



**INDIRECT TAXATION OF ELECTRONIC COMMERCE: THE U.S. AND EUROPEAN
EXPERIENCE, LESSONS FOR RUSSIA**

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ABSTRACT

Cross-border electronic transactions have challenged the existing tax regimes. This thesis addresses the issue of e-commerce indirect taxation focusing on the experience of the United States and the European Union and formulating the changes that should be introduced into the Russian legislation. A comparative analysis is conducted of the methods used in the U.S. and the EU in order to adapt their systems of taxation to the specifics of electronic commerce. The research demonstrates that all attempts to modify the U.S. sales and use tax system have failed and electronic commerce taxation in that country remains mainly unregulated, whereas the EU experience in adapting the existing VAT system has proved to be effective. Based on these findings, the thesis suggests that the European system should be taken as a model for Russia, which currently lacks any legislation on e-commerce taxation. The thesis also formulates specific proposals as to the amendments that need to be introduced into the Russian Tax Code.

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INTRODUCTION

With the rapid spread of the Internet in the 1990s, a new era of commercial transactions began – the era of electronic commerce. E-commerce, understood as all “commercial transactions, whether between private individuals or commercial entities, which take place in or over electronic networks”¹, has revolutionized the modern business world. Not only did it change dramatically the way goods and services are supplied, but it has also led to huge amounts of profits gained from electronic transactions conducted worldwide.²

The tremendous growth of online transactions has challenged the existing legal regimes in many respects. The most heated debates are held in the area of electronic commerce taxation, as the traditional concepts of taxation, which have always been determined by “territory and jurisdiction”³, could not be easily applied to the commercial activity conducted in the borderless cyberspace. In particular, the problems have occurred related to determining the jurisdiction entitled for tax collection, making a distinction between goods and services, establishing a seller’s and a buyer’s identity and location, the low level of tax compliance and the revenue losses. As a consequence, it has been recognized on both national and international levels that the existing tax systems need to be changed.

Despite being new, the issue of e-commerce taxation has already been dealt with by scholars. Most of the academic works (e.g. “Information Technology Law” by Ian Lloyd or “The Law of Electronic Commerce” by Benjamin Wright and Jane Winn) provide a brief overview of

¹ DIANE ROWLAND & ELIZABETH MACDONALD, INFORMATION TECHNOLOGY LAW 241 (Cavendish, 3d ed. 2005).

² See, e.g., U.S. Census Bureau, U.S. Department of Commerce, *Quarterly Retail E-commerce Sales, 4th Quarter 2010*, CENSUS.GOV (Feb. 17, 2011), http://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf (estimating total U.S. e-commerce sales for 2010 at \$165.4 billion). See also Erick Schonfeld, *Forrester Forecast: Online Retail Sales Will Grow To \$250 Billion by 2014*, TECHCRUNCH (Mar. 8, 2010), <http://techcrunch.com/2010/03/08/forrester-forecast-online-retail-sales-will-grow-to-250-billion-by-2014> (predicting that online retail sales will reach \$250 billion in the U.S. and \$156 billion in Western Europe by 2014).

³ SUBHAJIT BASU, GLOBAL PERSPECTIVES ON E-COMMERCE TAXATION LAW 2 (Ashgate 2007).

this matter as a part of the general analysis of e-commerce law. In the works of Charles McLure and Nonna Noto more specific examinations are conducted of the U.S. approach to e-commerce taxation, whereas Erik Scheer and Jürgen Stehn have addressed the EU regulation of this legal area. Furthermore, several studies have been devoted entirely to electronic commerce taxation. Namely, the researches done by Subhajit Basu, Björn Westberg and Richard Westin provide an insight into the general principles and specific problems of e-commerce taxation, as well as address the initiatives undertaken by the U.S., the EU and international organizations in order to deal with these problems. However, the regulation of e-commerce taxation is in the process of constant development and amendment. That is why, for instance, the latest changes made in the European legislation have not been addressed by scholars. Furthermore, there is an evident lack of studies on how e-commerce should be taxed in Russia. Only a few researchers, such as Astamur Tedeev, Stanislav Ilichev and Nadezhda Vasilieva, appear to have addressed this issue, but neither thorough examination of the current Russian legislation has been conducted, nor specific legislative proposals have been formulated by them.

This thesis examines the aspects of indirect taxation of e-commerce and presents the comparative analysis of the U.S. and the EU experience in regulating this area. The purpose of the paper is to determine whether any measures of e-commerce indirect taxation have proved to be effective in the U.S. and the EU and whether any of them can and should be transplanted into the Russian legal system.

The thesis will focus on the U.S. and the European Union, as they have been the most active players in the area of adapting existing systems of taxation to the realities of e-commerce.⁴ Moreover, most of the governments worldwide follow either the European system of VAT or the

⁴ Note that enormous work has also been done within the framework of the OECD and the WTO, but their activities will not be analysed in detail in this thesis.

US system of sales taxes.⁵ Taking Russia as an example, the paper will analyse how developing countries lacking any legislation on e-commerce taxation may use the positive experience of developed countries in regulating this issue. Although Internet transactions create problems in the application of direct and indirect taxes,⁶ the limitations of this research make it impossible to scrutinize both areas. Therefore, the thesis will be limited to the analysis of indirect taxation. Furthermore, it will focus only on the general turnover taxes, the application of which to e-commerce is the most problematic, and will not address taxes on specific goods or services.

This paper will be organized in three chapters. The first chapter will address the problems related to the application of the U.S. sales and use tax system to electronic transactions and evaluate the methods used by the federal and state governments in order to regulate e-commerce taxation. The second chapter will examine how the effectiveness of the traditional European VAT system was questioned by the spread of electronic commerce. It will further focus on the specific legislative rules intended to adapt the EU system of taxation to the realities of e-commerce. Finally, the third chapter will address the current Russian tax legislation and, based on the comparative analysis of the U.S. and the EU regulation of this legal area the proposals will be formulated regarding the amendments that need to be introduced into the Russian Tax Code.

⁵ BASU, *supra* note 2, at 55.

⁶ See ALAN SCHENK & OLIVER OLDMAN, *VALUE ADDED TAX: A COMPARATIVE APPROACH* 5 (Cambridge Univ. Press 2007) (discussing the definitions of and differences between direct and indirect taxes).

CHAPTER 1. TAXATION OF ELECTRONIC COMMERCE IN THE UNITED STATES

The U.S. government was among the first to express concerns about the unsuitability of the existing system of taxation to the new area of Internet transactions. Furthermore, the majority of the companies that are considered world leaders in the online retailing business are established in this country. Therefore, the study of the U.S. experience in regulating e-commerce taxation would be of relevance for all countries willing to adapt their systems of taxation to the needs of e-commerce. This chapter will comprise three sections. The first will focus on the problematic issues raised by the application of the U.S. sales and use tax system to e-commerce. The second section will address the measures taken by the federal government, as well as by the separate states in order to regulate e-commerce taxation. It will be argued that none of those measures has achieved its purpose. The third section will analyse the Streamlined Sales and Use Tax Project representing a collective attempt of the states to protect themselves from tax revenue losses incurred because of the growth of online transactions. It will be concluded that presently, the Project cannot be applied to e-commerce and, therefore, taxation of electronic commerce in the U.S. still remains mainly unregulated.

1.1. Problems of the application of the traditional sales and use taxes to electronic commerce

The U.S. system of indirect taxation comprises state sales and use taxes, which implement the destination principle of taxation.⁷ This means that taxes are not levied on the goods exported from the state, while the goods imported as well as produced within the state are charged with the taxes.⁸ Currently, forty-five states and the District of Columbia have the sales and use tax system,

⁷ BJÖRN WESTBERG, CROSS-BORDER TAXATION OF E-COMMERCE 154 (Int'l Bureau of Fiscal Documentation 2002). See also BASU, *supra* note 2, at 60-63 (defining destination and origin principles).

⁸ For the exceptions from this general rule existing in the U.S., see Charles E. McLure, Jr., *The Taxation of Electronic Commerce: Background and Proposal*, in PUBLIC POLICY AND THE INTERNET: PRIVACY, TAXES AND CONTRACT 49, 62 (Nicholas Imparato ed., Hoover Institution Press 2000).

with its own tax rates and tax rules in every state.⁹ A sales tax is charged at the last stage of the supply chain (i.e. when goods or services are supplied to final consumers) and represents a fixed percentage of the purchase price of goods or services.¹⁰ The sales tax should be collected and remitted by sellers.¹¹ Because the transactions in which the seller is located outside of the buyer's state are not subject to the sales tax,¹² most states impose a "compensatory" use tax¹³. By this, they force their residents who buy goods from out-of-state sellers to pay the sum which would be equivalent to the sales tax imposed in the given state.¹⁴

With the growth of Internet transactions, discussions started in the U.S. regarding the application of the existing taxes to this new type of transactions. There were two main positions.¹⁵ The proponents of the first position considered it necessary to adapt the existing system of taxation to the realities of the business conducted in cyberspace, without creating any new taxes. The second proposal insisted on the creation of new taxes for e-commerce. In particular, a "bit tax" was intensively discussed, which was first proposed in 1994.¹⁶ The bit tax means a levy paid by Internet users on every megabit of data sent through their computers.¹⁷ As early as 1996, the U.S. Office of Tax Policy put an end to these discussions and determined officially that the same principles should be applied to electronic commerce as are applied to conventional types of

⁹ See Federation of Tax Administrators, *State Sales Tax Rates and Food & Drug Exemptions (As of January 1, 2011)*, TAXADMIN.ORG (Feb. 2011), <http://www.taxadmin.org/fta/rate/sales.pdf> (containing the list of the states' tax rates).

¹⁰ Steven Maguire, *Internet Transactions and the Sales Tax*, in INTERNET TAXATION 1, 3 (Albert Tokin ed., Novinka Books 2003).

¹¹ RICHARD A. WESTIN, INTERNATIONAL TAXATION OF ELECTRONIC COMMERCE 76 (Kluwer Law Int'l 2000). See also John A. Swain, *State Sales and Use Tax Jurisdiction: an Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 351-352 (2003) (discussing the main characteristics of the U.S. sales tax).

¹² BASU, *supra* note 2, at 74.

¹³ McLure, *supra* note 8, at 50.

¹⁴ BENJAMIN WRIGHT & JANE K. WINN, THE LAW OF ELECTRONIC COMMERCE § 18.03 (Aspen Law & Business 4th ed. 2001).

¹⁵ See, e.g., WESTBERG, *supra* note 7, at 182-185 (discussing the development of the two positions in the U.S.)

¹⁶ IAN J. LLOYD, INFORMATION TECHNOLOGY LAW 600 (Butterworths 3d ed. 2000).

¹⁷ McLure, *supra* note 8, at 52. See also Arthur J. Cordell, *New Taxes for a New Economy*, GOV'T INFO. IN CANADA Vol. 2, No. 4.2. (Spring 1996), <http://www.usask.ca/library/gic/v2n4/cordell/cordell.html> (discussing the bit tax proposal).

commerce, and, thus, no VAT, bit tax or other new taxes should be imposed on electronic commerce.¹⁸ Hence, the choice was made by the government in favour of adapting the existing system of taxation to the new area of Internet transactions.

However, it was soon realized that such adaptation would not be easy and would be accompanied by a set of different problems determined by the specifics of the U.S. system of sales and use taxes. The first problem concerns the distinction between goods and services. It is a very important issue in the U.S., since only tangible corporeal property is usually subject to sales and use taxes.¹⁹ With the appearance of digital products, the question occurred whether to treat them as goods or as services. In 1996, the U.S. Office of Tax Policy expressed concerns about the categorisation of digital products and admitted that the current system based on the distinction of “tangible” and “intangible” property would be likely to violate the principle of neutrality when applied to e-commerce.²⁰ In particular, whereas the sale of a CD with the content of encyclopedia on it might be regarded as a “sale of goods”, the supply of on-line service providing an access to the same encyclopedia might be characterised as a “supply of services”.²¹

To date, no federal legislation has been enacted which would classify digital products, and court practice also does not provide any reliable guidance on this matter. In 1997, the U.S. Tax Court dealt with the case involving computer software and found this product falling under the broad definition of “tangible personal property”.²² In other words, digital software was declared

¹⁸ Office of Tax Policy, U.S. Department of the Treasury, *Selected Tax Policy Implications of Global Electronic Commerce*, DAILY TAX REP. 226, at §7.1 (1996), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/internet.pdf>.

¹⁹ Sandra Eden, *The Taxation of Electronic Commerce*, in LAW AND THE INTERNET: REGULATING CYBERSPACE 151, 165 (Lilian Edwards & Charlotte Waelde eds., Hart Publishing 1997). For the exception to this general rule, see Arthur R. Rosen, *United States: Sales Taxes in the Digital Environment*, in GLOBAL E-BUSINESS LAW & TAXATION 457, 458, n.10 (Ana D. Penn & Martha L. Arias eds., Oxford Univ. Press 2009).

²⁰ *Selected Tax Policy Implications of Global Electronic Commerce*, *supra* note 18, at § 7.3.

²¹ *Id.* at § 7.3.4.

²² *Northwest Corp. v. Commissioner*, 108 T.C. 358, 375 (T.C. 1997).

to be “goods”. However, the case related to the investment tax credits rather than sales or use taxes and, thus, could not be regarded as establishing a general rule for digital products taxation.

Legislation and court practice on this issue differ from state to state. In 2001, the New York Department of Taxation issued an Advisory Opinion providing that the “sale of digitized music recordings over the Internet constitutes the sale of intangible property and is not subject to sales or compensating use tax.”²³ However, a study of the literature on this matter reveals remarkable facts. In particular, having conducted the analysis of the state laws, Westin names nine states where downloaded products are subject to sales and use taxes.²⁴ Based on a similar examination, Basu lists seventeen states, in which content transmitted through electronic means is taxed.²⁵ Two points need to be emphasized. First, both authors name New York as one such state. The comparison with the Advisory opinion named above proves inconsistency of tax treatment of electronic transactions even within one state. Second, the researchers list different states, which when combined make a total of twenty states. This is a big number that contradicts the findings of some other authors, who state that most states “exempt . . . electronic transmission” from taxation.²⁶ The evident conclusion from the analysis of these studies is that there is no uniformity, consistency and clarity in the states taxation of digital products. This definitely presents a problem for the taxpayers involved in online business.

A further controversial aspect, which is of most importance for e-commerce taxation, relates to the issue of levying state sales and use taxes on the out-of-state sellers. Long before the issue of e-commerce taxation occurred, the U.S. courts had to deal with similar issues arising out of mail order sales. In the *Bellas Hess* case in 1967, the U.S. Supreme Court considered whether

²³ Office of Tax Policy Analysis, New York State Department of Taxation and Finance, *Advisory Opinion (Petition No. S000510A)*, TAX.NY.GOV (Apr. 18, 2001), http://www.tax.ny.gov/pdf/advisory_opinions/sales/a01_15s.pdf.

²⁴ WESTIN, *supra* note 11, at 79.

²⁵ BASU, *supra* note 2, at 167, n.119.

²⁶ Eden, *supra* note 19, at 165.

the state of Illinois could require an out-of-state mail-order seller to collect and pay the use tax to the state.²⁷ The court concluded that if such business is established outside of the boundaries of the given state and his “only connection with customers in the State is by common carrier or the US mail”, this state is prohibited, under the commerce clause and due process clause of the Federal Constitution, from requiring the business to collect and pay taxes due on purchases made by its citizens.²⁸

Later in 1992, the Supreme Court of North Dakota in the *Quill* case noted that it could not “ignore the tremendous social, economic, commercial, and legal innovations since 1967, and blindly apply an obsolescent precedent”²⁹ and, therefore, refused to follow the case of *Bellas Hess*. However, on appeal the U.S. Supreme Court affirmed its earlier ruling³⁰ stating that although the petitioner met the requirements of “minimum contacts” established by the due process clause, the taxes imposed by the state violated the commerce clause. According to the *Quill* decision, the commerce clause precludes collection of taxes unless there is a “substantial nexus” between the taxed activity and the taxing state. The requirement of nexus specified through the “physical presence” standard was recognized by the court as necessary for ensuring that “state taxation does not unduly burden interstate commerce”³¹. It should be noted, however, that the “physical presence” standard is also ambiguous, since different courts developed different approaches in this regard.³² For this reason, some authors conclude that “any physical connection, no matter how slight” could be sufficient to establish “physical presence.”³³

²⁷ National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753, 755 (U.S. 1967).

²⁸ *Id.* at 758-760.

²⁹ State by Heitkamp v. Quill Corp., 470 N.W.2d 203, 208 (N.D. 1991).

³⁰ Quill Corp. v. North Dakota, 504 U.S. 298 (U.S. 1992).

³¹ *Id.* at 313-314. See also Swain, *supra* note 11, at 356-365 (providing a thorough analysis of the *Quill* decision and the standard of “substantial nexus”).

³² For the cases where “substantial nexus” for on-line vendors was established, see, e.g., Borders Online, LLC v. State Board of Equalization, 129 Cal. App. 4th 1179 (Cal. Ct. App. 2005); America Online, Inc. v. Johnson, 2002 Tenn. App. LEXIS 555 (Tenn. Ct. App. 2002); Orvis Company, Inc. v. Tax Appeals Tribunal, 86 N.Y.2d 165 (N.Y.

It is often emphasized that the U.S. Congress could override the two decisions named above through passing the law stipulating a less strict test than “substantial nexus” requirement.³⁴ Nevertheless, we consider that this is hardly likely to happen in the close future, and, therefore, these decisions will remain a valid law. Hence, the states are prohibited from taxing out-of-state vendors, unless they have a “substantial nexus” with the given state. Although *Bellas Hess* and *Quill* dealt with the mail-order businesses rather than online sales, it is now generally recognized that the rule established by these decisions applies equally to transactions conducted over the Internet.³⁵

There are three main problems, which relate to the application of *Quill* rule to the taxation of online merchants. First, local vendors obliged to pay taxes in a given state appear to be in a disadvantageous position when compared to remote merchants that are free from the tax in that state.³⁶ Second, businesses can easily avoid taxation by limiting their presence in the different states.³⁷ For instance, a company can be established in the state where sales and use taxes are either absent or minimal, thus, manipulating the rule established in *Quill*. This is exactly what was done by the founder of Amazon.com who set up his online retailing company in Washington, which is a not very populated state, in order to limit sales tax liability.³⁸ Third, as a result, states and local authorities incur revenue losses. Although some authors argue that revenues are not significantly affected by the growth of e-commerce,³⁹ most of the sources name huge amounts

1995). See also WESTIN, *supra* note 11, at 82-85, 90-94; BASU, *supra* note 2, at 161-166 (both discussing the cases that clarified and refined the standard of “physical presence”).

³³ BASU, *supra* note 2, at 78-79.

³⁴ See, e.g., McLure, *supra* note 8, at 58.

³⁵ See, e.g., Austan Goolsbee, *The Implications of Electronic Commerce for Fiscal Policy (and Vice Versa)*, 15 J. OF ECON. PERSPECTIVES No.1 13, 14 (2001); BASU, *supra* note 2, at 159.

³⁶ McLure, *supra* note 8, at 63.

³⁷ WESTIN, *supra* note 11, at 69.

³⁸ *The Forbes 400*, 162 FORBES (Issue 8), 165, 244 (Oct. 12, 1998).

³⁹ See, e.g., Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, 52 NAT’L TAX J. No. 3. 413, 415-417 (1999).

that represent losses of revenue of the U.S. tax jurisdictions. According to one of the estimations, the annual loss of revenue is about \$3.2 billion.⁴⁰ The U.S. General Accounting Office emphasized the “high degree of uncertainty” in this area and stated that the annual loss could be from \$1,6 billion up to \$9,1 billion.⁴¹ Thus, the constitutional restraint imposed by the *Quill* decision prevents effective levying of the sales tax on electronic commerce in the U.S.

To protect their tax revenues, the states impose use taxes, which must be remitted by the buyer rather than the seller. However, given the absence of effective means of Internet sales monitoring, the collection of the use taxes is hardly possible. There are several cases when the compliance with the use tax law is more or less ensured. In particular, the state can trace a transaction when a purchased item is registered in the state or a buyer is a business entity that is subject to audit in the state.⁴² The states have also been able to send tax bills to their residents who did not pay use tax on the online purchases of tobacco,⁴³ since they are entitled to obtaining the lists of the buyers based on the federal Jenkins Act.⁴⁴ As for other Internet purchases, the states have not been very successful in forcing their local buyers to remit the tax.⁴⁵ The purchasers are aware of the fact that e-commerce is “footloose and easily given to concealment”⁴⁶. That is why the consumers almost do not pay use tax at all. According to the Report of the U.S. General Accounting Office, the use tax compliance by individual purchasers is

⁴⁰ IAN J. LLOYD, *LEGAL ASPECTS OF THE INFORMATION SOCIETY* 287 (Butterworths 2000).

⁴¹ U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses are Uncertain*, GAO.GOV at 18 (Jun. 30, 2000), <http://www.gao.gov/new.items/g600165.pdf>.

⁴² McLure, *supra* note 8, at 63.

⁴³ JONATHAN D. HART, *LAW OF THE WEB: A FIELD GUIDE TO INTERNET PUBLISHING* 277 (Bradford Pub. Co. 2003).

⁴⁴ Jenkins Act, 15 USCS § 376 (2010).

⁴⁵ See e.g. David E. Hardesty, *United States: MP3 and the Internet: taxing downloaded music*, T.P.I. E-COMMERCE 1(3), 21, 21 (1999).

⁴⁶ WESTIN, *supra* note 11, at 4.

maximum 5%.⁴⁷ Therefore, given the low level of compliance, the use tax also does not provide an efficient solution to the taxation of electronic commerce in the U.S.

Furthermore, even when businesses and individuals are indeed willing to remit the taxes on their online transactions, they are prevented from doing this because of the complexity of the tax system. Tax rates and tax rules differ in the U.S. not only from state to state, but also from county to county. The founder of Amazon.com called the U.S. tax system “horrendously complicated.”⁴⁸ Indeed, it is hardly possible that an on-line retailer would be able to analyse and comply with an estimated 6,400 state and local tax rates⁴⁹ established by 7,600 different local taxing authorities.⁵⁰ Although business representatives proposed to establish one tax rate per state,⁵¹ this has never been done. Moreover, registration and filing requirements differ from state to state.⁵² The complexity of tax system and the burden of administrative compliance, therefore, remain one of the main factors hindering the collection of taxes on Internet transactions.

Thus, numerous problems occurred when the traditional sales and use tax system was applied to the new area of online transactions. As a consequence, it was acknowledged by both federal and state governments that the tax system had to be changed in response to the challenges brought by the spread of electronic commerce. The next two sections will discuss the measures that were taken on national and state levels in order to regulate e-commerce taxation.

⁴⁷ *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses are Uncertain*, *supra* note 41, at 17.

⁴⁸ Andrea James, *Buying Online? State Sales Tax Now Awaits: Washington Law Kicks in Today*, SEATTLE POST-INTELLIGENCER, Jul. 1, 2008, at E1.

⁴⁹ Maguire, *supra* note 10, at 2.

⁵⁰ WRIGHT & WINN, *supra* note 14, at § 18.01.

⁵¹ National Tax Association, *Communication and Electronic Commerce Tax Project: Final Report* 10, 13-14 (National Tax Association 1999), *cited in* WESTBERG, *supra* note 7, at 156.

⁵² McLure, *supra* note 8, at 64.

1.2. Internet Tax Freedom Act and separate state laws: modification of e-commerce taxation rules on federal and state levels

By the end of the 1990s, it was generally recognized that the U.S. sales and use tax system conflicts with the rapidly developing area of Internet transactions. This section will cover the measures taken by the federal government and by the separate state governments in attempt to modify the application of tax rules to e-commerce. The conclusions will be made concerning the results and the effectiveness of these measures.

In 1998, in order to provide at least a partial solution to the problems of e-commerce taxation, the U.S. Congress passed the Internet Tax Freedom Act (ITFA).⁵³ This was done following the generally accepted principle that “businesses should not be fiscally penalized for engaging in e-commerce.”⁵⁴ When the bill was introduced to Congress, many businesses hoped that it would remove any taxes on e-commerce.⁵⁵ However, the ITFA did not establish freedom in cyberspace. It only imposed three measures. First, the prohibition was imposed against levying any new state or local taxes on Internet access services.⁵⁶ Second, states and local governments were prohibited from imposing multiple or discriminatory taxes on e-commerce.⁵⁷ Third, the Act contained a grandfather clause allowing the states to charge taxes on Internet access, which had existed prior to the ITFA enactment.⁵⁸

The act is important because it prevents the states from imposing new or discriminatory taxes on e-commerce. This prohibition had the form of a moratorium, initially adopted for three

⁵³ Internet Tax Freedom Act, 105 H.R. 4328, 105 P.L. 277, 112 Stat. 2681 (1998).

⁵⁴ LLOYD, *supra* note 16, at 594.

⁵⁵ BASU, *supra* note 2, at 206.

⁵⁶ 105 H.R. 4328, § 1101(a).

⁵⁷ *Id.*

⁵⁸ *Id.* § 1104.

years.⁵⁹ Heated debates were conducted on the issue of making the moratorium permanent. In 1999, the “Appeal for Fair and Equal Taxation of Electronic Commerce” was presented to the Advisory Commission on Electronic Commerce created by the ITFA.⁶⁰ More than 170 tax specialists supported this appeal against a permanent exemption for electronic commerce.⁶¹ At the same time, active work was conducted by the legislatures. Numerous bills were introduced in the sessions of the 106th and the 107th Congresses that dealt not only with the extension of the moratorium or making it permanent, but also with such matters as the grandfather clause on existing taxes and the possibility of the simplification of the tax system.⁶² The legislative acts, which were adopted by Congress, have already prolonged the effect of the moratorium and the grandfather clause three times,⁶³ and under the latest amendments its effect is extended till November 1, 2014.⁶⁴ Nevertheless, taxation of access to the Internet regulated by the ITFA should not be confused with taxation of e-commerce itself.⁶⁵ The ITFA did not make e-commerce “tax free”,⁶⁶ since traditional sales and use taxes were neither new nor discriminatory taxes. Therefore, online transactions were still subject to these taxes.

However, because of the constitutional prohibition discussed in the previous section no state could effectively levy taxes on online vendors unless the retailers had a “substantial nexus” with that state. In order to protect their tax interests with regard to Internet purchases, separate states enacted legislative acts that aimed at circumventing the prohibition of levying taxes on

⁵⁹ *Id.* §1101(a).

⁶⁰ McLure, *supra* note 8, at 55.

⁶¹ *Id.*

⁶² Nonna A. Noto, *Internet Tax Bills*, in *INTERNET TAXATION*, *supra* note 10, at 71 (conducting a comparative analysis of the proposed bills).

⁶³ Internet Tax Nondiscrimination Act, 107 H.R. 1552, 107 P.L. 75, 115 Stat. 703 (2001); Internet Tax Nondiscrimination Act, 108 S. 150, 108 P.L. 435, 118 Stat. 2615 (2004); Internet Tax Freedom Act Amendments Act of 2007, 110 H.R. 3678, 110 P.L. 108, 121 Stat. 1024 (2007).

⁶⁴ Internet Tax Freedom Act Amendments Act of 2007, 110 H.R. 3678.

⁶⁵ BASU, *supra* note 2, at 103.

⁶⁶ Maguire, *supra* note 10, at 4.

out-of-state sellers. One of the examples of such laws is the statute adopted in the state of New York that restricted the direct shipment of cigarettes to New York consumers and required it only to be shipped to the authorized dealers.⁶⁷ The effect of this act was that on-line vendors were prevented from selling tobacco to New York consumers, which protected indirectly the state's tax revenue from tobacco sales.⁶⁸ In the *Brown & Williamson Tobacco Corp.* case the constitutionality of this law was challenged based on commerce clause,⁶⁹ however the challenge was not successful. The U.S. Court of Appeals for the 2nd Circuit found that restriction of direct shipment to consumers was constitutional, because its effects on interstate commerce were *de minimis* and were substantially outweighed by the Act's "putative local benefits".⁷⁰ Hence, the state of New York was successful in protecting their tax interest in tobacco sales.

Another example of the state legislation intended to protect sales and use tax revenue from losses caused by electronic commerce is the law of the state of Arkansas passed in 2001. It provides that out-of-state vendors are obliged to collect and remit the use tax to the state if such vendor has a substantial connection with a brick-and-mortar retailer established in Arkansas.⁷¹ According to the act, the requirement of substantial connection is established when two conditions are met. First, the out-of-state seller owns, or is owned by, wholly or in a substantial part, the Arkansas retailer that conducts sales in Arkansas. Second, the same or substantially similar products are sold by two companies under the same or substantially similar business name, or the Arkansas seller is engaged in advertising or promoting sales by the out-of-state

⁶⁷ NY PUB. HEALTH LAW § 1399-II (CLS 2011).

⁶⁸ HART, *supra* note 43, at 277.

⁶⁹ *Brown & Williamson Tobacco Corp v. Pataki*, 320 F.3d 200 (2d Cir. 2003).

⁷⁰ *Id.* at 217.

⁷¹ 2001 Ark. Acts 922.

vendor.⁷² The law, thus, limits the “substantial nexus” requirement of commerce clause and requires use taxes to be paid by all out-of-state sellers that have affiliates in Arkansas.

Similar laws were adopted in New York, Rhode Island, North Carolina, Colorado and, most recently, in Illinois.⁷³ They are widely called “Amazon tax” laws because of their most obvious target – Amazon.com. The company decided to challenge in court the constitutionality of one such law, which limited the requirements for establishing a “nexus”.⁷⁴ According to the N.Y. Tax Law, if an out-of-state vendor enters into an agreement with a local independent contractor or other representative, by which the latter directly or indirectly refers potential customers to the former for certain consideration, he shall be obliged to pay use tax to the state of New York.⁷⁵ The Act specifically stipulates that referral of customers “by a link on an Internet website” falls under the scope of this rule.⁷⁶

Constitutionality of this law has become a subject of judicial consideration. The court established that Amazon.com, LLC did not have any offices, employees, representatives or property in New York.⁷⁷ However, it had numerous contracts with independent third parties, including New York residents. Those third parties advertized the Amazon.com website on their own websites and received commission from Amazon.com, LLC for every purchase made by the local users after clicking on the advertising links.⁷⁸ On November 4, 2010, The Supreme Court of New York declared the challenged provision constitutional on its face under the due process and commerce clauses. However, there were certain issues of fact that required further proceedings,

⁷² *Id.* §1(A)(3).

⁷³ Joseph Henchman, “Amazon Tax” Laws Signal Business Unfriendliness And Will Worsen Short-Term Budget Problems, TAXFOUNDATION.ORG (Mar. 8, 2010), <http://www.taxfoundation.org/research/show/25949.html>.

⁷⁴ See Amazon.com, LLC v. Department of Taxation and Finance, 913 N.Y.S.2d 129, (N.Y. App. Div. 2010).

⁷⁵ NY TAX LAW, § 1101 (2011).

⁷⁶ *Id.* § 1101(b)(8)(vi).

⁷⁷ Amazon.com, LLC v. Department of Taxation and Finance, 913 N.Y.S.2d 129, 133-134 (N.Y. App. Div. 2010).

⁷⁸ *Id.*

and the case was remanded.⁷⁹ Although a final decision in this case has not been made yet, it seems very unlikely that the challenged provision would be ruled to be unconstitutional. Thus, Amazon.com, LLC and other on-line retailers would have to collect and remit state use taxes on all purchases made by local consumers through the independent contractors established in that state.

However, the practical effect of “Amazon tax” laws has been the opposite of what was intended in theory. Online companies did not start to generate revenue by paying use taxes in the states where such legislation was enacted. Instead, they simply terminated their relations with the affiliates in those states. In particular, Amazon.com discontinued its affiliate program in all states that enacted “Amazon tax” laws.⁸⁰

Currently, a federal moratorium is imposed on levying new or discriminatory taxes on e-commerce, however, proper rules for the application of the existing taxes to electronic transactions have not been established on the national level. Although separate laws enacted by different states might regulate some specific aspects of e-commerce taxation, the states acting separately still cannot overcome the constitutional restraints of the *Quill* decision and oblige all out-of state vendors to pay taxes on on-line purchases. For this reason, the states initiated the project, which was intended to fill the gaps in federal legislation and to provide uniform rules for e-commerce taxation throughout the U.S. The next section will address the main characteristics and evaluate the effectiveness of this states’ initiative.

⁷⁹ *Id.* at 146.

⁸⁰ Joseph Henchman, *supra* note 73. See also Verne G. Kopytoff, *Amazon Pressured on Sales Tax*, N.Y. TIMES, March 14, 2011, at B1; Janet Novack, *Illinois Governor Signs Amazon Internet Sales Tax Law*, BLOGS.FORBES.COM (Mar. 10, 2011), <http://blogs.forbes.com/janetnovack/2011/03/10/illinois-governor-signs-amazon-internet-sales-tax-law>.

1.3. Streamlined Sales and Use Tax Agreement: a way to the uniform regulation

With the growth of e-commerce the states have found themselves in a position where they could not protect their tax interests with regards to online transactions because, on the one hand, they are prohibited from imposing new taxes by the Internet Tax Freedom Act, and on the other hand, existing sales and use taxes cannot be levied on out-of state vendors because of the constitutional prohibition. This section will analyse the Streamlined Sales and Use Tax Project representing a collective attempt of the states to regulate indirect taxation of e-commerce without contradicting the two prohibitions named above.

In 2000, the states began to work together on the Streamlined Sales and Use Tax Project, the purpose of which was to simplify states sales and use tax systems and create the basis for voluntary tax collection by merchants.⁸¹ As a result of this work the Streamlined Sales and Use Tax Agreement (the SSUTA or the Agreement)⁸² was adopted on 12 November 2002 and offered to the states for approval. On October 3, 2005 the SSUTA entered into effect⁸³ and currently, twenty-four states are its members.⁸⁴ Among them, twenty states are full members (their laws and regulations are in compliance with the Agreement), and four states are associate members (their laws and regulations are in compliance with the SSUTA, but these laws are not in effect yet).⁸⁵

⁸¹ Nonna A. Noto, *Extending the Internet Tax Moratorium and Related Issues*, in INTERNET TAXATION, *supra* note 10, at 18, 36.

⁸² *Streamlined Sales and Use Tax Agreement*, STREAMLINEDSALESTAX.ORG, http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2012_13_10.pdf (last amended Dec. 13, 2010).

⁸³ *Sales Tax Simplification Agreement Becomes Effective Today and Launches Key Element: Amnesty Program*, SALESTAXADVISORS.COM, <http://www.salestaxadvisors.com/v4.2/tax/streamlinedsales> (last modified May 30, 2009).

⁸⁴ *See State Info: Streamline Sales Tax State Members*, STREAMLINEDSALESTAX.ORG, <http://www.streamlinedsalestax.org/index.php?page=state-info> (last visited Mar. 25, 2011).

⁸⁵ *Id.*

A primary purpose of the Agreement is to “establish and maintain a cooperative, simplified system for the application and administration of sales and use taxes under the duly adopted law of each member state”⁸⁶. Eight principal rules can be distinguished in the SSUTA, which serve this purpose. First, the Agreement establishes a set of uniform definitions of taxable goods and services⁸⁷ and obliges all member states to utilize these definitions.⁸⁸ It is acknowledged that changes in definitions would result in some revenue losses.⁸⁹ However, the clarity that the uniformity provides for taxpayers is considered more important,⁹⁰ since sellers will not have to deal with the problem that a product, which is not subject to tax in one state, would be taxable in another state.⁹¹ Second, the Agreement introduces and defines a category of products called “digital goods”,⁹² which is distinguished from both “tangible personal property” and “services”.⁹³ Thus, the SSUTA puts an end to the debate concerning attribution of digital products to either goods or services through creating a separate taxable category, which is supposed to be uniform throughout the member states.

Third, the SSUTA eliminates multiple state tax rates and allows each state to have only one general tax rate and one additional rate established for specific items (food and drugs).⁹⁴ Furthermore, each local jurisdiction is also allowed to have only one tax rate.⁹⁵ These rules are intended to eliminate the complexity of tax system discussed in the beginning of the chapter and

⁸⁶ *Streamlined Sales and Use Tax Agreement*, *supra* note 82, § 1101.

⁸⁷ *Id.* Appendix C.

⁸⁸ *Id.* § 327.

⁸⁹ See Raymond P. Carpenter, *United States: Sales and Use Taxation of Telecommunications Services Including Voice-Over Internet Protocol*, in *GLOBAL E-BUSINESS LAW & TAXATION*, *supra* note 19, at 383, 396.

⁹⁰ Charles Collins, *The Streamlined Sales Tax Agreement: What It Means for Business*, 55 *TAX EXECUTIVE* (Issue 1), Jan./Feb. 2003, at 28, 29.

⁹¹ BASU, *supra* note 2, at 209, n.34.

⁹² *Streamlined Sales and Use Tax Agreement*, *supra* note 82, Appendix C, Part II.

⁹³ *Id.* § 309(A).

⁹⁴ *Id.* § 308(A).

⁹⁵ *Id.* § 308(B).

make the system “more accurate and reliable”⁹⁶. Fourth, the Agreement establishes state-level administration for all sales taxes.⁹⁷ This means that local administration of sales tax that was allowed in some states will be liquidated.⁹⁸ This rule represents a substantial advantage for taxpayers who will have to deal only with one taxing authority in each state instead of the previous practice of filing returns in each local jurisdiction.

Fifth, the SSUTA stipulates that tax jurisdictions have to maintain databases that assign nine-digit zip code boundaries to each tax jurisdiction.⁹⁹ Through this rule, the Agreement solves the difficulty caused by the fact that a remote seller could not always identify a buyer’s taxing jurisdiction based on the street address or zip code.¹⁰⁰ Furthermore, sellers are relieved from liability if they charge taxes “relying on erroneous data provided by a member state on tax rates, boundaries, or taxing jurisdictions.”¹⁰¹ Therefore, not only is tax collection significantly simplified, but also taxpayers’ interests are better protected.

Sixth, the Agreement provides for uniform sourcing rules.¹⁰² In particular, electronic transactions including delivery of the product are sourced to the location of the recipient based on the delivery address.¹⁰³ If the transaction does not involve delivery, it is still sourced to the location of the buyer based on the address indicated by the purchaser.¹⁰⁴ In the case none of these rules can be applied the transaction will be sourced to the location of the seller.¹⁰⁵ Hence, a uniform guidance is provided by the SSUTA for determination of the proper taxing jurisdiction.

⁹⁶ Collins, *supra* note 90, at 28.

⁹⁷ *Streamlined Sales and Use Tax Agreement*, *supra* note 82, § 301.

⁹⁸ Carpenter, *supra* note 89, at 396.

⁹⁹ *Streamlined Sales and Use Tax Agreement*, *supra* note 82, § 305.

¹⁰⁰ Swain, *supra* note 11, at 375-376.

¹⁰¹ *Streamlined Sales and Use Tax Agreement*, *supra* note 82, § 306.

¹⁰² *Id.* § 310.

¹⁰³ *Id.* § 310(A)(2).

¹⁰⁴ *Id.* § 310(A)(3)-(4).

¹⁰⁵ *Id.* § 310(A)(5).

Seventh, the Agreement obliges the member states to create an online registration system “that will allow the sellers to register in all the member states”.¹⁰⁶ This “one-step seller registration”¹⁰⁷ stipulates that the sellers would voluntarily agree to collect and remit taxes, including the taxes on electronic transactions. Eighth, the SSUTA establishes three models for tax collection and remittance.¹⁰⁸ Namely, a seller can select a Certified Service Provider (CSP) as an agent, or select a Certified Automated System (CAS) that would calculate the amount of tax due, or utilize its own automated sales tax system that has been certified as a CAS.¹⁰⁹ It is asserted that use of the first model would cost nothing to the sellers, and the use of the second model would require little expense.¹¹⁰ Thus, the issue of the cost of compliance that used to be one of the main taxpayers’ concerns is addressed by the Agreement.

The analysis of the rules named above demonstrates that the SSUTA appears to have achieved its purpose of tax system simplification. These solutions, which became available for businesses, are recognized as “giant steps forward” in the taxation regulation.¹¹¹ However, there are a number of concerns regarding the application of the Agreement in general, and in the context of e-commerce, in particular.

One of the problems of the SSUTA application relates to consumer privacy, since the centralized registration stipulates also a centralized storage of the “sensitive tax and financial data”, which is very likely to raise the objections of taxpayers.¹¹² A further controversial aspect of the Agreement concerns the absence of any provisions on how cooperation should be conducted between member states and non-member states, especially those five states that do not

¹⁰⁶ *Id.* § 401.

¹⁰⁷ Swain, *supra* note 11, at 378.

¹⁰⁸ *Streamlined Sales and Use Tax Agreement*, *supra* note 82, § 403.

¹⁰⁹ *Id.* For further information on the tax collection systems, see *id.* §§ 202-203, 501-502.

¹¹⁰ Collins, *supra* note 90, at 28.

¹¹¹ Jere D. McGaffey, *Wisconsin Tax Policy Within a Federal System*, 88 MARQ. L. REV. 93, 99-100 (2004).

¹¹² BASU, *supra* note 2, at 210, n.39.

have sales tax at all.¹¹³ Another problem relates to the voluntary character of sellers' registration. Although the simplicity of registration is supposed to increase tax revenues,¹¹⁴ some commentators expressed concerns about the effectiveness of non-mandatory character of registration.¹¹⁵ Indeed, there is no any guarantee that the sellers would participate in such system.

The main concern with respect to the application of the SSUTA to electronic commerce is based on Constitutional grounds. In particular, the issue is whether the Agreement can be applied without infringing the commerce clause in the light of the *Quill* decision. Some commentators suggest that the mechanism established by the SSUTA does not encroach upon interstate commerce, because the sellers are offered to register voluntarily.¹¹⁶ In other words, the sellers, including online retailers, are not compelled to participate in registration, and, therefore, the members of the Agreement do not attempt to regulate interstate commerce.

However, the majority of observers believe that the states' ability to tax out-of-state merchants is still limited by the constitutional restraints.¹¹⁷ Since the SSUTA does not attempt to replace existing nexus rules,¹¹⁸ the states, even in cooperation, "cannot change the current prohibition on taxing remote sales by vendors without nexus on their own".¹¹⁹ Therefore, the rules on e-commerce taxation cannot be modified by the Agreement and remain governed by the *Quill* decision.

The question remains whether there is any possibility that the rules established by the SSUTA will be applied to e-commerce any time in the future. The widespread belief is that the

¹¹³ J. Michael Reese, *Does the Streamlined Agreement Signal the End of Quill in the Area of E-Commerce?* 29 ST. TAX NOTES 639, 648 (2003).

¹¹⁴ BASU, *supra* note 2, at 209, n.34.

¹¹⁵ See, e.g., Reese, *supra* note 113, at 648.

¹¹⁶ BASU, *supra* note 2, at 210.

¹¹⁷ Reese, *supra* note 113, at 648.

¹¹⁸ Swain, *supra* note 11, at 371.

¹¹⁹ Samantha L. Cowne, *The Streamlined Sales and Use Tax Agreement: How Entrepreneurs Can Plan for the Uncertain Future of E-Commerce Sales Taxation*, 4 ENTREPRENEURIAL BUS. L.J. 129, 136 (2009).

only way to achieve this is through the “affirmative action of the Congress”, by which the *Quill* prohibitions will be eliminated.¹²⁰ In fact, the Court itself in *Quill* stated that “the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve”¹²¹.

Thus, although the SSUTA appears to establish a simplified and effective system of taxation, this system cannot be applied to e-commerce taxation, because constitutional restraints are still in force. It is recognized that the agreement serves only as a means to influence Congress and allow the legislative changes to be enacted faster.¹²² However, until Congress eliminates the *Quill* requirement of “physical presence”, which some commentators call “a relic of . . . [a] bygone era”¹²³, taxation of e-commerce in the U.S. remains mainly unregulated. Given the fact that such federal changes are not expected to appear in the near future,¹²⁴ electronic transactions are and will continue to be largely untaxed. All attempts by the states to protect their tax interests have failed, and all problems discussed in the beginning of the chapter still exist in the U.S. Therefore, a fundamental reform on the federal level is needed, which would change the application of taxation rules to e-commerce.

¹²⁰ *Id.*

¹²¹ *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (U.S. 1992).

¹²² BASU, *supra* note 2, at 210.

¹²³ Swain, *supra* note 11, at 392.

¹²⁴ *Id.* at 370.

CHAPTER 2. TAXATION OF ELECTRONIC COMMERCE IN THE EUROPEAN UNION

Most of the problems related to e-commerce indirect taxation were rather successfully addressed by the legislative measures taken in the European Union. The analysis of the EU experience in applying their value added tax system to electronic transactions would provide a deeper understanding of the e-commerce problems related to VAT in general. This chapter is threefold. The first section will deal with the problems that occurred when the European traditional VAT system was applied to Internet transactions. The second section will address the first changes brought to the EU regulation of e-commerce taxation by the Directive 2002/38/EC. The third section will analyse the latest amendments established by the VAT package of 12 February 2008.

2.1. Problems of the application of the traditional VAT system to electronic commerce

The main characteristics of the VAT in general, and European VAT in particular, are that it is a consumption tax levied at all stages throughout the production chain based on the output-input system.¹²⁵ This distinguishes VAT from the U.S. sales and use taxes, which are charged only once – when the goods are supplied to the final consumers. VAT tax rates in the European Union are established by each member state individually,¹²⁶ although the standard rate may not be lower than 15%.¹²⁷ Until 2007, the main EU legislative act regulating VAT used to be the Sixth Directive,¹²⁸ which was replaced by the Council Directive 2006/112/EC.¹²⁹

¹²⁵ For more detailed explanation of VAT, see, e.g., SCHENK & OLDMAN, *supra* note 6, at 16-23, 33-35. See also WESTIN, *supra* note 11, at 124-125 (exemplifying the output-input system).

¹²⁶ Sixth Council Directive 77/388/EEC of 17 May 1977 on the Harmonization of the Laws of the Member States Relating to Turnover Taxes - Common System of Value Added Tax: Uniform Basis of Assessment, Art. 12(3)(a), 1977 O.J. (L 145) 1, 16; Council Directive 2006/112/EC of 11 December 2006 on the Common System of Value Added Tax, Art. 96, 2006 O.J. (L 347) 1, 23. For the full list of the EU VAT tax rates, see Taxation and Customs Union, European Commission, *VAT Rates Applied in the Member States of the European Union*, EC.EUROPA.EU, http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf (last amended Jan. 1, 2011).

¹²⁷ Council Directive 2006/112/EC, *supra* note 126, art. 97, at 23.

¹²⁸ Sixth Council Directive 77/388/EEC, *supra* note 126.

¹²⁹ Council Directive 2006/112/EC, *supra* note 126.

Several areas of particular concern could be distinguished when the traditional VAT rules were applied to e-commerce. In the same way as in the U.S., the main problem relates to the distinction between goods and services for the purpose of taxation, and attribution of digital products to one of these two categories. When Internet transactions became subject to the existing VAT rules, this issue became intensively discussed since differential treatment existed for supplies of goods and supplies of services.

The first difference in treatment was created by the distinct tax rates established for sales of goods and supplies of services by the EU member states. Two U.K. cases may provide an insight into this problem. In the first case, *Emphasis Ltd*,¹³⁰ the court dealt with a food delivery company, which allowed the customers to order food online and then delivered it to the consumers' location. If such food delivery had been classified as a "supply of catering services", the standard rate would have been applied. However, if it had been characterised as a "supply of food", the transaction would have been zero-rated under the U.K. law.¹³¹ The difference was, indeed, substantial given the 17,5 % standard VAT rate in the UK.¹³² The court declared the transaction zero-rated.¹³³ Thus, the general principle stating that the nature of the transaction shall not depend on the means of placing an order was confirmed in this case,¹³⁴ since purchase of food on-line was treated as equal to the conventional purchase of food in a brick-and-mortar shop.

The tribunal in the second case, *Forexia Ltd*,¹³⁵ came to the opposite conclusion. Specifically, it made a distinction between a conventional supply of books and newspapers,

¹³⁰ *Emphasis Limited* [1995] V.A.T.D.R. 419 (13759) (UK) cited in GRAHAM J.H. SMITH ET AL., *INTERNET LAW AND REGULATION* 588-589 (Sweet & Maxwell, 3d ed. 2002).

¹³¹ *Id.*

¹³² OSBORNE CLARKE, *A PRACTICAL GUIDE TO E-COMMERCE AND INTERNET* 236 (ICSA Publ., 2d ed. 2005).

¹³³ *Emphasis Limited* [1995] V.A.T.D.R. 419 (13759) (UK) cited in SMITH, *supra* note 130, at 588-589.

¹³⁴ Eden, *supra* note 19, at 164.

¹³⁵ *Forexia Ltd*, VAT and Duties Tribunal Decision No. 16041, Apr. 22, 1999 (UK) cited in SMITH, *supra* note 130, at 589.

which was zero-rated, and an online distribution and communication of news, which was standard-rated. It is indisputable that such a ruling was made against the principle of neutrality between e-commerce and traditional commerce.¹³⁶ These contradicting decisions prove that VAT rules, which existed at that time, were insufficient and inefficient, even when the parties to an electronic transaction were located in one member state.

The more complicated problems occurred when the parties were located in different member states, or even worse, one of them was established outside the EU. While all transactions that took place within the EU were subject to VAT, the supplies of goods and services from outside the EU were treated differently,¹³⁷ thus, representing a mix of both the destination and the origin principles.¹³⁸

For the supply of goods, the destination principle applied, which means that imported goods were taxed, while exported goods were not.¹³⁹ Even when goods were ordered online, the taxation did not create any problems, because under the destination principle the taxes could be levied when the purchased goods passed through customs.¹⁴⁰ As for imported services, two regimes were established depending on the type of the transaction. For business-to-business (B2B) electronic services the destination principle applied: exported services were free from VAT, while imported services were subject to VAT.¹⁴¹ Although non-EU operators supplying services to European consumers were not responsible for the tax, VAT was still paid, because European recipients of electronic services were obliged to account for VAT using the reverse charge mechanism.¹⁴² However, for business-to-consumer (B2C) transactions the origin principle

¹³⁶ SMITH, *supra* note 130, at 589.

¹³⁷ LLOYD, *supra* note 40, at 288.

¹³⁸ JÜRGEN STEHN, *LEVIATHAN IN CYBERSPACE: HOW TO TAX E-COMMERCE* 7 (Institut für Weltwirtschaft 2002).

¹³⁹ Sixth Council Directive 77/388/EEC, *supra* note 126, Art. 2, at 5.

¹⁴⁰ BASU, *supra* note 2, at 143.

¹⁴¹ Sixth Council Directive 77/388/EEC, *supra* note 126, Art. 2, at 5; McLure, *supra* note 8, at 60.

¹⁴² Erik T.H. Scheer, *Electronic Commerce and VAT: the European View*, 10 J. INT'L TAX'N 14, 17 (1999).

established by the Sixth Directive used to be applicable,¹⁴³ under which the exported services were taxed, while the imported ones were not.¹⁴⁴

The latter rule became important for e-commerce in the context of the supply of software, music, images or other products in a digital form. Such electronic transactions were treated as services¹⁴⁵ and, thus, were free from VAT when supplied to European customers by non-EU operators.¹⁴⁶ This certainly created a competitive disadvantage to EU vendors who were obliged to remit VAT as compared to their competitors established outside the EU who were free from VAT on the supplies to European consumers.¹⁴⁷ This problem was very similar to the distortion in tax treatment of local and out-of-state merchants that the spread of e-commerce created in the U.S. As noted later by the European Commission, unfair treatment of EU and non-EU suppliers clearly “conflicted with the neutrality which is central to VAT”¹⁴⁸. Nevertheless, the traditional country-of-origin rule for B2C imports of services continued to exist, because, as explained by the Commission in 1998, the volumes of electronic transactions had been very small¹⁴⁹ and, therefore, did not represent a real problem¹⁵⁰.

In the meantime, alternative forms of taxation were proposed. Similarly to the U.S., the ‘bit tax’ became the subject of considerable debates.¹⁵¹ However, it was soon generally recognized that the bit tax would cause even more problems related to jurisdiction and

¹⁴³ Sixth Council Directive 77/388/EEC, *supra* note 126.

¹⁴⁴ McLure, *supra* note 8, at 61.

¹⁴⁵ See *Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Electronic Commerce and Indirect Taxation*, at 5, COM (1998) 374 final (Jun. 17, 1998).

¹⁴⁶ LLOYD, *supra* note 40, at 288.

¹⁴⁷ STEHN, *supra* note 138, at 7.

¹⁴⁸ *Proposal for a Council Directive Amending 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*, at 2, COM (2006) 210 final (May 15, 2006).

¹⁴⁹ COM (1998) 374 final, *supra* note 145, at 5.

¹⁵⁰ STEHN, *supra* note 138, at 6.

¹⁵¹ See WESTBERG, *supra* note 7, at 187-91.

enforcement.¹⁵² This was confirmed by the EU Commission, which named the bit tax as “not appropriate” because all transactions, including electronic ones, were already regulated by the VAT rules.¹⁵³ The Commission reiterated a year later that no new tax would be levied on electronic commerce.¹⁵⁴

However, the volumes of the Internet sales continued to grow, and the need of specific e-commerce taxation régulation became evident. The competitive advantage created by the gap in the VAT rules was, in fact, used by businesses for tax planning purposes, since they could easily avoid paying VAT in Europe by establishing the company outside the EU.¹⁵⁵ As a result, it was recognized in 2000 that changes needed to be introduced in the system of VAT, so that the sellers established outside the EU would be required to collect and remit VAT on digital products bought by EU purchasers.¹⁵⁶ Despite the fact that U.S. businesses and critics expressed fierce objections to the EU initiative,¹⁵⁷ the plan was implemented and legislative amendments were made in 2002, which will be analysed in the next section.

Furthermore, in the same way as in the U.S., there were problems in the EU related to the identification of the buyer and establishing his location and status (taxable business or non-taxable consumer). Lack of technical means available for tax authorities to trace electronic sales also impeded the application of VAT rules to e-commerce and caused revenue losses.¹⁵⁸ Moreover, there was no effective cooperation and exchange of information between member

¹⁵² Eden, *supra* note 19, at 169.

¹⁵³ *Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, A European Initiative in Electronic commerce*, at 19, COM (1997) 157 final (Apr. 16, 1997).

¹⁵⁴ COM (1998) 374 final, *supra* note 145, at 4-5.

¹⁵⁵ SMITH, *supra* note 130, at 586.

¹⁵⁶ *See Proposal for a Council Directive Amending Directive 77/388/EEC as Regards the Value Added Tax Arrangements Applicable to Certain Services Supplied by Electronic Means*, COM (2000) 349 final (Jun. 7, 2000).

¹⁵⁷ WRIGHT & WINN, *supra* note 14, at § 18.06. *See also* BASU, *supra* note 2, at. 218, 228-232 (citing the U.S. business and government representatives who criticized the EU reform).

¹⁵⁸ *See Directorate General XXI, Interim Report on the Implications of Electronic Commerce for VAT and Customs*, at 15, XXI/98/0359 (Apr. 3, 1998).

states about transactions conducted in the cyberspace. All these problems have had to be dealt with by the European Union legislatures. Whether the measures taken were successful and whether all the problems indicated above have been solved will be discussed in the following section.

2.2. Council Directive 2002/38/EC of 7 May 2002: first attempts to regulate electronic commerce taxation

As discussed in the previous section, numerous problems occurred in the European Union when the existing system of VAT was applied to Internet transactions. In order to adapt taxation mechanisms to the needs of e-commerce, several measures have been taken. This section will analyse the first changes brought to the regulation of e-commerce taxation by the Council Directive 2002/38/EC of 7 May 2002. Specifically, it will discuss three new rules established by the Directive and provide an insight into the problems, which remained unsolved after the Directive was adopted.

The first attempts to establish the EU rules on taxation of Internet transactions were made by the Council Directive 2002/38/EC of 7 May 2002,¹⁵⁹ which was passed in line with the principles of e-commerce taxation developed by the OECD.¹⁶⁰ Under this Directive, new VAT rules were established for non-EU merchants supplying electronic services to European

¹⁵⁹ 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, 2002 O.J. (L 128) 41.

¹⁶⁰ Rep. of the Committee on Fiscal Affairs, OECD, *Electronic Commerce: Taxation Framework Conditions. A Borderless World: Realising the Potential of Electronic Commerce*, OECD.ORG (Oct. 8, 1998), <http://www.oecd.org/dataoecd/46/3/1923256.pdf>.

consumers. The new regime was established initially for three years starting from 1 July 2003,¹⁶¹ but three other directives extended its effect through 31 December 2009.¹⁶²

The Directive 2002/38/EC provided for three major rules related to e-commerce taxation. The first rule was related to the list of services which were characterised as “electronically supplied services” for the purposes of taxation. In particular, all digital products, such as software, images, databases, music, movies and games were included in that list.¹⁶³ Thus, the problem of distinction between goods and services with regard to digital goods, which was analysed in the previous section, was solved. The same list of “electronically supplied services” was later implemented into the Directive 2006/112/EC¹⁶⁴ and, thus, classification of digital products as “electronically supplied services” became a permanent rule.

The second rule intended to eliminate the competitive advantage of non-EU suppliers of electronic services as compared to European sellers. While EU suppliers were made free from the duty to charge VAT on services exported on the markets outside the EU, non-EU vendors were obliged to charge VAT on services provided to European consumers.¹⁶⁵ In other words, the country-of-origin principle was replaced with the country-of-destination principle for business-to-consumer transactions.

According to the new VAT mechanism established by the Directive, merchants from outside the EU should choose one of the member states, in which they would register and submit

¹⁶¹ Council Directive 2002/38/EC, *supra* note 159, art. 4, at 44.

¹⁶² See Council Directive 2006/58/EC of 27 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, art. 1, 2006 O.J. (L 174) 5, 5; Council Directive 2006/138/EC of 19 December 2006 Amending Directive 2006/112/EC on the Common System of Value Added Tax as Regards the Period of Application of the Value Added Tax Arrangements Applicable to Radio and Television Broadcasting Services and Certain Electronically Supplied Services, art. 1, 2006 O.J. (L 384) 92, 92; Council Directive 2008/8/EC of 12 February 2008 Amending Directive 2006/112/EC as Regards the Place of Supply of Services, art. 1, 2008 O.J. (L 44) 11, 12.

¹⁶³ See Council Directive 2002/38/EC, *supra* note 159, Annex L, at 44 (containing the full list of “electronically supplied services”).

¹⁶⁴ Council Directive 2006/112/EC, *supra* note 126, Annex II, at 68.

¹⁶⁵ Council Directive 2002/38/EC, *supra* note 159, art. 1, at 42-43.

VAT return on all electronic services supplied to European customers.¹⁶⁶ However, the amount of VAT that had to be paid was determined based on the tax rates of the country of consumption (i.e. where the buyer was located) rather than on the tax rates of the country of identification (i.e. where the seller was registered). The latter provision confirms the application of the country-of-destination principle for such transactions.¹⁶⁷ It also appears to have the purpose of ensuring that the principle of neutrality is followed, since non-EU sellers would not have any incentives to register in the member state with the lowest VAT rates. Otherwise, all merchants would register in Cyprus and Luxembourg, where the VAT rate is the minimum – 15%.¹⁶⁸

Although the second rule introduced by the Directive 2002/38/EC seems to have fulfilled the function of eliminating a “competitive distortion”,¹⁶⁹ it, nevertheless, created another form of disbalance. Specifically, vendors from outside the EU were put in a disadvantageous position. First, despite the fact that the Directive imposed “simplified registration and reporting obligations” on them and required to “deal with a single European tax administration of their choice”,¹⁷⁰ non-EU merchants still had to bear higher compliance costs caused by the obligation to analyse and apply the tax legislation of all EU members where they had customers.¹⁷¹ Second, in some circumstances sellers from outside the EU had to pay higher taxes than European suppliers. For instance, a European company established in Luxembourg would collect VAT at

¹⁶⁶ *Id.* See also Council Regulation 792/2002 of 7 May 2002 Amending Temporarily Regulation (EEC) No 218/92 on Administrative Cooperation in the Field of Indirect Taxation (VAT) as Regards Additional Measures Regarding Electronic Commerce, 2002 O.J. (L 128) 1; Council Regulation 1798/2003 of 7 October 2003 on Administrative Cooperation in the Field of Value Added Tax and Repealing Regulation (EEC) No 218/92, 2003 O.J. (L 264) 1 (laying down additional measures related to the mechanism of non-EU vendors registration and remittance of VAT in the EU).

¹⁶⁷ WESTBERG, *supra* note 7, at 152.

¹⁶⁸ See VAT Rates Applied in the Member States of the European Union, *supra* note 126.

¹⁶⁹ Taxation and Customs Union, European Commission, *VAT on Electronic Services*, EC.EUROPA.EU, http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/index_en.htm (last updated Nov. 12, 2010).

¹⁷⁰ COM (2006) 210 final, *supra* note 148, at 2.

¹⁷¹ See Martin A. Weiss & Nonna A. Noto, *EU Tax on Digitally Delivered E-Commerce. CRS Report for Congress*, IPMALL.INFO (2005), http://www.ipmall.info/hosted_resources/crs/RS21596_050407.pdf (last updated Apr. 7, 2005).

the rate of 15% when it supplied an electronic service to a Danish customer. However, a U.S. company that registered in Luxembourg and sold digital software to the same customer, would pay VAT at the rate of 25% (a standard VAT rate in Denmark).¹⁷² Therefore, the Directive solved some neutrality deficits but created new ones,¹⁷³ which prevented it from establishing complete fairness in the new mechanism of e-commerce taxation.

The last, third, rule established by the Directive 2002/38/EC concerned the definition of the “place of supply” for the services provided electronically. This rule dealt only with the services provided by non-EU vendors to European non-taxable persons (i.e. consumers). The Directive established that the “place of supply” for such business-to-consumer transactions should be the place where the European consumer “is established, has his permanent address or usually resides”.¹⁷⁴ The Directive, therefore, regulated the “place of supply” for B2C import transactions.

It should be noted that in order to supplement the “place of supply” rules established by the Directive 2002/38/EC, further documents were adopted. New rules, which dealt with the transactions not addressed by the previous Directive, were contained in the Council Regulation 1777/2005¹⁷⁵ and later implemented in the Directive 2006/112/EC.¹⁷⁶ These rules were based primarily on the OECD principles regulating the place of supply¹⁷⁷ and related to the services supplied electronically to non-EU customers or EU taxable persons (i.e. businesses). For such services the place of supply was deemed to be the place “where the customer has established his

¹⁷² See *VAT Rates Applied in the Member States of the European Union*, *supra* note 126.

¹⁷³ WESTBERG, *supra* note 7, at 153.

¹⁷⁴ Council Directive 2002/38/EC, *supra* note 159, art. 1(1)(b), at 42.

¹⁷⁵ Council Regulation 1777/2005 of 17 October 2005 Laying Down Implementing Measures for Directive 77/388/EEC on the Common System of Value Added Tax, 2005 O.J. (L 288) 1.

¹⁷⁶ See Council Directive 2006/112/EC, *supra* note 126.

¹⁷⁷ OECD, *The Application of Consumption Taxes to the International Trade in Services and Intangibles: Progress Report and Draft Principles*, OECD.ORG (2005), <http://www.oecd.org/dataoecd/51/32/34422650.PDF> (last visited Mar. 25, 2011).

business or has a fixed establishment for which the service is supplied, or, in the absence of such a place, the place where he has his permanent address or usually resides”.¹⁷⁸ Thus, the “place of supply” rules for exports and B2B transactions within the EU were determined.

The Directive 2002/38/EC was a big step in the direction of modifying VAT rules to regulate e-commerce taxation. It attempted to eliminate non-neutrality between EU and non-EU vendors supplying electronic services to European customers. It also provided the rules for determination of the “place of supply”. However, the Directives discussed above did not bring any light on the problem of the buyer’s identification and establishing his location/residence and status (business or consumer). It remained unclear how merchants could discover information about the buyers and how tax authorities could trace electronic transactions. Until there are reliable technical means for doing both, the collection of VAT cannot be effective.¹⁷⁹ Furthermore, the supply of services by EU operators to EU consumers was still based on the origin principle,¹⁸⁰ although the destination principle had already been internationally accepted as the proper principle for consumption taxes, including VAT.¹⁸¹ For these reasons, the work of the European Union in the direction of the development of new rules for e-commerce taxation continued. As a result of this work, substantial changes were made in 2008, which will be discussed in the next section.

¹⁷⁸ Council Directive 2006/112/EC, *supra* note 126, Art. 56(1)(k), at 18.

¹⁷⁹ SCHENK & OLDMAN, *supra* note 6, at 215.

¹⁸⁰ COM (1998) 374 final, *supra* note 145, at 7.

¹⁸¹ SCHENK & OLDMAN, *supra* note 6, at 60.

2.3. VAT package of 12 February 2008: new rules on electronic commerce taxation

The analysis conducted in the previous section demonstrated that the Council Directive 2002/38/EC¹⁸² did not solve all the problems related to the application of VAT to the rapidly developing e-commerce. Thus, the need for new rules continued to be present. This section will address the latest EU reforms in the area of e-commerce taxation that were implemented through the VAT package of 12 February 2008 (two Council Directives and one Council Regulation).¹⁸³ It will, firstly, analyse these three documents providing the explanation of the changes brought by them. The section will conclude with the summary of the e-commerce taxation areas, which still remain problematic and, thus, require further regulation.

Among the three documents, the Directive 2008/8/EC¹⁸⁴ was the one that brought the most substantial changes. It established new taxation rules for both business-to-business and business-to-consumer transactions. As regards B2B transactions, the “place of supply” rules established earlier¹⁸⁵ remained unchanged. The place where the services were consumed (i.e. where the recipient was established) was confirmed to be the “place of supply”.¹⁸⁶ However, based primarily on the work of the OECD in this legal area,¹⁸⁷ the Directive established a new mechanism called “reverse charge”. This mechanism, which was applied earlier only to the

¹⁸² Council Directive 2002/38/EC, *supra* note 159.

¹⁸³ See Council Directive 2008/8/EC, *supra* note 162; Council Directive 2008/9/EC of 12 February 2008 Laying Down Detailed Rules for the Refund of Value Added Tax, Provided for in Directive 2006/112/EC, to Taxable Persons not Established in the Member State of Refund but Established in Another Member State, 2008 O.J. (L 44) 23; Council Regulation 143/2008 of 12 February 2008 Amending Regulation (EC) No 1798/2003 as Regards the Introduction of Administrative Cooperation and the Exchange of Information Concerning the Rules Relating to the Place of Supply of Services, the Special Schemes and the Refund Procedure for Value Added Tax, 2008 O.J. (L 44) 1.

¹⁸⁴ Council Directive 2008/8/EC, *supra* note 162.

¹⁸⁵ Council Directive 2006/112/EC, *supra* note 126, Art. 56(1)(k), at 18.

¹⁸⁶ Council Directive 2008/8/EC, *supra* note 162, art. 2(1), at 14-15.

¹⁸⁷ See Rep. from Working Party No. 9, OECD, *Consumption Tax Aspects of Electronic Commerce*, OECD.ORG (Feb. 2001), <http://www.oecd.org/dataoecd/37/19/2673667.pdf>.

imports of tangible products,¹⁸⁸ is now applied to the transactions in which a company established in one member state (a taxable person) supplies electronic services to a company established in another member state (also a taxable person).¹⁸⁹ The meaning of the reverse charge mechanism is as follows: the recipient of the service is obliged to “self-assess the appropriate amount of VAT on the acquired service”.¹⁹⁰ The new scheme appears to be very efficient. Indeed, before the changes, the seller was obliged to collect and remit output VAT, while the buyer was entitled to deduct the same amount in the form of input VAT.¹⁹¹ Under the new system, the buyer should account for both output and input VAT, and as a result, no VAT is actually paid to the tax authorities by either a seller or a buyer.¹⁹² Thus, with the establishment of the reverse charge mechanism for intra-EU B2B transactions, the process of tax collection was simplified significantly.

It should be emphasized that the reverse charge mechanism was not considered a practical solution for B2C transactions, especially considering the US unsuccessful experience with the use tax.¹⁹³ For B2C transactions, the Directive established differential treatment for the supplies made by the vendors from outside the EU and supplies made by European operators. For the first type of transactions, temporary rules established by the Council Directive 2002/38/EC¹⁹⁴ were considered to be working effectively¹⁹⁵ and, thus, were extended from the 1 January 2010 as a permanent measure.¹⁹⁶ Hence, all non-EU vendors are required to register in

¹⁸⁸ BASU, *supra* note 2, at 144.

¹⁸⁹ Council Directive 2008/8/EC, *supra* note 162, rec. 7, at 1.

¹⁹⁰ *Id.*

¹⁹¹ JULIAN J.B. HICKEY ET AL., E-COMMERCE: LAW, BUSINESS AND TAX PLANNING 139 (Jordans 2000).

¹⁹² WESTBERG, *supra* note 7, at 170.

¹⁹³ WESTIN, *supra* note 11, at 125.

¹⁹⁴ Council Directive 2002/38/EC, *supra* note 159.

¹⁹⁵ COM (2006) 210 final, *supra* note 148, at 3.

¹⁹⁶ Council Directive 2008/8/EC, *supra* note 162, art. 2, at 12.

one of the member states and pay VAT at that state for all supplies to European consumers based on the tax rates of the countries of consumption.¹⁹⁷

The second type of B2C transactions regulated by the Directive included those electronic services that involved European suppliers and European consumers not established in one member state. For this type of transactions, the country-of-origin rules applied earlier were extended until 31 December 2014.¹⁹⁸ According to these rules, a European company which is established in one member state and supplies electronic services to the consumers in other member states is required to pay VAT only to its local tax authorities at the tax rates of its own member state. Thus, a Luxembourg company remits VAT at the rate of 15% for all supplies to European companies, whereas a Swedish company pays 25% for the same supplies.¹⁹⁹ Therefore, the country-of-origin principle for such transactions remains in effect.

However, from 1 January 2015 the origin principle is eliminated completely.²⁰⁰ New rules will be applicable, which will require each European company supplying services to the consumers from other member states to remit VAT at the tax rates of the country of consumption. In other words, European suppliers will have to pay VAT to the authorities of its own member state but based on the differential tax rates determined by the tax legislation of the recipient's member state. These new rules, although not in effect yet, will be of great importance for the EU e-commerce taxation. First, they will solve the issue of "non-neutrality" between European vendors and suppliers from outside the EU discussed in the previous section. Second, the new rules will ensure that the remains of the country-of-origin principle would be eliminated

¹⁹⁷ *Id.* art. 5(11)-(14), at 19-20.

¹⁹⁸ *Id.* art. 2, at 12.

¹⁹⁹ See *VAT Rates Applied in the Member States of the European Union*, *supra* note 126.

²⁰⁰ Council Directive 2008/8/EC, *supra* note 162, Art. 5(15), at 20-21.

completely from the VAT regulation of e-commerce. Thus, from that point on the country-of-destination principle will be applicable to the taxation of all electronic transactions.

However, the Directive did not regulate how the supplier is supposed to discover the residence of its customers, which is necessary for the application of new rules. It is notable that the OECD made substantial findings in this field. Specifically, it analysed consumer self-declaration, credit card billing address, IP traces and digital certificates as possible methods to identify the buyer.²⁰¹ Nevertheless, none of these or any other methods appeared in the EU documents as proper means for the recipient's identification.

The second document adopted as a part of the VAT package of 12 February 2008 was the Council Directive 2008/9/EC, which laid down the procedure for the refund of VAT to European companies not established in the refunding member states.²⁰² The Directive obliged each member state to develop an electronic system through which the companies established in the given member state might claim the refund of VAT incurred in another member state. These measures were intended to simplify the VAT refund procedure, since European companies would have an opportunity to apply electronically for the VAT refund in their own country, without the necessity to deal with the tax authorities of all countries where the VAT was charged.

It should be noted, however, that member states were supposed to enact all necessary laws and make electronic portals operational by 1 January 2010,²⁰³ so that the companies could use the system for the refund of VAT incurred in 2009.²⁰⁴ Nevertheless, the portals were not established in some member states and businesses could not use the system of refund

²⁰¹ See OECD, *Report by the Technology Technical Advisory Group (TAG)* at 5-7, OECD.ORG (Dec. 2000), <http://www.oecd.org/dataoecd/46/2/1923248.pdf>.

²⁰² Council Directive 2008/9/EC, *supra* note 183.

²⁰³ *Id.* art. 29(1), at 28.

²⁰⁴ *Id.* art. 28, at 28.

effectively.²⁰⁵ Because of this, the deadline for the submission of VAT refund applications for the expenses incurred in 2009 was extended to 31 March 2011.²⁰⁶ The necessity to extend the deadline clearly indicates that the establishment of a simplified and efficient system of VAT refund is not easy. Moreover, it is still unclear whether all member states would be able to comply with the new deadline and how effective the new system will be in practice.

The last constituent document of the VAT package of 12 February 2008 was the Council Regulation 143/2008, which provided for the measures necessary for ensuring administrative cooperation and exchange of information between the member states.²⁰⁷ The Regulation required member states to introduce the systems of electronic exchange of information, which were necessary for the proper functioning of the reverse charge mechanism, as well as of the special scheme for non-EU vendors and VAT refund procedure.

To conclude, the European Union has done considerable work in the direction of adapting existing VAT rules to the realities of e-commerce. The measures were adopted to restore a fair balance between the taxation of European and non-European companies. The specifics of B2B and B2C transactions were taken into account, and separate rules were established. However, constant legislative amendments, as well as setting the late entry into force for some measures (e.g. 1 January 2015 for new rules on intra-Union B2C transactions) demonstrate that the EU is still in the transitional period of establishing rules for e-commerce taxation. Furthermore, some problems in this area remain unsolved. For instance, it is not regulated which methods are appropriate for the identification of the buyer in B2C transactions. Thus, the VAT rules for electronic services will certainly continue to be developed and changed in the European Union.

²⁰⁵ Council Directive 2010/66/EU of 14 October 2010 Amending Directive 2008/9/EC Laying Down Detailed Rules for the Refund of Value Added Tax, Provided for in Directive 2006/112/EC, to Taxable Persons not Established in the Member State of Refund but Established in Another Member State, rec. 3, 2010 O.J. (L 275) 1.

²⁰⁶ *Id.* art 1, at 1.

²⁰⁷ Council Regulation 143/2008, *supra* note 183.

CHAPTER 3. TAXATION OF ELECTRONIC COMMERCE IN THE RUSSIAN FEDERATION

Although Russia is still considered to be a developing country, it has recently experienced a tremendous growth in the number of Internet users.²⁰⁸ Individual purchasers and businesses buy more and more goods online both from local and foreign retailers. However, given the absence of proper tax regulation, most online purchases simply escape taxation. In fact, Russia is among the ten countries that have the largest fiscal losses resulting from replacing physical delivery of goods by electronic delivery.²⁰⁹ The purpose of this chapter is twofold. The first section will examine VAT legislation that currently exists in Russia focusing on the issues related to the application of this legislation to Internet transactions. The second section will address the possibility of adopting in Russia any of the U.S. and EU regulations in the area of e-commerce taxation and formulate the amendments that should be introduced into the Russian tax legislation.

3.1. Problems of the application of the traditional VAT system to electronic commerce

The Russian system of indirect taxation is based on value added tax and is in many respects similar to the VAT system existing in the EU. According to the Russian Tax Code, VAT is levied on all sales of goods in the territory of Russia, as well as on imports of goods from other

²⁰⁸ See, e.g. *Top 20 Countries with the Highest Number of Internet Users*, INTERNETWORLDSTATS.COM, <http://www.internetworldstats.com/top20.htm> (last updated Jun. 30, 2010) (stating that Russia is currently on the 7th place in the world rating of the countries with the highest number of Internet users and estimating that there are 59,700,000 of Internet users in Russia).

²⁰⁹ Susanne Teltscher, UNCTAD, *Tariffs, Taxes and Electronic Commerce: Revenue Implications for Developing Countries*, POLICY ISSUES IN INTERNATIONAL TRADE AND COMMODITIES, Study ser. No. 5, Doc. UNCTAD/ITCD/TAB/5, at 19 (UN 2000).

countries.²¹⁰ As for exports, the general rule is that they are not taxed.²¹¹ Thus, the country-of-destination principle of taxation, which is “almost universally employed”²¹² for indirect taxation, is typically applied in Russia.

In the absence of any specific rules on e-commerce, several problems occur when general VAT rules are applied to electronic transactions. The first problem that demonstrates insufficiency of the traditional rules for regulation of e-commerce taxation relates to the classification of digital products as goods or as services. The Russian Tax Code distinguishes three main categories of transactions: sale or import of goods, performing a work, and supply of services. The term “goods” comprises “any property sold or intended to be sold”.²¹³ The term “work” covers “any activity, the results of which have tangible expression and can be consumed by an organization and/or an individual”.²¹⁴ Finally, the term “service” is deemed to include “any activity, the results of which do not have tangible expression and are consumed in the process of the performance of such activity”.²¹⁵ Some commentators interpret these provisions literally and conclude that digital products cannot be considered “work” since they do not have tangible expression”.²¹⁶ Nor can they be regarded “services” because these products are not “consumed” when the activity is conducted. Therefore, all products supplied in a digital form must be classified as “goods”.²¹⁷

²¹⁰ NALOGOVYI KODEKS ROSSIISKOI FEDERATSII, CHAST' VTORAIA OT 5 AVGUSTA 2000 G. NO. 117-FZ [NK RF, Ch. 2] [Tax Code, Part 2, of Aug. 5, 2000] art. 146, SOBRANIE ZAKONODATEL'STVA ROSIISKOI FEDERATSII [SZ RF] [Russian Federation Collection of Legislation] 2000, No. 32, Item 3340.

²¹¹ See *id.* art. 148, 151, 164.

²¹² McLure, *supra* note 8, at 61.

²¹³ NALOGOVYI KODEKS ROSSIISKOI FEDERATSII, CHAST' PERVAIA OT 31 IULIA 1998 G. NO. 146-FZ [NK RF, Ch. 1] [Tax Code, Part 1, of Jul. 31, 1998] art. 38(3), SOBRANIE ZAKONODATEL'STVA ROSIISKOI FEDERATSII [SZ RF] [Russian Federation Collection of Legislation] 1998, No. 31, Item 3824 [translation by author].

²¹⁴ *Id.* art 38(4) [translation by author].

²¹⁵ *Id.* art 38(5) [translation by author].

²¹⁶ Nadezhda M. Vasilieva. Pravovoe Regulirovanie Nalogooblozheniia elektronnoi kommercii [Legal Regulation of Taxation of Electronic Commerce] at 118 (2007) (unpublished S.J.D. dissertation, Higher School of Economics) (on file with author).

²¹⁷ *Id.*

However, Russian tax authorities appear to adopt a different approach to categorisation of digital products, since they are more inclined to treat digital products' supplies as supplies of services. In particular, Moscow Tax Office considers sales of computer software in a digital form to be "supplies of services".²¹⁸ Such position is more appropriate, as it coincides with the European rules on treating all digital supplies as "electronically supplied services".²¹⁹ Nevertheless, the letters from Moscow Tax Office do not have obligatory character, and presently, nothing prevents other tax authorities from adopting a different approach.

Characterisation of supply of digital products as a sale of goods or as a supply of services is of high importance, because, similarly to the U.S. and the EU, differential treatment is established in Russia for these two types of transactions. In particular, the problems have occurred with regards to exports and imports of digital products. If digital products are considered goods, then, according to the general rules for goods, imports will be subject to VAT at the rate of 18%, whereas exports will be zero-rated.²²⁰ Thus, the destination principle of taxation would be applied to electronic transactions.

If digital products are deemed to be services, the rate of VAT in the cases of imports and exports will depend on whether the service is supplied in the territory of Russia or not. Given the absence of specific provisions for determination of the "place of supply" in electronic transactions, it is necessary to analyse the general rules. Current provisions of the Tax Code

²¹⁸ See Pis'mo Upravleniya MNS po g. Moskve No. 15-08/9924 ot 17 marta 2000 g. o Naloge na Dobavlennuiu Stoimost' s Inostrannykh Kompanii Proizvoditelei pri Oplate Za Programmnye Producty [Letter of Moscow Tax Office No. 15-08/9924 of Mar. 17, 2000 on VAT Imposed on Foreign Companies for Purchases of Software], SPS KONSULTANTPLUS [Database ConsultantPlus], 2000; Pis'mo Upravleniya MNS po g. Moskve No. 24-11/6478 ot 13 fevralia 2002 g. o Nalogooblozhenii Pribyli Inostrannykh Iuridicheskikh Lits [Letter of Moscow Tax Office No. 24-11/6478 of Febr. 13, 2002 on Taxation of Profits of Foreign Business Entities], SPS KONSULTANTPLUS [Database ConsultantPlus], 2002.

²¹⁹ See Council Directive 2006/112/EC, *supra* note 126, Annex II, at 68.

²²⁰ NK RF, Ch.2, *supra* note 210, art. 146, 148, 151, 164.

determine “place of supply” of certain types of services based on the location of the purchaser.²²¹

Among such services are services involving the transfers of copyright, trademark, patent and other IP rights.²²² The question arises whether sale of software is subject to this “location of purchaser” rule and, therefore, should be taxed accordingly.

In 2002 Moscow Tax Office expressed the position that the “place of supply” in the transactions involving sales of software is determined by the location of the purchaser, because such transactions include the transfer of copyright.²²³ If such position is adopted, sales to foreign customers are not taxed, since the purchaser is not located in the territory of Russia. At the same time, sales of software by foreign retailers to Russian consumers are subject to 18% VAT. Thus, neutrality between supplies of physical products and supplies of digital products is ensured, as all exports regardless of the form are zero-rated and all imports are standard-rated.

However, in 2004 the Russian Tax Ministry adopted a different approach, which implied non-equal treatment of electronic and conventional services.²²⁴ Specifically, it stated that the “place of supply” is governed by the “location of purchaser” rule only when a transaction involves an outright sale of an IP right and the change in IP right’s ownership takes place. As for transactions in which only a license to use IP rights is granted without a transfer of ownership, the place of supply is not determined by the purchaser’s location.²²⁵ Since sales of digital products do not typically involve transfer of ownership, according to this approach, imported digital products are not subject to VAT, whereas exported ones are taxed. Thus, what the Russian Tax Ministry suggested was that the origin principle should apply to such transactions. This

²²¹ *Id.* art. 148(1)(4), 148(1.1)(4).

²²² *Id.* art. 148(1)(4).

²²³ Pis’mo Upravleniya MNS po g. Moskve No. 15-08/9924, *supra* note 218.

²²⁴ Pis’mo MNS No. 03-1-08/1222/17 ot 17 maia 2004 g. o Naloge na Dobavlennuiu Stoimost’ [Letter of the Russian Tax Ministry No. 03-1-08/1222/17 of May 17, 2004 on VAT], SPS KONSULTANTPLUS [Database ConsultantPlus], 2004.

²²⁵ *Id.*

would certainly violate neutrality between electronic and conventional types of commerce, because different principles (origin and destination) would govern the transactions depending on the form of supply.

The Ministry of Finance attempted to establish a fairer approach than the one of the Tax Ministry. In 2005 it stated that transactions involving a grant of exclusive license also fall under the “location of purchaser” rule.²²⁶ A year later, the Ministry of Finance extended the “location of purchaser” rule to non-exclusive licenses as well.²²⁷ Although the position of the Ministry of Finance has been intensively criticized,²²⁸ it is more appropriate for e-commerce taxation, since it provides for the application of the “location of purchaser” rule to supplies of digital products, and, thus, attempts to eliminate non-neutral tax treatment of electronic and conventional commerce.

Based on the analysis of the abovementioned ministerial letters, three conclusions can be drawn. First, it remains unclear whether digital products are treated as goods or as services. Although the tendency of Moscow tax authorities is to treat them as services, this does not necessarily mean that tax offices in other regions will follow this approach. Second, given the absence of specific e-commerce rules on the “place of supply”, tax and finance authorities attempt to regulate online transactions through the existing rules. However, the application of rules on IP rights transfer to Internet sales does not work effectively, as the authorities interpret and apply these provisions differently. Third, the letters from both the Ministry of Finance and the Tax Ministry do not have a mandatory character in Russia. Ministerial letters only interpret

²²⁶ Pis'mo Ministerstva Finansov No. 03-04-08/116 ot 11 maia 2005 g. [Letter of the Russian Ministry of Finance No. 03-04-08/116 of May 11, 2005], SPS KONSULTANTPLUS [Database ConsultantPlus], 2005.

²²⁷ Pis'mo Ministerstva Finansov No. 03-04-08/12 ot 18 ianvaria 2006 g. [Letter of the Russian Ministry of Finance No. 03-04-08/12 of Jan. 18, 2006], SPS KONSULTANTPLUS [Database ConsultantPlus], 2006.

²²⁸ See, e.g., M.V. Moiseev, *Tovarnyi Znak: Bukhgalterskii Uchet i Nalogooblozhenie* [Trademark: Accounting and Taxation], AKTUAL'NYE VOPROSY BUKHGALTERSKOGO UCHETA I NALOGOOBLOZHENIYA [Urgent Matters of Accounting and Taxation] (Jul. 20, 2006), available at http://www.innovbusiness.ru/content/document_r_3108FE95-E1C9-46B5-AB02-AB8E60ED27EC.html.

legal provisions rather than create new legal norms.²²⁹ Consequently, no tax office in Russia is required to follow the rules expressed in the letters of the Tax Ministry or the Ministry of Finance. While different approaches adopted by two ministries continue to co-exist, tax authorities may either adopt one of them, or combine both, or may even create a new approach if they are willing to do so. Hence, the situation of total uncertainty for taxpayers exists with regards to the application of the VAT rules to e-commerce.

It should be admitted that certain VAT legislation was adopted in Russia that regulates, although indirectly and partially, the taxation of e-commerce. Specifically, from 1 January 2008 all transactions involving transfer of exclusive rights to use computer software under a license agreement are exempt from VAT.²³⁰ Remarkably, this provision introduced into the Tax Code established a zero rate for such transactions without categorising software as either goods or services.²³¹ The amended Tax Code provision does not specify whether it covers supplies of software in a digital form, or in a physical form, or both. The Ministry of Finance has already issued about thirty letters attempting to interpret this provision.

Nevertheless, the analysis of these letters reveals that the Ministry of Finance itself appears to be uncertain about the scope of the legislative VAT exemption, as it changes its position from letter to letter. Namely, it firstly stated that the exemption relates only to digital supplies,

²²⁹ See Postanovlenie Prezidiuma Vysshego Arbitrazhnogo Suda RF No. 7526/07 ot 9 oktiabria 2007 g. [Ruling of the Presidium of the Highest Arbitration Court of the RF No. 7526/07 of Oct. 9, 2007], VESTNIK VYSSHEGO ARBITRAZHNOGO SUDA RF [VESTN. VAS] [The Highest Arbitration Court of the RF Reporter] 2008, No. 1.

²³⁰ Federal'nyi Zakon RF No. 195-FZ o Vnesenii Izmenenii v Otdel'nye Zakonodatel'nye Akty Rossiiskoi Federatsii v Chasti Formirovaniia Blagopriiatnykh Nalogovykh Uslovii dlia Finansirovaniia Innovatsionnoi Deiatel'nosti ot 19 iiulia 2007 g. [Federal Law of the Russian Federation on Amending Certain Legislative Acts of the Russian Federation to Create Favourable Tax Conditions for the Financing of Innovative Activity No. 195-FZ of Jul. 19, 2007], SOBRANIE ZAKONODATEL'STVA ROSIISKOI FEDERATSII [SZ RF] [Russian Federation Collection of Legislation] 2007, No. 31, Item 3991.

²³¹ NK RF, Ch.2, *supra* note 210, art. 149(2)(26).

whereas sales of software in a physical form (e.g. on a CD) are standard-rated.²³² However, in another letter, the Ministry of Finance acknowledged that all supplies of software are zero-rated irrespective of the form.²³³ This has caused heated debates among lawyers and accountants,²³⁴ but no definite solution has been found and no uniform interpretation has been accepted. Therefore, it is still unclear how tax authorities as well as courts will apply this provision and whether sales of software will be free from VAT regardless of the form of supply. Furthermore, the law named above dealt only with the supplies of software without considering any other digital products (movies, music, images, etc.). Even if under that law, all supplies of software are exempt from VAT, it remains uncertain how all other digital supplies should be taxed.

A further problem related to the application of the existing VAT rules to electronic commerce concerns the transactions in which foreign vendors sell digital products to Russian consumers. Currently, foreign suppliers are not obliged to collect and remit VAT to Russian authorities. Therefore, the problem occurs similar to the one that exists in the U.S. where out-of-state sellers do not pay sales tax while domestic sellers do. The EU also faced the same problem when domestic suppliers who were required to pay VAT found themselves in a disadvantageous position as compared to foreign merchants who were free from VAT. The identical distortion of tax treatment exists in Russia, which needs to be regulated.

Several other problems could be distinguished that currently exist in Russia, as well as in all other countries attempting to regulate e-commerce indirect taxation. In particular, similarly to the U.S. and EU vendors, Russian sellers face the problem of identification of the buyer and

²³² Pis'mo Ministerstva Finansov No. 03-07-08/338 ot 19 noiabria 2007 g. [Letter of the Russian Ministry of Finance No. 03-07-08/338 of Nov. 19, 2007], SPS KONSULTANTPLUS [Database ConsultantPlus], 2007; Pis'mo Ministerstva Finansov No. 03-07-11/649 ot 29 dekabria 2007 g. [Letter of the Russian Ministry of Finance No. 03-07-11/649 of Dec. 29, 2007], SPS KONSULTANTPLUS [Database ConsultantPlus], 2007.

²³³ Pis'mo Ministerstva Finansov No. 03-07-15/44 ot 1 apreliia 2008 g. [Letter of the Russian Ministry of Finance No. 03-07-15/44 of Apr. 1, 2008], SPS KONSULTANTPLUS [Database ConsultantPlus], 2008.

²³⁴ See, e.g., M.L. Kosul'nikova, *Est' li NDS pri prodazhe programmnogo obespecheniia?* [Is the VAT Imposed on Sales of Software?], KLERK.RU (Mar. 7, 2008), <http://www.klerk.ru/buh/articles/102697>.

establishing his location. Furthermore, Russian tax authorities, in the same way as all tax authorities worldwide, do not have reliable technical means to trace electronic transactions. As a result, most electronic transactions escape taxation, and the government incurs revenue losses.

Thus, the application of the existing VAT rules to e-commerce in Russia has caused several problems, which resemble greatly the problems occurred in the U.S. and the EU. First, it is unclear whether digital products are classified as goods or as services. Second, the controversial issue is when and at what rate Russia is entitled to tax exports and imports of digital products. Third, foreign suppliers involved in B2C transactions are not subject to Russian VAT and, therefore, have a competitive advantage as compared to Russian vendors. Fourth, there are no reliable methods for determination of the buyers' identity and location, as well as for tracing electronic transaction. Given the fact that all main problems of e-commerce taxation that occurred in Russia have become a subject of concern in both the U.S. and the EU as well, the next section will evaluate whether experience of the latter jurisdictions in regulating this area may help to develop appropriate solutions for the Russian legislation.

3.2. Russian Tax Code: amendments to be made

Due to the serious problems occurring when the existing VAT rules are applied to electronic transactions, the need to modify the Russian VAT system has become evident. This section will examine in which form the amendments related to e-commerce should be introduced into the Russian tax legislation. It will also evaluate whether any of the measures undertaken by the U.S. and the EU in order to regulate e-commerce taxation can be transplanted into the Russian legal system. Furthermore, specific proposals will be formulated concerning the amendments that should be inserted into the Russian Tax Code.

To date, no legislative changes have been made in order to adapt the existing system of VAT to the specifics of electronic commerce. The State Duma (i.e. the Russian legislative body) has considered and rejected several Bills on Electronic Trade,²³⁵ however none of them contained any provisions on the issue of taxation. The only legislative initiative touching upon the area of e-commerce taxation was the Bill on Electronic Transactions introduced to the State Duma in 2000.²³⁶ According to that bill, all taxes and other charges on electronic transactions should be imposed in accordance with the Russian legislation.²³⁷ In other words, the bill stipulated that no specific rules would be created for e-commerce and, therefore, Internet transactions would be subject to the existing VAT system. Although the Bill on Electronic Transactions was not adopted, its provision named above reflects the actual situation of e-commerce taxation in Russia. The existing tax rules are applied to e-commerce, but they cannot ensure efficient taxation of electronic transactions, and, therefore, have to be changed.

There have been several positions expressed concerning the form in which the amendments on e-commerce have to be made a part of the Russian legislation. According to the first position, a special law on electronic transactions is required to regulate different legal aspects of e-commerce, including the issue of taxation.²³⁸ The proponents of the second position

²³⁵ See Proekt Federal'nogo Zakona No. 11081-3 ob Elektronnoi Torgovle ot 3 oktiabria 2000 g. [Bill of the Law No. 11081-3 on Electronic Trade of Oct. 3, 2000], SPS KONSULTANTPLUS [Database ConsultantPlus], 2000; Proekt Federal'nogo Zakona No. 47432-3 ob Elektronnoi Torgovle ot 12 ianvaria 2001 g. [Bill of the Law No. 47432-3 on Electronic Trade of Jan. 12, 2001], SPS KONSULTANTPLUS [Database ConsultantPlus], 2001; Proekt Federal'nogo Zakona No. 132754-4 ob Elektronnoi Torgovle ot 24 ianvaria 2005 g. [Bill of the Law No. 132754-4 on Electronic Trade of Jan. 24, 2005], SPS KONSULTANTPLUS [Database ConsultantPlus], 2005; Proekt Federal'nogo Zakona No. 136018-4 ob Elektronnoi Torgovle ot 31 ianvaria 2005 g. [Bill of the Law No. 136018-4 on Electronic Trade of Jan. 31, 2005], SPS KONSULTANTPLUS [Database ConsultantPlus], 2005; Proekt Federal'nogo Zakona No. 310163-4 ob Elektronnoi Torgovle ot 16 iyunia 2006 g. [Bill of the Law No. 310163-4 on Electronic Trade of Jun. 16, 2006], SPS KONSULTANTPLUS [Database ConsultantPlus], 2006.

²³⁶ See Proekt Federal'nogo Zakona No. 27813-3 o Sdelkakh, Sovershaemykh pri Pomoshchi Elektronnykh Sredstv Sviazi (ob Elektronnykh Sdelkakh) ot 16 noiabria 2000 g. [Bill of the Law No. 27813-3 on Transactions Conducted by Electronic Means (on Electronic Transactions) of Nov. 16, 2000], SPS KONSULTANTPLUS [Database ConsultantPlus], 2000.

²³⁷ *Id.* art. 21.

²³⁸ See, e.g. Bills of the Law on Electronic Trade, *supra* note 235.

argue that a separate chapter on e-commerce taxation should be added to Part 2 of the Russian Tax Code,²³⁹ which would mean a creation of a new tax for e-commerce. The third group of scholars asserts that in order to provide for effective regulation of e-commerce taxation it is sufficient to introduce certain changes into some of the Tax Code articles, without creating new taxes and special laws.²⁴⁰

The third position requiring only certain articles of the Tax Code to be changed is the most appropriate for the following reasons. First of all, regulation of electronic commerce taxation by the same provisions that regulate taxation of conventional types of commerce is most likely to ensure the observance of the neutrality principle recognized by the U.S., the EU and international organizations as the crucial principle of electronic commerce taxation²⁴¹. Second, governments all over the world, including the U.S. and the EU, have discussed the ideas of imposing new taxes on e-commerce (e.g. the “bit tax”) and unanimously rejected this idea.²⁴² Therefore, Russia should follow the international tendency and regulate e-commerce taxation within the framework of existing taxes, without creating new ones.

As indicated in the previous section, the first problem that requires regulation relates to the distinction of goods and services and attribution of digital products to one of these categories for the purposes of VAT. The U.S. experience in regulating this matter does not appear to provide a reliable guidance. Since no federal legislation has been adopted, the approaches to

²³⁹ See, e.g., STANISLAV K. ILICHEV, OSOBENNOSTI NALOGOVBLOZHENIIA V SFERE ELECTRONNOI KOMMERCI [SPECIFICS OF ELECTRONIC COMMERCE TAXATION] 104 (Market DC 2004).

²⁴⁰ See, e.g., Vasilieva, *supra* note 216, at 131; ASTAMUR A. TEDEEV, ELEKTRONNAIA KOMMERTSIIA (ELEKTRONNAIA EKONOMICHESKAIA DEIATEL'NOST'). PRAVOVOE REGULIROVANIE I NALOGOVBLOZHENIE [ELECTRONIC COMMERCE (ELECTRONIC ECONOMIC ACTIVITY). LEGAL REGULATION AND TAXATION] 190-191 (PRIOR 2002).

²⁴¹ See *Electronic Commerce: Taxation Framework Conditions. A Borderless World: Realising the Potential of Electronic Commerce*, *supra* note 160.

²⁴² *Selected Tax Policy Implications of Global Electronic Commerce*, *supra* note 18, at §7.1; COM (1998) 374 final, *supra* note 145.

classification of digital goods differ from state to state causing uncertainty for taxpayers.²⁴³ Although the SSUTA attempted to provide uniform definitions and specific rules for digital products,²⁴⁴ the Agreement cannot and is not applied to e-commerce because of the constitutional restraints.²⁴⁵ Since the SSUTA's rules defining digital goods as a category separate from both tangible personal property and services exist only on paper and are not working in practice, it is presently impossible to evaluate their effectiveness. Therefore, they should not be transplanted into the Russian tax legislation.

As for the EU practice of dealing with digital products, their regulation does indeed represent an appropriate solution of the problem and can be taken as a model for the Russian legislation. Specifically, the Directive 2006/58/EC considers digital products as covered by the term "electronically supplied services" and provides for the indicative list of such services.²⁴⁶ Thus, supplies of digital products are uniformly treated as a specific type of services in the EU member states. Taking into account that the European rules operate successfully in practice and that the OECD is suggesting the same approach²⁴⁷, such rules should be introduced into the Russian legal system.

In order to regulate the taxation of digital goods, it is necessary to amend articles 38 and 146 of the Russian Tax Code, which cover, respectively, the objects of taxation in general and the objects of VAT, in particular. It is proposed to extend the definition of "services" contained in article 38(5)²⁴⁸ by including a statement that the term "services" includes "electronically supplied services". Furthermore, it is necessary to provide for the list of services covered by the

²⁴³ BASU, *supra* note 2, at 167.

²⁴⁴ *Streamlined Sales and Use Tax Agreement*, *supra* note 82, Appendix C.

²⁴⁵ Cowne, *supra* note 119, at 136.

²⁴⁶ Council Directive 2006/112/EC, *supra* note 126, Annex II, at 68.

²⁴⁷ See *Electronic Commerce: Taxation Framework Conditions. A Borderless World: Realising the Potential of Electronic Commerce*, *supra* note 160.

²⁴⁸ See NK RF, Ch.1, *supra* note 213, art. 38(5).

term “electronically supplied services”, taking the indicative list contained in the EU Directive²⁴⁹ as the guidance. In addition, article 146(1)(1) should also be supplemented by the statement that services that are subject to VAT include “electronically supplied services”. This would solve the problem of attributing digital products to either goods or services, as all digital supplies would be treated as a type of services.

The second problem calling for changes to be made in the Russian tax legislation concerns the “place of supply” rules, which determine the jurisdiction entitled to tax. There are two basic principles governing the “place of supply”: the destination principle and the origin principle.²⁵⁰ The destination principle is employed in the U.S. system of sales and use taxes.²⁵¹ Although the EU still represents a “hybrid origin-destination system”,²⁵² it appears to be eliminating the remains of the origin principle, and from 1 January 2015 the destination principle will apply to all electronic transactions.²⁵³ As for the Russian VAT system, it is generally based on the destination principle and, in fact, it moves in the direction of establishing this principle for all types of transactions.²⁵⁴ Establishing the destination principle for electronic transactions in Russia would coincide with the worldwide tendency of applying this principle to indirect taxation. Furthermore, it would prevent the distortion between tax treatment of foreign and domestic suppliers that occurred in the EU when the origin principle was applied there.

²⁴⁹ Council Directive 2006/112/EC, *supra* note 126, Annex II, at 68.

²⁵⁰ See BASU, *supra* note 2, at 60-63. See also McLure, *supra* note 8, at 61-62 (discussing advantages and disadvantages of both principles).

²⁵¹ WESTBERG, *supra* note 7, at 154.

²⁵² SCHENK & OLDMAN, *supra* note 6, at 60.

²⁵³ Council Directive 2008/8/EC, *supra* note 162, Art. 5(15), at 20-21.

²⁵⁴ See, e.g. Federal'nyi Zakon RF No. 102-FZ o Vnesenii Izmenenii v Chast' Vtoruiu Nalogovogo Kodeksa Rossiiskoi Federatsii i Nekotorye Drugie Akty Zakonodatel'stva Rossiiskoi Federatsii ot 18 avgusta 2004 g. [Federal Law of the Russian Federation on Amending Part Two of the Tax Code of the Russian Federation and Some Other Acts of Legislation of the Russian Federation No. 102-FZ of Aug. 18, 2004], SOBRANIE ZAKONODATEL'STVA ROSSIISKOI FEDERATSII [SZ RF] [Russian Federation Collection of Legislation] 2004, No. 34, Item 3517 (providing for a zero rate instead of the former standard rate for the exports of oil and natural gas to the members of the Commonwealth of Independent States, thus, replacing the origin principle by the destination principle).

Therefore, it is proposed to establish the destination principle for all electronically supplied services in Russia.

For the destination principle to be employed, the “place of supply” rules should be determined based on the location of the purchaser (i.e. the recipient of the service). Therefore, it is necessary to supplement Article 128 of the Russian Tax Code defining the “place of supply”²⁵⁵ by the provision stipulating that the place of supply of electronically supplied services is determined based on the location of the recipient of the service. Furthermore, it is advisable to specify the “location of the purchaser” in that article as well, following the EU Directive rules determining the location of the purchaser as the place where he “is established, has his permanent address or usually resides”²⁵⁶. If such provisions are inserted, supplies of electronic services to Russian purchasers by foreign vendors would be standard-rated, whereas exports of electronic services to foreign purchasers would be zero-rated. Hence, supplies of physical products and supplies of digital products would be treated equally and neutrality principle would be observed.

To operate effectively, the destination principle requires further specification of the collection mechanisms applied when electronic services are supplied by foreign merchants. Regarding B2B transactions, there will be no difficulties with collection, since Russian importers will pay VAT in accordance with the “tax agent” mechanism.²⁵⁷ This mechanism is analogous to the European “reverse charge” scheme in the sense that a foreign exporter is not accountable for VAT in Russia, whereas a Russian importer acting as a tax agent is required to account for VAT. Therefore, the existing Russian system is suitable for taxation of B2B transactions, accords with the international practice of taxation and should not be changed.

²⁵⁵ NK RF, Ch.2, *supra* note 210, art. 148.

²⁵⁶ Council Directive 2002/38/EC, *supra* note 159, art. 1(1)(b), at 42.

²⁵⁷ NK RF, Ch.2, *supra* note 210, art. 161.

As for B2C transactions, rules need to be established, which would prevent foreign vendors from escaping taxation in Russia. The U.S. approach obliging purchasers to pay compensatory use tax has proved to be ineffective.²⁵⁸ Therefore, a similar system requiring individual purchasers to remit tax should not be implemented in Russia. Instead, it would be appropriate to adopt the European approach to this problem and make foreign vendors subject to Russian VAT. Similarly to the EU system,²⁵⁹ it is necessary to establish a special scheme, which would require foreign vendors involved in supplying electronic services to Russian consumers to register in the Russian tax offices for the purpose of remitting VAT. To implement the registration scheme for foreign suppliers, it is required to amend articles 83 and 84 of the Russian Tax Code, which regulate registration of taxpayers in general²⁶⁰, as well as article 144 that regulates registration of VAT taxpayers²⁶¹. Establishment of the registration system would guarantee neutral tax treatment of foreign and Russian vendors supplying electronic services to Russian consumers.

A further problem that relates to the taxation of e-commerce in Russia concerns the inability of sellers to determine the identity and location of buyers. This problem still remains unsolved in both the U.S. and the EU. Although within the framework of the OECD certain methods of identifying the buyer were proposed and discussed,²⁶² none of them was found to be absolutely reliable. The OECD's statement that "digital certificates and digital signatures show the most promise for identification of parties in the future"²⁶³ appears to be correct with regards

²⁵⁸ See *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses are Uncertain*, *supra* note 41, at 17.

²⁵⁹ Council Directive 2008/8/EC, *supra* note 162, art. 5(11)-(14), at 19-20.

²⁶⁰ NK RF, Ch.1, *supra* note 213, art. 83-84.

²⁶¹ NK RF, Ch.2, *supra* note 210, art. 144.

²⁶² See *Report by the Technology Technical Advisory Group (TAG)*, *supra* note 201, 5-7.

²⁶³ *Id.* at 35.

to the Russian practice of use of digital certificates. Although the proper legislation exists,²⁶⁴ a lot of problems occur with the issuance of electronic certificates in practice and, as a result, their use, especially among individual consumers, is not widespread in Russia yet²⁶⁵. Therefore, the problem of identification of the buyers, as well as of determining their location and status (a business or a consumer) is still to be solved in future. Until a proper solution is found, all available means, such as buyer's self-declaration, billing address and IP address, should be used as a temporary solution to this problem.

In the same way, the issue of inability of tax authorities to trace electronic transactions is yet to be solved not only in Russia, but in the U.S. and the EU as well. Lack of reliable technologies creates the situation when "the opportunities for tax evasion seem endless"²⁶⁶, and ensuring tax compliance appears to be a very difficult task. Therefore, the development of new technologies should be conducted, which would allow tax authorities to identify transactions taking place in cyberspace and guarantee a higher level of tax compliance.

The U.S. and the EU experience of regulating indirect taxation of e-commerce suggest that the existing legal framework should be applied for taxation of electronic transactions in Russia. In order to ensure the observance of the principle of neutrality, certain amendments should be included into the Russian Tax Code. By following the internationally accepted approaches and applying the mechanisms, which have already proved to be effective elsewhere, Russian tax legislation amended as suggested would be able to ensure effective taxation of e-commerce.

²⁶⁴ See Federal'nyi Zakon RF No. 1-FZ ob Elektronnoi Tsifrovoy Podpisi ot 10 ianvaria 2002 g. [Federal Law of the Russian Federation on Electronic Digital Signature No. 1-FZ of Jan. 10, 2002], SOBRANIE ZAKONODATEL'STVA Rossiiskoi Federatsii [SZ RF] [Russian Federation Collection of Legislation] 2002, No. 2, Item 127.

²⁶⁵ See *Biznes ETSP v Rossii: "Pridvornyi" servis* [Digital Signatures Business in Russia: "Court" Service], DOC-ONLINE.RU (2006), http://www.doc-online.ru/a_id/137 (last visited Mar. 25, 2011).

²⁶⁶ BASU, *supra* note 2, at 104.

CONCLUSION

This thesis analysed the issue of indirect taxation of electronic commerce that is currently intensively discussed on both national and international levels. The purpose of the paper was to establish whether any of the U.S. and EU measures aimed at regulation of e-commerce indirect taxation had proved to be effective and whether any of them could be transplanted into the Russian tax system.

The research demonstrated that the U.S., the EU and Russia have faced very similar problems when the existing systems of indirect taxation have been applied to electronic transactions. This provided a basis for a comparison of the approaches taken by the countries in order to deal with these problems. The initial assumption was that both the U.S. and the EU had been successful in adapting their tax laws to the needs of e-commerce. However, the analysis revealed that none of the initiatives undertaken in the U.S. in order to modify their sales and use tax system had achieved their purpose. Since electronic commerce taxation in the U.S. remains mainly unregulated, the conclusion was made that none of their measures should be introduced in Russia.

The EU experience in adapting their VAT system to the realities of e-commerce was found to be much more effective, because all major challenges brought to the existing VAT system by the spread of e-commerce were addressed by the EU Directives. Hence, the thesis suggested that the EU methods and mechanisms should be transplanted into the Russian tax legislation, which, presently, does not have any regulation of e-commerce taxation. Furthermore, the paper formulated specific proposals concerning the amendments that should be introduced into the Russian Tax Code in order to adapt the existing VAT system to the needs of e-commerce.

The study of the U.S. and EU practice of regulating e-commerce indirect taxation demonstrated that a significant number of controversial issues are raised by the application of the traditional taxation rules to electronic transactions. Each jurisdiction attempting to resolve these issues encounters numerous difficulties, the overcoming of which requires constant amendment and development of tax legislation. Moreover, some problems were revealed in the paper that had not been properly solved in the U.S., the EU, or elsewhere. These problems include the absence of reliable means to identify the parties to electronic transactions and determine their location, as well as inability of tax authorities to trace transactions conducted in cyberspace. Complexity of the issue proves that examination and evaluation of other countries' experience is of paramount importance for every jurisdiction, which is willing to regulate indirect taxation of electronic commerce.

The comparative analysis of the approaches and methods used for adapting the two principal models of indirect taxation to the specifics of e-commerce constitutes a theoretical contribution of the thesis to the field of e-commerce taxation. Furthermore, the amendments to the Russian Tax Code formulated in the paper determine the practical application of the research, as their implementation would certainly make the Russian tax system capable of meeting the challenges created by the growth of electronic transactions. Moreover, since the governments of other developing countries face very similar problems, the recommendations made in the thesis are of practical use to them as well.

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