evasion. Tax authorities all over the world, therefore, will have to realise that traditional tax rules may have to be modified or adjusted to take account of borderless commerce.

BACKGROUND

The sudden emergence of Internet[1] has facilitated the communication and exchange of information at an unprecedented level. The term Internet can be traced from the phrase 'Interconnected Networks'. This term (Internet) is, therefore, meant to imply a web of different computer networks that use fixed rules to send and receive information (Mckeown and Watson, 1997). Electronic commerce (E-commerce), on the contrary, is any transaction involving the exchange of goods and services between two or more parties using technological tools and techniques. Of course, the use of Internet as a new communication technology, renders exciting scope for enterprises to enhance trade via e-commerce and for purchasing agents to access goods and services at minimum cost all over the world. Managers and entrepreneurs, particularly in developed countries, are increasingly asked about the legal and tax implications of e-commerce. According to recent data released by the World Trade Organisation (WTO), 51 percent of global trade was transacted through facsimile and telephone while 17 percent was conducted through the Internet and the balance by other means. The WTO has predicted Internet trade will further expand to 42 percent by the year 2000 while business communication through facsimile and telephone will contract to 32 percent. The WTO further estimated that global revenues from Internet commerce could be US$200 billion a year by the turn of the century and grow briskly after that. By the year 2005, one billion people are expected to be on-line (NST, 1998).

In the UK, it is estimated that British shoppers would have by the end of this year spent about £500 million (RM3,200 million) over the Internet. By the end of 2005, this figure would have shot up to £22 billion (RM140.8 billion) (Chartered Secretary, 1999). One significant impact of the development of e-commerce is a shift in the conventional manner businesses are conducted both in the domestic and international arena by a greater use of information technology.

Examples of common forms of e-commerce include computer software companies selling software; mail order companies and wholesalers; electronic research databases selling information to users; on-line sale of services such as travel, legal, medical needs and Internet casinos.

The Internet was originally perfected in the mid 1960s by the United States (US) Defense Department for the main aim of linking several radio and satellite networks. The satellite network also connected together universities and high-technology defense entrepreneurs. During the mid-1980s, the National Science Foundation constructed a couple of supercomputer centres to assist in the study of technological communications. The outcome of this intense research resulted in the development of a network system which linked several regional networks in the US. By the mid-nineties, the US Government encouraged several commercial concerns to take over the responsibility of running the Internet and the connection network backbone. Presently, various network backbones located in Asia-Pacific, Europe, the United States and elsewhere around the world are linked together, constituting what we today refer to as the Internet (Abraham and Doernberg, 1997).

This paper is organised as follows. After providing a background to the emergence of Internet, Section 2 explains some of the concepts and definitions used in this paper. The following section examines the tax and legal issues relating to e-commerce. Some recent developments in industrialized countries such as Australia, UK and the US are covered in this section. Section 4 examines the current developments in Malaysia pertaining to e-commerce, growth of Multimedia Super Corridor and tax implications on cyber income. The findings of a survey carried out by the authors are reported in Section 5. This survey sought the level of understanding among firms and individuals the practical side of the use of e-commerce. The final section provides some concluding remarks on the potential development of e-commerce in Malaysia.

CONCEPTS AND DEFINITIONS

The Internet is a global information system that is linked together using Internet protocol address. It is a worldwide system between unrelated operators. The Internet can be regarded as part of an Information Highway, which consists of thousands of interconnected logical networks linking millions of computers around the world together through gateways connecting organizations in Asia, Europe, the US and other countries. The two main methods for transporting data across a network are circuit and packet switching. The circuit switching is commonly used for transmitting voice while packet switching is meant transmitting data. The Internet is in fact a packet switching network. The Transmission Control Protocol/Internet Protocol (TCP/IP) is responsible for splitting a message from the sending computer into packets, numbering and transmitting the packets and subsequently putting them together in the correct sequence at the receiving computer.

The process of determining the path a message will take from the sending to the receiving computer is referred to as 'routing'. It is the responsibility of the IP part of TCP/IP for ascertaining the best route through the network. Messages can, however, can be sent from one computer to another only when every server on the Internet is uniquely addressable. The Internet Network Information Centre (InterNIC) manages the assignment of unique IP address so that TCP/IP networks in any part of the world can communicate with each other. An IP address is a unique 32-bit number consisting of four groups of decimal numbers in the range of 0 to 255. For example, the IP address for Universiti Utara Malaysia is 161.142.40.29.

A single important application of the Internet is the World Wide Web, often designated as WEB. The WEB is a navigational device which permits the user to browse through and locate information that is presented in multimedia form available on storage devices known as servers. These servers are physically located within computers. The term used to describe electronic information moving about the WEB is "bits". The technology which permits data to be transformed into bits is called digitization. Digitization of data is the means of transforming information into a sequence of numbers. The transformed data can be images, music, speech or written words. After the information is transformed into bits, it is condensed into parcels of data and transmitted at enormous speed over telephone network lines to and from computers and servers located all over the world.

TAX AND LEGAL ISSUES

Tax authorities are expected to arm themselves with this new found information technology and perhaps allow them to exchange information with their clients (taxpayers) in a punctual manner. Client services too can be further improved through an advanced electronic communication mechanism. On the other hand, taxpayers too can trade in a borderless world and discover new opportunities to legitimately escape the payment of tax. New issues would then emerge. Are tax authorities prepared for a tax-free environment and if so, to what extent?

Current tax laws and regulations, prevailing all over the world, are definitely inadequate to cope with the rapidly evolving manner in which businesses are carried out, particularly via e-commerce.

Most countries have yet to enact new legislations to tax transactions carried out via e-commerce. It is generally perceived that revenue authorities will have to tackle new problems in assessing income arising from transactions in a borderless economy. Several emerging economies would rather wait and learn from new developments and experiences from other developed countries before taking any definite steps to tax cyber income. It was agreed at the conference of the member countries of Organisation of Economic Co-operation and Development (OECD) that the taxation of goods and services in cyber space should be equal to the taxation of similar physical transactions (OECD, 1998). Twenty-seven of the 29 member OECD countries use some form of Value Added Tax (VAT) which averages about 30 percent of tax revenues in the OECD area. These countries are concerned that the Internet provides opportunities to evade this tax. Vendors are able to avoid the VAT if they do not have a physical presence in the country where they are selling their goods and services. The problem that the tax authorities have with existing VAT or sales tax systems is that it is almost impossible to identify the venue of the (Internet) seller.

Some of the tax and legal issues faced by developed countries such as Australia, UK and US are examined below.

Australia

Australia plans to tax consumers, not businesses, on the goods and services sold on the Internet. The tax would be automatically deducted when consumers use their credit cards, or new electronic smart cards, to order products from businesses operating Internet web sites. Taxing the consumer rather than the vendor seems the only solution to the problem that it is almost impossible to identify the venue of the Internet seller (Australian Accountant, 1998). The technology of the Internet would be used to collect more, not less tax than present systems by using computer software set with individual tax rates for goods and services bought on the Internet. When consumers use their credit cards or smart cards to pay for their purchases, the appropriate tax will be deducted automatically and sent to the appropriate tax authority. Businesses would no longer have to worry about collecting tax and the tax office would get more revenue as the compliance rate would be higher and the consumer would have a simpler tax-payment process. There are technical problems yet to be worked out but the final details should be resolved by January 1, 2000.

United Kingdom

In the UK, the Electronic Commerce Bill was introduced in November 1998. Once the bill is enacted, it will give digital signatures[2] legal force and will create a voluntary licensing system for trusted third parties which offer signature and encryption services. Digital signatures are forgery resistant computer codes which are used to prove someone's identity (Singleton, 1999). The UK Electronic Commerce Draft Directive, has identified five issues relating to the development of e-commerce. These issues relate to:

- Commercial communications
- Establishment of information service providers
- Liability of intermediaries
- Online finalisation of contracts
- Implementation

The first issue covers the meaning of 'commercial communication' and makes it subject to specific transparency requirements to enhance consumer confidence trading. In this respect, commercial communications by electronic mail must be easily identifiable. The second issue relates to definition of the place of establishment in line with the principles of the European Union (EU) Treaty and the Court of Justice. A contract at a distance is recognized as a service provided without the parties being simultaneously present. The third covers the liability of intermediaries. It has been proposed to allow a mere conduit exemption for those who are simply intermediaries transmitting information provided by third parties. The fourth area will require member states to amend national law and to ascertain the moment of the conclusion of a contract. Finally, the fifth issue relates to the implementation and enforcement of contract in an electronic environment.

United States

As in other developed countries, the US government too has vigorously promoted the use of e-commerce but has urged countries all over the world to adopt a cautious and neutral tax policy towards trade on the cyberspace. It is estimated that Web-based shopping revenues has increased from US407.3 million in 1996 to US1.1 billion in 1997 and will reach US4.5 billion in the year 2000 (Maddox and Blankenhorn, 1998). These figures indicate an increasing number of companies have adopted e-commerce to sell their products online, thereby reaching millions of consumers via Internet.

The Clinton administration has urged other countries to cooperate with the United States to make the Internet a global free trade zone. In 1997, the Internet Tax Freedom Act (ITFA) was introduced in the US Congress. If passed into law, the ITFA could exempt Internet-related businesses from state and local taxation. The individual states of the US have had varying reactions to the Act. Those who are likely to benefit from Internet related commerce have obviously welcomed it while others are concerned that the federal government is limiting their ability to tax their residents.

CURRENT DEVELOPMENTS IN MALAYSIA

Although the development of e-commerce is particularly significant in developed countries such as Australia, UK and the US, Malaysia is not far behind. There is a nationwide effort in Malaysia towards an electronic environment, with the government actively involved in the business of e-commerce within its own systems (Zurina, 1998).

Since e-commerce has created a borderless business world, laws and regulations have to be adopted and be applicable in a world without boundaries. During the Asia-Pacific Economic Corporation (APEC) Business summit held between 12 and 18 November 1998 at Kuala Lumpur, the Malaysian government announced that it would award certification authority license to a private company to provide a digital certification system. Digital certification ensures the security of transactions over the Internet and identification of parties involved in the transactions. Furthermore, the development of e-commerce would expand the markets for businesses as potential consumers around the globe would be accessible through the Internet. Competition would also be intensified as consumers would also have more choice as they would not have to restrict themselves to the local vendors. An essential ingredient to the growth of e-commerce is a computer network system that is capable of satisfying the requirements of the entrepreneurs. Companies need to have an information technology (IT) infrastructure system that is able to cope with the increasing demands of e-commerce. Available data indicate that Malaysian companies having one to 499 employees contribute approximately 47 percent of the personal computer market locally. In numbers, this accounted for about 200,000 units in 1997 and 240,000 by the end of the following year.

The Basis of Malaysian Taxation

The imposition of income tax in Malaysia depends as much on the establishment of sources and residence as on whether income has been derived, and if so, when and by whom. From an income tax compliance perspective, the question of who derives the income can be ascertained by tracing who owns the investment which generates the income. However, in cases involving transactions via e-commerce, ascertainment of who derives specific sales income will be problematic if a history of transactions is not kept. Furthermore, transactions may be made off-shore making it difficult to enforce third-party information reporting.

The basis year for a year of assessment is the calendar year immediately preceding that year of assessment. Consequently, a basis year is always the 12 months to 31 December. Nevertheless, the Act recognises that business organisations may have accounting year-ends which do not end on 31 December and hence allows the accounting year to be the basis period for income derived from a business source. In contrast, the tax year in Australia runs from 1 July to 30 June whereas in UK, the year of assessment begins on 6 April.

Scope of Charge

The basis of taxation is the derived scope. Income of an individual is only assessed if it is derived in Malaysia or received in Malaysia from abroad. However, only income of a non-resident that is accrued in or derived from Malaysia is subject to tax. Foreign income received in Malaysia by resident companies are, however, excluded from the scope of taxation. The exception to this rule is when a resident person carries

on banking, insurance or air/sea transport operations. In such cases, the resident person carrying on such operations is assessable to tax on worldwide income even though the income is not received in Malaysia.

Significance of Residence Status

The residence status of individuals is determined under Sec. 7 ITA. In general, residence is determined by the number of days an individual is present in Malaysia, that is a quantitative test. This quantitative test determines whether an individual is:

- exempted from remittances of income from abroad, and
- entitled to personal reliefs.

Individual residents are granted personal reliefs and exemptions including, RM 5,000 self relief, RM 3,000 wife relief (if wife is not assessed separately) and child relief of RM 800 for each unmarried child not exceeding 18 years of age. A relief on the employee provident fund contribution and life insurance premium up to RM 5,000 is also provided for an individual taxpayer.

Classes of Income

Income is categorised into various classes such as business, employment, interest, rent, discount, premium, pension, annuities, royalties and other gains. The classification, however, does not exhaust all the possible sources of income since there is a catch-all category [Sec. 4(f) ITA] which includes all the incomes not elsewhere classified. In the case of other income, it should be noted that income should have the characteristics of one or more of the specific classes of income in order for it to be considered under the catch-all category and subjected to tax.

Exemptions

Tax exemption is provided on a range of income including salaries paid to the royal families, allowances to members of parliament, compensation for loss of office due to ill-health and emoluments of any member of the armed forces of a Commonwealth country.

Retirement gratuities are wholly exempt if the retirement:

- is due to ill health; or
- takes place after the age of 55 or on reaching the compulsory age of retirement from employment and in either case, the employment must be for a period of at least 10 years with the same employer.

Certain interest and dividend income are exempt from tax. Finally, employment income of a non-resident individual from the exercise of employment in Malaysia for a period, or periods, which do not exceed 60 days in a calendar year is also exempt.

Opportunities to Evade

Transactions making use of unaccounted forms of electronic cash provide opportunities for income tax non-compliance. Levels of income tax compliance would depend on the opportunity to evade and the likelihood of detecting taxpayers omitted income. Under Internet payment systems, the temptation to dishonesty becomes harder to resist as there is little likelihood of the taxpayer's deceit being traced (Reed, 1996).

Multimedia Super Corridor

On August 1 1996, the Malaysian Prime Minister, Dr. Mahathir Mohamad announced the creation of a new urban zone designed specifically to enhance and develop a world-class multimedia industry and provide all necessary services to that industry. A new government entity, the Multimedia Development Corporation (MDC) has been set up to promote, implement, coordinate and manage the Multimedia Super Corridor (MSC)[3]. The MSC was introduced as a catalyst for the development of the latest information-based industries and is an area developed to encourage mutual enrichment of companies using modern technologies in a borderless world (MDC, 1997). The establishment of the MSC[4] will enable Malaysia to leapfrog into the Information Age.

MSC-status companies incorporated in Malaysia can be wholly owned by both local and foreign legal entities. A total of 171 companies have received MSC-status, out of which 69 are local companies (The Star, 1998).

The Malaysian Government has provided several incentives to encourage the growth of multimedia companies (Kasipillai, 1998). For instance, companies that are granted MSC-status are eligible for a package of financial and non-financial incentives. Financial incentives include a zero income tax for a maximum period of ten years or a 100 percent investment tax allowance on new investments made in MSC designated zones. Non-financial. incentives include unrestricted employment of foreign knowledge workers, freedom to source capital globally and freedom of ownership.

Research and Development (R&D) grants for local enterprises

Under the Seventh Malaysian Plan, the Malaysian Government allocated an initial sum of RM200 million or 20 percent of the Plan's R & D budget to the MDC (http://www.mdc.com.my). This sum is to be distributed as 'seed capital'[5] for small and medium enterprises in the MSC that are at least 51 percent Malaysian-owned. Companies have to apply to the MDC, if they want to benefit from these R & D grants.

Legislative Support

The Malaysian government has legislated the necessary laws to provide support to the MSC. In this respect six pieces of multi-specific legislation have been passed in the Parliament.

- The Digital Signature Act 1997 governs electronic signature.
- The Computer Crimes Act 1997 outlaws the fraudulent use of computers and unauthorised access to and modification of the contents of computers.
- The Electronic Government Act 1997 regulates communication within the public sector. This Act also enhances communication between the public and private sectors.
- The Multimedia Convergence Act 1997 streamlines communication, information and broadcasting services.
- The Telemedicine Act 1997 allows for promote provision of medical services.
- The Intellectual Property Protection Act 1998 protects copyright laws.

SURVEY QUESTIONNAIRE

An exploratory survey was carried out by the authors (Kasipillai & Razak, 1998) to seek an understanding of the practical side of the use of e-commerce in Malaysia. The survey was confined to the northern region of Peninsular Malaysia and covered three states namely, Penang, Kedah and Perlis. Since two main groups of respondents were identified, two sets of questionnaires were designed. The first set of questionnaire was sent to firms while the second set of questionnaire was sent to individuals. A total of 240 questionnaires were sent to randomly selected respondents. Approximately, two third of the respondents targeted were individuals while the remainder were firms. Both the questionnaires contained two broad sections. The first section gathered information about the respondents background while the second section sought information on the attitude and extent of use regarding Internet services.

Survey Findings

The findings of the survey suggested that most consumers and retailers are aware of the use of Internet for purposes of commerce. However, only four firms surveyed (eight percent) marketed the products using Internet. Two of these firms (four percent) were from the service sector while the other two firms were from the manufacturing sector. Except for one firm, all the other firms were in operation between two to eight years. A single firm was in operation for over 30 years, suggesting that new firms are more prepared to use Internet to market their products compared to traditionally established firms.

The questionnaire also solicited information on the possible reasons for firms not using the Internet to market their products. Some of the respondents provided more than one reason for not using the Internet services. Generally, the possible reasons provided by the respondents could be summarised into four groupings:

- One third (33 percent) of the respondents indicated that they did not set-up the network facilities to transact via e-commerce.

- Twenty four percent of the respondents who were tied-up with services such as legal, secretarial and accountancy work do not require Internet facilities. To reiterate the views of the respondents, such services do not entail the use of Internet.
- Twenty-six percent of the firms do not have trained personnel to manage Internet transactions.
- The last group (17 percent) of respondents are not aware of the existence of e-commerce.

As for individual respondents, merely 15 percent (12 respondents) experienced using Internet services. The overall findings of the survey indicated that the Malaysian public find it insecure to finalise a deal preferring face to face contact between purchasers and vendors. Retailers worry about recovery of amounts due while consumers fear that they may not receive the goods after having paid through credit cards. Such apprehensions may, however, change in the next millenium when Malaysians are exposed to a greater use of electronic media. Although several new legislations have been introduced during the last two years primarily to provide support to MSC, the deficiencies that exist in the present legislation in both protecting consumers and sellers is a major drawback for the growth of e-commerce in Malaysia. Every effort should, therefore, be made to overcome these deficiencies to foster greater development in e-commerce

CONCLUDING REMARKS

The use of Internet as an alternative way of transacting commercial deals provide new opportunities for businesses to increase their trade through e-commerce. Consumers too would be able to access goods and services at minimal cost worldwide. Current tax laws and regulations, however, are not able to keep pace with the sudden change in the manner businesses are transacted via Internet. Issues that could emerge between tax authorities and the taxpayer in determining taxability of income include:

- residence status and scope of charge of taxable persons;
- character and classification of income;
- application of prevailing tax treaties on income doubly taxed; and
- scope of withholding tax.

Tax administrators and policy makers have now begun to review existing tax legislation to ascertain whether they are able to cope with new approaches to carry out businesses. Recent developments suggest some moves by governments to introduce new legislations to smoothen the manner of trading in the Internet. For instance, in the United Kingdom, the Electronic Commerce Bill was introduced recently to formulate rules for commercial transactions via cyber commerce. In Australia, the taxation office has released a report on tax and the Internet. This report is meant to guide the business community and taxpayers in trading on the Internet while preserving the nations tax base (Australian Accountant, 1997). Furthermore, the Attorney General's Department launched a public exposure draft of the Electronic Transaction Bill on 28 October 1998 and the public are encouraged to comment on the draft Bill. The Malaysian government too has legislated several multi-specific legislations to provide support to the Multimedia Super Corridor. More changes to tax law provisions is expected to be introduced to cope with the anticipated growth of e-commerce.

FOOTNOTES

1. The words Internet trade and electronic commerce are used inter-changeably.
2. A digital signature is an electronic signature that can be used by a person to authenticate the identity of the sender of a message. It is created and verified by means of cryptography, the branch of applied mathematics that concerns itself with transforming messages into seemingly unintelligible forms and back again
3. Companies approved by the Multimedia Development Corporation (MDC) will be granted Multimedia Super Corridor (MSC) status.
4. The Multimedia Development Corporation envisions a 20-year time-frame for the full implementation and execution of the MSC.
5. 'Seed capital' is funding for businesses which have not commenced operation but have complete prototypes. These businesses are striving to acquire their first share by penetrating into the market.

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