DIGITAL ECONOMY TAXATION UNDER INTERNATIONAL REGIME: POSSIBLE SOLUTIONS AND ITS APPLICATION IN HONG KONG CONTEXT

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I. INTRODUCTION

Information and communication technology (ICT) revolution has led to more inexpensive, powerful and standardized technologies, which improve business processes and overcome geographical constraints (Apulu, 2011). This happens across many sectors. For instance, customers can make online purchases and retailers can tailor services by collecting and analysing consumer data online; banks can allow clients to perform money transactions and manage their finances via e-banking; educators can provide courses and conduct classes remotely.

According to OECD’s Base Erosion and Profit Shifting Project Action 1 (BEPS Action 1) (2014), businesses in various sectors have widely adopted ICT. This is illustrated by their high broadband connectivity, especially for smaller businesses in which broadband connections have reached 90% or more. This rapid technological progress helps to shape the digital economy, and has caused numerous emerging trends and potential developments with tax implications. These implications raise questions to the applicability of the existing international tax framework in coping the spread of digital economy, as ICT was uncommon when the current tax rules were formulated. Since the digital economy is continuously evolving, tax policy makers should monitor closely as this may generate additional tax challenges in the near future.

The paper aims to examine digital economy taxation under the current international tax regime and its implications to Hong Kong. The paper will start with providing definitions of digital economy and its associated characteristics. Next, it will give an overview of the current international tax framework and how the spread of digital economy has posed challenges to it. Various alternatives as well as the responses of countries and regions towards the issue will be explored. Lastly, the paper will analyse the alternatives and discuss their applicability in Hong Kong context.
II. DIGITAL ECONOMY AND THE CURRENT INTERNATIONAL TAX REGIME

A. Definition of Digital Economy and Its Features

Businesses characterized by the use of electronic means used to be regarded as engaging in electronic commerce (Pastukhov, 2006). According to the United Nations’ definition, electronic commerce, i.e. e-commerce, is “commercial activities conducted through an exchange of information generated, stored, [or] communicated by electronic, optic, or analogous means” (Azam, 2007, p. 6). It is regarded as the whole body of “transactions involving the exchange of goods and services between two or more parties using electronic tools and techniques.” (Pastukhov, 2006, p. 4). However, in face of the continuous development of ICT, the result of such transformative process seems to be viewed as something broader than electronic commerce. This is termed as digital economy. It “enables and executes the trade of goods and services through electronic commerce on the Internet” (OECD, 2012). In other words, e-commerce is one of the varieties used in business operations (OECD, 2014). Hence, this paper has interpreted “digital economy” as the term that represents a bigger picture.

Before assessing the impact of digital economy in a tax perspective, it is necessary to note some of its key features which may have relevant tax implications. These features are mobility, reliance on data, multi-sided business models, network effect, volatility, and tendency towards monopoly or oligopoly.

1. Mobility

Mobility of digital economy refers to the mobility with respect to intangibles, users and business functions.

Under the digital economy, companies relies on intangibles (e.g. upgrading existing and developing new software products) to create values and expand their businesses, even for those dealing with tangible resources. Existing tax rules allow easy assignment and transference of rights of intangible assets among associated enterprises (European Commission Taxation and Customs Union [ECTCU], 2014).
User’s mobility is enhanced by increased connectivity due to technological advancements. Sellers and buyers can carry on commercial activities at ease from multiple locations via the Internet and are still able to remain anonymous (Pastukhov, 2006).

Mobility of business functions is highly improved as advances in ICT reduces remote operating costs and hence the need for local staff to perform certain activities. Since many commercial activities and operations can be done via online platforms, companies are more flexible to choose the location of their resources and servers (OECD, 2014).

2. **Reliance on data**

Businesses usually collect data about their micro- and macro-environments to improve their goods and services. Their reliance is particularly strengthened in the digital economy as the computing power, storage capacity and storage cost are greatly improved by ICT advancements (ECTCU, 2014).

3. **Multi-sided Business Models**

Multi-sided business model is “based on a market in which multiple distinct groups of persons interact through an intermediary or platform”, in which one group of persons’ decisions will affect the result of the other group (OECD, 2014, p. 92). It becomes increasingly prevalent as digital economy grows.

Multi-sided business models can be easily designed and implemented through the Internet under a digital economy. Consequently, it is relatively flexible for a firm to respond to any changes in consumer demand and the company’s market position in a cross-border context. This is achieved by using digital technology to adapt to different sides of the market that the business models are directing to (OECD, 2014).

Digital economy also helps to connect different sides of the same business model even they are located far from each other. With digital technology, they are less bound by physical
constraints (OECD, 2014). For example, a buyer from Country A can order and purchase a commodity through a firm’s website from that firm’s branch located at Country B.

4. **Network Effect**

Network effect is when “decisions of users may have a direct impact on the benefit received by other users” (OECD, 2014, p. 91). ICT users from different locations can easily interact and share content with each other in a digital economy, and the content shared will in turn affect other users’ welfare and experiences. This is a prominent characteristic especially for businesses that require user participation, integration and synergies (OECD, 2014). For example, a retailer is likely to attract more customers when its social-networking homepage has more favourable reviews from previous buyers, as these reviews improve the ability of other users to make more informed choices.

5. **Volatility**

Digital economy is highly volatile due to fast pace of innovation. Businesses that used to enjoy dominant position in the market may, therefore, found themselves losing market share to competitors within a short time (OECD, 2014).

6. **Tendency Toward Monopoly or Oligopoly**

Despite the volatility that businesses are facing in the digital economy, minimal incremental cost, network effects, and exclusive rights granted from patents or intellectual property rights may turn firms into monopoly or oligopoly. For example, when users on one side of the market prefers a single provider of a platform, the price charge to the other side of the market will eventually be higher since that platform is the users’ only way of access. As a result of consumer choices empowered by network effects, the ease of adopting a new platform in a digital economy may imply that certain companies can quickly rise into dominance (OECD, 2014).
B. Overview of the Current Tax Regime and Challenges Posed by Digital Economy

Since the dawn of electronic commerce in the late 20th century, there has been a rapid growth in e-commerce and led to the spread of digital economy. More companies are using digital means on top of conventional ways, which has increasingly become a necessary component to conduct businesses in the emerging global economy (Andam, 2003). This is supported by commercial reasons such as procurement savings, reducing dependence on intermediaries and lower inventory cost through adopting just-in-time inventory system (Pinto, 2005). Despite the benefits bring by digital economy, it raises challenges to the current tax system.

Under the present international tax regime, countries or places that impose an income tax mainly adopts two types of tax jurisdictional bases, namely residence-based and source-based (Pinto, 2003). The former is justified by the view that the country has authority to tax its residents on their income wherever it comes from, while the latter is based on the principle that the country has the jurisdiction to tax income or profits generated from it (Azam, 2007). In general, source-base taxation holds the “right to tax active (business) income” and forsake the “right to tax passive (investment) income” (Tax Justice Network [TJN], 2005, p. 2). Most importantly, it involves the concept of “permanent establishment” (PE), meaning “a fixed place of business through which the business of an enterprise is wholly or partly carried on” (OECD, 2003, p. 8).

The way that business models evolve under the digital economy has led to non-resident corporations conducting businesses in a market jurisdiction very different to the one when the existing tax rules were designed. Broader tax challenges, including issues related to nexus, data, characterization and administration, have either been raised or magnified by the spread of digital economy. These challenges can intertwine to some extent. For example, collection of data from users at a jurisdiction may give rise to issues relating to how data should be treated for tax purposes and whether an activity will constitute nexus with that authority (OECD, 2014). This questions the capability of existing international tax frameworks in coping with the changes caused by digital economy. The following sections will discuss the aforementioned challenges posed by such development. As the usage of Internet continues to grow, it is justifiable to deduce that these issues will continue to persist and intensify. This highlights the importance for countries to take an active position in re-examining the current tax regimes and to consider alternatives to deal with the arising problems.
1. **Nexus**

The nature of digital economy itself is borderless, virtual and anonymous, and such basic character of digital economy will, therefore, ignore or even destroy territorial borders between countries (Azam, 2007). Although technological advancement has not altered the basic nature of major activities conducted by businesses in generating profits, it has extended the potential reach of commercial transactions and has affected their taxable character (Pastukhov, 2006). Digital economy provides a way for businesses to earn profits even without having any permanent establishment or physical presence as they can perform business activities from abroad via the Internet (Pinto, 2005). Business processes or transactions that used to be performed by staff can be completed over the Internet remotely (ECTCU, 2014).

Flexibility and mobility are consequently enhanced, allowing companies to choose where to locate most of their business activities. It is therefore possible, and common, to distribute different business functions among multiple locations with different jurisdictions, especially for multinational enterprises (MNEs) (Pastukhov, 2006). Businesses may take advantage of the internet and shift their activities to places with low-tax jurisdictions at low cost, threatening and eroding the tax base of source countries (Pastukhov, 2006). Even though the issue of nexus should not be overstated, as a MNE may maintain its core resources close to major markets due to commercial reasons like ensuring service quality, the possibility for companies to earn huge revenue without taxable presence shall not be overlooked as well (OECD, 2014).

The flexibility brought by digital economy particularly questions the appropriateness of the current PE definition. Not only it is possible for enterprises to remotely conclude contracts via electronic means even no staff or dependent agents are involved, certain activities that were supposedly preparatory or auxiliary may now become significant business components. For example, maintaining a local warehouse may deem to be a core activity of online vendors of tangibles, if proximity and quick delivery to customers are essential elements of their business models (ECTCU, 2014). It is no longer necessary for companies to maintain a fixed place in the buyer’s country, nor to contact their consumers with an agent (Azam, 2007). Therefore, the determination of PE according to existing principles may be inappropriate and is far more complex than it used to be.
The need for a physical presence is also questioned by the increasingly participative and interactive nature of businesses operating in the digital economy. Digital economy allows customers to interact and establish closer relationships with companies that generate extended effects beyond the point of sale (OECD, 2014). For instance, buyers can leave favourable reviews and tag merchandises on the website of a retail company. This enables other consumers to find goods that are relevant to their interests and be more informed. The resulted attraction of new customers creates value to businesses, which can be achieved without physical presence.

On top of that, the traditional definition for determining a corporation’s residency under residence-based regime is also challenged by digital economy (Azam, 2007). In particular, the main storefronts of e-commerce corporations are often their webpages, with highly mobile employees. This limits their physical presence, as it is hard to ascertain the “central place of management and control”. Alike to source-based taxation, it is also easy for e-commerce companies to manipulate the definition for reducing or avoiding tax by relocating to low tax jurisdictions (Azam, 2007).

2. Data

The ease of collecting, storing and using data remotely via digital technologies raises issues concerning the attribution of the resulting value created. Technological advancement enables businesses to gather information through various ways. These may include requesting data from users and pooling information through social networking and cloud computing. Values such as improved decision making and ability to segment markets to tailor offerings are created in the process, which inevitably arouses concerns towards the expanding role of data. Therefore, it is relevant to examine how companies of digital economy add value and make their profits in order to determine whether and to what extent the data is appropriately valued for tax purposes (ECTCU, 2014).

The fact that the data is collected from various sources for different business purposes and adopted in different ways to create value has made tracing the source of data difficult. For example, Country A may gather data from customers from Country B, where the information is also processed, to improve offerings for consumers in Country A. This is further exacerbated by the
changing roles of users and consumers in businesses caused by digital economy. As mentioned above, buyers are able to contribute to certain digital economy business models by creating values to them (OECD, 2014). But since the users may spread among separate countries with multiple jurisdictions, additional challenges are also created on determining the locations of conducting these economic activities and the value created for tax purposes. This is because current tax rules require “analysis of functions performed, assets used, and risk assumed” to attribute “income among different parts of the same MNE” (OECD, 2014, p. 131).

3. Characterization

Digital economy complicates the income and expenses classifications as well as the distinction between tangibles and intangibles (Pastukhov, 2006). ICT has offered new ways of trading goods and services that do not fall under classic categories of transactions. Say, on top of downloading a book’s electronic version to the computer desktop or subscribing via a database that contains it, one can also receive online updates of the book. These possibilities create difficulty to identify the transaction as “trade income” or “service income” (Azam, 2007, p. 8).

Take payments for cloud computing in respect of tax treaty purposes as another example. Under treaties that include payments for commercial, industrial or scientific equipment rentals into the definition of royalties, such payments for cloud computing may be treated as royalties. If the treaty has specific provisions in respect of technical service payments, it may be classified as technical service fees. It may be identified as business profits depending on whether infrastructure-as-a-service is treated as service. Since most treaties only tax business profits if such income is attributable to PE, and income like royalties “may be subject to withholding tax in the country of the payer” depending on treaty terms, the characterization of such income is of paramount importance as it results in different tax treatments (OECD, 2014).

4. Administration

Challenges are met in identifying businesses in the digital economy. Due to the difficulty for tax authorities to notice the remote trading activities, some market jurisdictions may come across
problems with effecting registration requirements, or simply may not require registration for businesses overseas to trade with buyers in the jurisdiction from far distance (OECD, 2014).

Besides, the scope of sales or other activities of overseas sellers may be difficult to determine. The existence of transactions is hard to discover due to the anonymity of digital economy (Azam, 2007). Sales or accounting records can be hardly accessible to local revenue authorities since offshore vendors may not hold any of those in the local jurisdiction. To obtain such information from third parties including consumers or payment intermediaries may also depend on respective privacy or relevant law regulations (OECD, 2014).

For countries that impose value-added taxes (VAT), issues may relate to the levy of such tax. Digital economy greatly enhances the capability of conducting online trade among buyers and sellers, even with limited or without physical presence. This further creates difficulty in revealing the business’s transactions and income, therefore hard to enforce tax duties even if they were clearly ascertained (Azam, 2007). The growth of digital economy, especially the increasing business-to-consumer (B2C) trade of digital products, also renders the lack of mechanism for collecting VAT on services provided by non-resident vendors to private customers unsustainable, even such mechanism is known to be burdensome on tax administrators (OECD, 2014).

The anonymous and virtual nature of digital economy poses challenges in identifying the customers as well. In principal, although there are ways to identify the buyers’ country of residence and where the consumption takes place, such as by tracking Internet Protocol (IP) and billing address, they may not work as consumers can disguise their locations (Pastukhov, 2006).

**III. ALTERNATIVES IN RESPONSE TO THE RISE OF DIGITAL ECONOMY**

Since countries started to address the issues of digital economy, different options have been proposed. The first proposal emphasizes the preservation of the existing source-based taxation by applying certain modifications necessary to keep pace with the digital economy. The second option supports the idea of shifting to residence-based taxation. Other alternatives include introducing a new tax named “bit tax” as well as modifying value added taxes and other indirect consumption taxes.
A. Preserving the Current Source-Based Taxation

The source principle of taxation (sometimes referred to as the ‘territorial approach principle’) entitles a country to tax income originating within its borders. The country where a business conducts its trade and earns its income is usually referred to as the ‘source country’. ‘Source’ refers to a state that in some way or other is connected to the production of the income in question, to the state where the income-generating activities occur, to the state where value is added to a good (Pinto, 2003). Source-based taxation is justified by the principle that the country has the jurisdiction to tax income or profits generated from it (TJN, 2005).

In dealing the matter of digital economy taxation, majority believes that the exiting taxation regime should remain. The income generated from digital economy should be governed by existing taxation principle and not be treated differently (Spencer, 2014). Neutrality is of paramount importance when it comes to the principles of taxation. No matter whether the income is earned by conventional or electronic means, the tax system should have equal treatments for similar income. The economic choices about the structure of economic activities would therefore not be affected by the tax rules (Lee, 2004). The general principle to ensure “profits are taxed where economic activities generating the profits are performed and where value is created” is again confirmed by OECD in BEPS Action 1 (2014). On top of the existing source-based tax framework, several modifications mainly directing against the interpretation of PE concept have been put forward in the past decade.

1. Addition of New Nexus – Electronic (Virtual) Permanent Establishment

According to the Article 5 (Permanent Establishment) of the OECD Model Tax Convention (2003), it provided the PE definition with two thresholds: (i) a fixed place through which the business of the enterprise is wholly or partly carried on or, where no place of business can be found, (ii) a person acting on behalf of the foreign enterprise and habitually exercising an authority to conclude contracts in the name of the foreign enterprise. “Fixed place” can be locations such as “a place of management, a branch, an office, a factory” (OECD, 2003, p. 8). Certain level of physical presence is required in the source jurisdiction, either directly or through the actions of a dependent agent. Prof. Chang Hee Lee (2004), however, commented that during this digital era,
the definition of permanent establishment is no longer appropriate. The concept was outdated as it is invented before the advent of modern communication networks. It dates back to a period in which physical presence was necessary to conduct significant business operations as stated by Prof. Reuven Avi-Yonah (as cited in Spencer, 2014). The digital economy fundamentally changes these limitations.

A new proposal is therefore introduced by OECD which involves adding a new nexus of “Electronic (Virtual) Permanent Establishment” (as cited in Spencer, 2014). It is a suggestion that requires modifications of the existing PE definition, such as:

- To include “virtual fixed place of business” through which the enterprise carried on a business (i.e. an electronic equivalent of traditional PE); and
- To include “virtual agency” (i.e., an electronic equivalent of dependent agent PE).

Once an enterprise maintains a website or a server of another enterprise located in a jurisdiction and carries on business through such website, “Virtual Fixed Place of Business PE” will create a PE. The web site, which is virtual, is the place of business. The need for corporations to have any tangible properties or premises within the jurisdiction will be effectively eliminated upon such modification. As a result, a commercial website is regarded as a fixed place of business when a company conducts its business that exists at a fixed location or on a server located within that jurisdiction (Spencer, 2014).

Apart from habitually concluding contracts on behalf of the company through a real person, the original dependent agent PE concept is extended to other circumstances by the proposed “Virtual Agency PE” in which technological means are used (Spencer, 2014). For instance, contracts binding on the foreign company can be completed habitually through a website. Regardless of the server location on which this website is stored, it may constitute as a dependent agent permanent establishment (Spencer, 2014).
2. Evolvement of “Physical Presence” to “Economic Nexus”

Another extension to the current definition that is interpreted by certain jurisdictions is the concept of economic nexus. In countries where sales tax is imposed, the United States (U.S.) for instance, digital economy has driven the concept of physical presence to evolve into economic nexus. The development is supported by several U.S. high court cases over the last 75 years.

When electronic commerce had still not come into prominence from the 1940s to the early 1990s, U.S. Supreme Court decisions generally showed affirmation on the concept of physical presence. That is, the court upheld the conventional interpretation of physical presence in accordance to the Commerce Clause of the Constitution of the United States. The clause states that if an out-of-state seller, who “has a place of business or employees in the state, it is construed to have maintained ‘residency’ in the state”, i.e. physical presence (Yang, 2013, p. 19). Sales tax is therefore required to be collected from the purchaser by the seller who has physical presence in the state (Yang, 2013). By referring to Table 1, the earlier court cases that involved maintaining a branch and having staff (including traveling salesmen and independent contractors) in the state were all regarded by the court as maintaining a physical presence, while buyers and mail orders from other states did not. But since the enacting of Amazon Tax Law in 2008, the term “economic nexus” started to arise and has brought drastic and far-reaching changes to the landscape for digital economy taxation (Yang, 2013).

As an extension of physical presence, economic nexus implies that an out-of-state seller has to collect sales tax as long as it “entered into a contract with an in-state affiliate that puts the vendor’s Internet link on the affiliate’s computer website to promote sales with an annual gross sales revenue of $10,000 or more” (Yang, 2013, p. 20). The court initially affirmed this groundbreaking nexus in the 2008 court case involving Amazon.com and the New York Department of Taxation and Finance, despite the former has later made an appeal and it is still pending (Yang, 2013). The following table is a brief history of the cases.
Table 1: Brief history of court cases extracted from Yang’s Paper (2013)

<table>
<thead>
<tr>
<th>Year</th>
<th>Parties Involved</th>
<th>Issue(s) in Debate</th>
<th>Court Decision</th>
</tr>
</thead>
</table>
| 1941 | • Sears & Roebucks Company (“SBC”)  
      • Iowa | Did mail orders from another state with a branch, i.e. SBC’s branch in Iowa, construe physical presence? | Affirmative |
| 1944 | • General Trading Company (“GTC”)  
      • Iowa | Did GTC’s sending of traveling salesmen to Iowa construe physical presence? | Affirmative |
| 1954 | • Miller Brothers Company (“MBC”)  
      • Maryland authority | Did consumers, i.e. MBC, coming from neighbouring states construe physical presence? | Negative |
| 1954 | • Scripto Company  
      • Florida | Did Scripto Company’s hiring of independent contractors triggered physical presence? | Affirmative |
| 1967 | • National Bella Hess Company (“NBHC”)  
      • Illinois | Did mail orders from other states without a branch, i.e. NBHC, constitute physical presence? | Negative |
| 1992 | • Quill Corporation  
      • North Dakota | Did mere catalog and computer software construe physical presence? | Negative |
| 2008 | • Amazon.com  
      • New York Department of Taxation and Finance | Did Amazon.com’s internet link being put on in-state affiliate’s website by signing a contract construe physical presence? | Affirmative |

In short, a guiding principle for digital economy taxation can be derived from the above cases: An out-of-state seller must maintain a place of business or staff in a state to construe physical presence, and such presence is also triggered by signing a contract with an affiliate in the state. The legal basis for sales tax collection from an in-state buyer by an out-of-state vendor has evolved into economic nexus, implying that the seller has to collect the sales tax no matter what despite its location (Yang, 2013).
3. **Modifications to the Exemptions from PE Status**

BEPS Action 1 (2014) has suggested that significant activities that were previously considered as preparatory or auxiliary and treated as exceptions under PE definition may now be increasingly significant business functions in the digital economy. The existing definitions should, therefore, be reexamined and authorities should determine which of these exceptions may be considered as core activities. For example, the maintenance of a local warehouse or sales through a storefront may constitute core activity and that it should fall outside the scope of exceptions included in Article 5 of the OECD Model Tax Convention (OECD, 2014). This is to ensure that core activities will not inappropriately benefit from being excluded under the PE definition in the digital economy.

4. **A New Nexus – Significant Digital Presence**

BEPS Action 1 also proposed another alternative that specifically puts emphasis on addressing situations where “certain business activities are conducted wholly digitally” (OECD, 2014, p. 143). Under this approach, if a business engaged in certain “fully dematerialized digital activities” has maintained a “significant digital presence” in a country’s economy, it is deemed to have a taxable presence in that country. Those businesses that perform their core functions and activities with minimal physical presence in the market jurisdiction are the targets under this option (OECD, 2014).

Some of the activities that are defined as “fully dematerialized digital activities” include the following: the core business of the enterprise relies completely or in a considerable part on digital goods or services; the actual creation of the goods and services does not involve any physical elements or activities; credit cards or other electronic means are the sole means of payments; websites are used only for establishing a relationship with a business (OECD, 2014).

Examples for “significant digital presence” are as follows: signing a substantial amount of contracts for the provision of fully dematerialized digital goods or services remotely; offering secondary functions such as consulting and marketing by an existing branch of the company to clients (OECD, 2014).
The following is a summary table of the aforementioned modification alternatives to the existing source-base tax regime.

**Table 2: Modification alternatives to the existing source-based taxation**

<table>
<thead>
<tr>
<th>Means of Modifications</th>
<th>Content</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Electronic (Virtual) Permanent Establishment</strong></td>
<td>a) “virtual fixed place of business”</td>
</tr>
<tr>
<td></td>
<td>- A website or a server located in a jurisdiction and carries on business through such website is P.E.</td>
</tr>
<tr>
<td></td>
<td>b) “virtual agency”</td>
</tr>
<tr>
<td></td>
<td>- Technical means used to conclude contracts on behalf of the company is P.E.</td>
</tr>
<tr>
<td><strong>2. “Economic Nexus”</strong></td>
<td>- An out-of-state seller which enters into a contract with an in-state affiliate that puts the vendor’s Internet link on the affiliate’s computer website to promote sales is P.E.</td>
</tr>
<tr>
<td><strong>3. Exemptions from PE Status</strong></td>
<td>- Reexamine the exemptions under P.E. definition, especially whether those preparatory or auxiliary activities should be treated as core activities now</td>
</tr>
<tr>
<td><strong>4. Significant Digital Presence</strong></td>
<td>- If a business engaged in certain “fully dematerialized digital activities” has maintained a “significant digital presence” in a country’s economy, it is deemed to have a taxable presence in that country.</td>
</tr>
</tbody>
</table>

**B. Switching to Residence-Based Taxation**

Under residence-based taxation system, while source countries will not have the jurisdiction to tax transactions, they would be taxed exclusively in the countries where the enterprises conducting the business are considered to be resident. This tax framework lies on the view that the country has authority to tax its residents on their income wherever it comes from (TJN, 2005).

In November 1996, a paper named *Selected Tax Policy Implications of Global Electronic Commerce* was issued by the U.S. Treasury Department. It indicated that e-commerce can render source-based regime obsolete, and that “the growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even
greater importance” (as cited in Basu, 2007, p. 115). It is often difficult, if not impossible, to adopt the traditional source-based concept and relate a certain income to a specific geographic location in the world of cyberspace. As stated by the U.S. Treasury Department, almost all taxpayers are resident somewhere and at least under U.S. law, all corporations must be established under the laws of a given jurisdiction.

By adopting residence-based taxation to cope with digital economy, the PE status may be disregarded. Since it allocates taxing rights according to the enterprises’ residency rather than the location that the activities took place, tax authorities need not determine the existence of physical presence in the source country for the income arising from transactions. This avoids potential conflicts and difficulties in dealing with electronic transactions concerning whether a PE exists (Pinto, 2007).

However, the white paper that emphasizes the possibility of residence-based taxation of electronic commerce has been met with criticism. First, Professor Avi-Yonah (as cited in Basu, 2007) observed that shifting to residence-based taxation is inconsistent with generally accepted international consensus as embodied in tax treaties and in the U.S. international tax regime. That consensus is based on the principle that the residence jurisdiction has the primary right “to tax passive (investment) income” while the source jurisdiction has the authority “to tax active (business) income” (TJN, 2005, p. 2). Therefore it violates accepted international norms of tax policy by abandoning source-based principles in favour of residence-based taxation. The proposed scheme of residence-based approach may therefore need to overcome numerous obstacles before it is put into practice.

Second, it highly benefits the world’s leader in producing electronic content, i.e. the United States (Basu, 2007). This approach gives advantages to resident countries at the expense of source countries (Azam, 2012). This diverges from the taxation principles of a leading tax framework as the flow of tax revenue between countries is severely imbalanced (OECD, 1998).

Third, scholar stressed that while it can be difficult to determine the source of income, it is even harder in defining the residence of taxpayers in the digital economy (Spencer, 2014). In the era of digital economy, enterprises usually lack fixed physical facilities. The rules\(^1\) that look to the

\(^1\) There are a few methods to determine the residence of an enterprise: the location of central control and management, the residence of the shareholders and the place of incorporation.
corporation’s place of central control and management to establish the corporate residence can be rendered obsolete. As technology advances, instead of holding meetings in one particular physical location, communication via email or video conferencing are readily available to serve the purpose. Thus, corporate management can be dispersed in many different countries. Since the shares of many MNEs are publicly traded on various exchanges in multiple countries, there is no single corporate residence. Thus, it will also be impracticable to establish the corporation’s residence by using the residence of shareholders.

Establishing bright-line rules to determine residence is also not easy. Countries use varying definitions to ascertain corporate residence and the inherit difficulties of formulating rules for determining it, multi-national enterprises in particular, create complications to adopt a residence-based taxation for digital economy (Pinto, 2007).

Last but not least, it is easy to establish a holding company in a “tax haven” while electronic commerce can be carried out in whatever places that is connected to the Internet. As a result, a company may not subject to tax in the absence of source-based taxation.

C. Other Approaches

1. Bit Tax

There have been discussions on introducing a new tax to cope with digital economy, for instance, “bit tax”. The idea of bit tax is first explored during the mid-1990s. It is a tax that “would tax users based on the amount of data they consumed” (Andes & Atkinson, 2013, p. 4). This gross basis tax is comprised of three elements: tax base, tax rate, and the taxpayer (Pinto, 2006).

The tax base of a bit tax will be “each digital bit of information that flows in global networks”, regardless of its types and forms, including all transactions, images, text, data etc. that are transmitted over digital networks, which seems to be the simplest way to implement the tax (Pinto, 2006, p. 42). Due to the massive of bits being carried over the internet, a low tax rate should be imposed as substantial revenue can already be created even with a rate of 0.000001 and to “avoid tax being levied absent any net income” (Pinto, 2006, p. 42). Taxpayer, theoretically,
will be either the information intermediaries and carriers such as Internet service providers (ISPs), or the users (Pinto, 2006).

In terms of mechanism, the first advocators of the bit tax, Idle and Cordell (as cited in Pinto, 2006), proposed two ways of computation. One is by using software, which is already able to measure bits streams. This is worth considering as ISPs are now using such systems for billing and monitoring operations. The other way is to implement different rates according to different categories: a “variable rate based on statistical average of information flows in the relevant region” will be applied at the local level; a fixed rate for taxing leased lines; and a tax will be proportionately applied to long distance public lines according to respective usage patterns and digital flow across the country.

Bit tax may offer a way out for Governments in face of a continuous loss in tax revenue since its imposition can tax the added value yield by the information generated via digital network (Molinari, 2011). That is, it helps to monetize some of the unaccounted productivity created by information technologies. Besides, the computation method is relatively simple and transparent since all transmissions will be included and the tax will be objectively and openly calculated. The use of automated systems such as software also makes administration easier (Pinto, 2006).

Moreover, it may be possible to integrate bit tax with the existing tax systems by adopting the credit mechanisms, similar to withholding tax. For instance, business may receive a credit, which equals to the bit tax levied, to apply against tax assessed in a foreign country where it has PE (Pinto, 2006).

Furthermore, bit tax may eliminate characterization issues as the treaty definition of royalty does not include payments made to obtain digital goods and information. More importantly, since electronic commerce “may allow for the avoidance of the prevailing tax system” and lead to importing countries of e-commerce goods and services to suffer from tax base erosion, if the government’s tax base is not adjusted accordingly, it will lead to non-neutrality (Pinto, 2006). Other potential benefits include more efficient use of e-information; tax revenue sharing among nations; and a desirable system to prevent tax competition (Pinto, 2006).

Nonetheless, the introduction of a bit tax has met with oppositions. Again, by taking the principle of neutrality into account, the two-end sword can be used to argue against a bit tax of
being non-neutral since it distinguishes from non-digital and imposes only on digital transfers (Pastukhov, 2006). A bit tax will contravene the principle and create inefficiency as firms may choose physical means of delivery over electronic. For example, companies may revert to shipping disks instead of dispatching software electronically (Pinto, 2006).

It is argued that imposing a bit tax globally will hamper international trade as the informational technology development of developing countries are lagging behind European countries and the United States, hence, a new tax is deemed inappropriate (Pinto, 2006). Imposition of a bit tax may also discourage the use of e-commerce and impede its development (Pastukhov, 2006). If the bit tax fails to implement internationally, it may drive corporations to operate their businesses in jurisdictions that refuse to impose such tax. Consensus have to be reached among countries on mutual bit tax rates (Pinto, 2006).

Besides, the indiscriminate nature of bit tax can result in distortions and economic anomalies as it is taxing on the quantity of information transmitted rather than the value of the communication itself (Pinto, 2006). This can violate the tax policy criteria of equity (Pastukhov, 2006). Without distinguishing between free information and commercial transactions, bit tax may seek to tax knowledge. A bit tax can result in taxing all bits of information regardless of its inherent value, which may cause businesses to modify their behaviours simply to avoid tax (Pinto, 2006).

On top of that, there are concerns about the presence of a reliable regulatory body to “collect, account for, and remit the proper amount of tax” (Pinto, 2006, p. 51). Technical feasibility problems and high costs may arise. These may include the measurement of Internet data traffic as well as tracking tax avoidance activities resulting from the use of encryption techniques. Administration costs may overweight the tax revenue generated from bit tax (Pinto, 2006).

2. *Value Added Taxes and Other Indirect Consumption Taxes*

Value added taxes (VAT) and other consumption taxes are generally designed to be indirect taxes. They aim to tax the final consumption of goods and services made by customers but are collected from suppliers. However, vendors will in turn increase the market price of the goods or services and consumers will bear the tax burden (OECD, 2014).
“Each business (taxable person) is responsible for collecting the tax on its outputs (supplies) and remitting the proportion of tax corresponding to its margin, i.e. the value added” in a specific tax period (OECD, 2014, p. 42). In other words, businesses will remit “the difference between the VAT imposed on its taxed outputs (output tax) and the VAT imposed on its taxed inputs (input tax) for this period” (OECD, 2014, p. 42). The majority that imposes a VAT adopts the invoice-credit method. That is, taxable person will charge at a specified VAT rate for each supply and passes the amount of tax charged, which will be showed on an invoice, to customers. A consumer can credit that input tax against the output tax charged on its sales if he or she is a taxable person as well. If there are any excess credits, that buyer can either remit the balance to tax authorities or receive a refund (OECD, 2014).

To ensure VAT collection is carried out effectively and efficiently, be they goods or services, B2C or B2B, cross-border or domestic, is the destination principle. According to BEPS Action 1, “while such a vendor collection mechanism was first recommended under the OECD’s 2003 E-commerce Guidelines, experience since then, notably within the European Union, which has been the first to implement it, has shown that it still remains the most viable option today” (OECD, 2014, p. 148). The destination principle rules that tax will be levied only on the final consumption that occurs within that taxing jurisdiction. Imports will be taxed but not on exports (often referred as “free of VAT” or “zero-rated”). The determination of total tax paid related to the supplies is by “the rules applicable in the jurisdiction of its consumption and all revenue accrues to the jurisdiction where the supply to the final consumer occurs” (OECD, 2014, p. 43). One will not benefit from consuming in a low or no-tax jurisdiction, and the composition and level of exports of a country will not be interfered. Hence, applying the destination principle can help to achieve international trade neutrality (OECD, 2014).

Since 1998, OECD Ministers have started to welcome a series of Taxation Framework Conditions in relation to consumption taxation of e-commerce in a cross-border trade environment. The advent and growth of digital economy has considerably enabled companies to remotely trade goods and services with customers in foreign jurisdictions. As the digital economy continues to evolve, VAT system in different jurisdictions requires amendments in order to accommodate the new challenges emerged.
i. Exemptions for import of low valued goods

Digital economy has facilitated online shopping of consumers by introducing the online payment mechanisms. This growth in cross-border business-to-consumer (B2C) transactions has challenged the VAT systems as either nil or improperly low amount of VAT is often resulted. Since the cost of administrating the bringing of the low value goods are very likely to outweigh the revenue gained, countries are motivated to apply such exemption (OECD, 2014).

ii. Remote digital suppliers to consumers

Non-resident suppliers often provide goods and services to consumers in many foreign jurisdictions. Requiring them to register and account for the VAT in different jurisdictions may impose compliance burdens on these suppliers, particularly to small and medium enterprises. Countries should, as a result, make sure that registration is simple. The mechanisms for compliance including on-line registration and filing should be clear and easily accessible to all non-resident vendors. Third-party intermediaries can also help to facilitate and encourage compliance (OECD, 2014).

IV. RESPONSES TO DIGITAL ECONOMY TAXATION

Various countries and regions have been responding to challenges raised by digital economy differently. Below will address in particular, how the United States, the European Union and Hong Kong have dealt with digital economy taxation. While both the United States and the European Union have taken a more proactive role through imposing new rules, Hong Kong has been comparatively inactive. Such stance taken by Hong Kong will also be examined in the following.

A. The United States (U.S.)

In U.S., one pressing issue raised by digital economy is taxing out-of-state sellers. In 1992, U.S. Supreme Court ruled in Quill Corp. v. North Dakota 504 U.S. 298 that “states cannot require retailer to collect sales and use taxes for in-state customers unless the retailer has ‘nexus’, e.g., a
physical presence in their state” (Castro, 2012, p. 1). This inevitably led to tax revenue losses ($8.6 billion according to study estimates) due to the inability of states to tax online retailers without physical presence in the state (Castro, 2012).


Second is by passing the Streamlined Sales and Use Tax Agreement (SSUTA). SSUTA emphasizes uniformity and simplification based on general requirements including “state level administration, uniform tax base, simplified tax rates and uniform sales sourcing rules” (Azam, 2012, p. 659). Furthermore, three legislations including the Main Street Fairness Act, Marketplace Equity Act, and Marketplace Fairness Act were introduced in Congress to enable states in taxing online sales (Castro, 2012).

Another measure is by introducing regulations being referred as “‘Amazon Laws’, in reference to the Internet retailer” (Lunder & Pettit, 2014, p. 1). Amazon Laws can be enacted by “click-through nexus” statutes, which requires collection of tax on online purchases when an affiliate is used; as well as by requesting information from remote vendors about sales and taxes to the state and consumers (Lunder & Pettit, 2014, p. 5). The former approach was initially enacted in New York while the latter was first passed in Colorado (Lunder & Pettit, 2014).

B. The European Union (E.U.)

In light of digital economy developments, E.U. has imposed a new rule that comes into force on 1 January 2015. The rule states “telecommunications, broadcasting and electronic services will, in all cases, be taxable in the country of the customer”, regardless of whether it is a B2B or B2C transaction and whether the supplier is E.U. based or non-E.U. based (European Commission Taxation and Customs Union, 2014, p. 11).

Before enacting this legislation, there was an anomaly concerning the different treatments of E.U. and non-E.U. businesses that are selling e-services to consumer residing in E.U.: VAT on e-
services was levied on E.U. companies but not on certain non-E.U. firms as their location of residency may not require such tax. The new imposed regulation helps to capture the loss of tax revenue from non-E.U. companies. It also creates a level playing field for all e-service vendors selling to customers in E.U (Bloomberg BNA, 2013).

C. Hong Kong

When the rise of digital economy started to challenge the current international tax regime and first brought about discussions, Hong Kong tax authority, i.e. Hong Kong Inland Revenue Department (HKIRD), issued a practice note on e-commerce taxation in 2001. The Departmental Interpretation and Practice Notes No. 39: Profits Tax Treatment of Electronic Commerce (DIPN 39), sets out the guidelines towards treatments regarding e-commerce and stated that a mere server presence may not necessarily constitute a taxable presence (Hong Kong Inland Revenue Department [HKIRD], 2001). Unlike U.S. and E.U., there is since no further action carried out by HKIRD despite the apparent growth of digital economy.

The relatively inactiveness of HKIRD may be accounted for by its current adoption and main emphasis on the status quo approach. Through adopting such approach, HKIRD seeks to enable e-commerce to operate within the current tax system, as well as to uphold the principle of neutrality when coming across treatment of transactions relating to e-commerce and conventional business (Ho, Mak, & Wong, 2002).

Hong Kong has traditionally considered and closely monitored the tax recommendations set by OECD. For instance, issuing DIPN 39 to clarify Hong Kong’s interpretation of PE definition in e-commerce context after OECD released an official document\(^2\). In 2014, Hong Kong also signed on to OECD’s new global tax standards\(^3\) in relation to information exchange for increasing tax transparency and dealing cross-border tax avoidance. These have reflected Hong Kong’s intent in taking OECD’s standards into account, as well as the desire in incorporating the suggestions into

\(^2\) Clarification on the Application of Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5’ issued in December 2000.

the tax system with reference to Hong Kong’s environment. Therefore, HKIRD is not in a good position to be the first-mover or to propose legislations that may not best conform to international tax standards before OECD formally releases any conventions. Hong Kong’s renowned simple and low-tax system may also discourage HKIRD from introducing rules that lack international conventions as basis as this may possibly defeat its advantageous and business-friendly tax framework.

Nonetheless, the existing DIPN 39 is no longer sufficient to cope with the changes constantly raised by digital economy. Hence, it is essential for Hong Kong to act against the challenges by incorporating the suggested guidelines in BEPS Action 1 and the model to be proposed by OECD afterwards.

V. APPLICATION IN HONG KONG CONTEXT

A. Framework for Evaluating Potential Options

The Ottawa Taxation Framework Conditions from 1998 Ottawa Ministerial Conference may provide a good reference for addressing taxation issues related to digital economy. The intention of using this framework to evaluate potential options is to make sure consistent and objective analysis can be performed. All principles will be given equal priority when assessing the potential approaches (Siliafis, 2007).

1. Neutrality

It is important to ensure neutral and equitable taxation between different forms of electronic commerce as well as between electronic and conventional forms of businesses. Instead of tax considerations, economic considerations should be the reasons that motivate business decisions. Taxation with similar levels should be imposed to taxpayers in similar situation carrying out similar transactions in order to avoid market distortions (Siliafis, 2007).
2. **Efficiency**

The lower the administrative costs for tax authorities and compliance costs for taxpayers are the better (Siliafis, 2007).

3. **Certainty and Simplicity**

In order to enable taxpayers to anticipate tax consequences beforehand, i.e. knowing the time, the location and the way the tax is to be accounted, the tax rules have to be clear and easy to understand (Siliafis, 2007).

4. **Effectiveness and Fairness**

Correct amount of tax should be produced at the correct time. Minimize possible tax evasion and avoidance activities as well as keep counteracting measures proportionate to the risks involved (Siliafis, 2007).

5. **Flexibility**

A flexible and dynamic taxation framework to cope with commercial and technological developments (Siliafis, 2007).

**B. Evaluation of Possible Approaches**

1. **Residence-based Taxation**

The suggestion of changing to residence-based taxation has stirred heat discussion among countries. They tend to either accept or reject it based on whether the change will benefit or harm them in terms of the expected revenue being derived from digital economy. Countries, whose residents are expected to earn a significant amount of such income, are predictably more supportive to the U.S. Treasury Department stated in the White Paper’s proposal than those
countries that are adopting source-based jurisdiction for a long time. In 2012, the e-commerce sales value of Hong Kong was amounting to around US$37 billion for Hong Kong (Yuen, 2014), which is much lower compared to China (US$70.88 billion) and U.S. (US$225.3 billion) (Statista, 2015). Although Hong Kong’s environment is favourable to the development of Internet and e-commerce, the majority share of Hong Kong’s Gross Domestic Product (GDP) is contributed by the service sector rather than e-commerce activities (Information Services Department, 2014). With that being the case, the outcomes of shifting to a residence-based jurisdiction may not be as remarkable as intended. In addition, it may not be fair if the taxation system for digital economy is changed to residence-base which may cause a significant decrease in tax revenue for Hong Kong tax authority.

On the contrary, it is expected that a residence-based rule will benefit the U.S. because its residents are leaders in the electronic commerce arena. Take Amazon.com as an example. Amazon, the giant leader that occupied the top of the list of Internet Retailer Top 500 and Europe 500, increased its e-commerce sales in 2013 by 20.3% compared with the previous year (Rutherford, 2014). With this constant and huge increase of sales from Amazon together with the Apple Inc., eBay, etc., the tax revenue earned by the U.S. Inland Revenue Service will have no doubt enormous if the tax system is switched to residence basis. Consequently, the White Paper’s proposal issued by U.S. Treasury Department underlies the preference of U.S.

Moreover, certain countries that are net exporters of goods and services sold electronically can inappropriately favour from a shift to residence-based regime. At present, since usually capital-exporting countries are developed countries while capital-importing countries are developing countries, the move to residence-based taxation could substantially affect the distribution of tax revenues between these nations. Under this approach, the capital-exporting developed countries (e.g. U.S.), which currently lead the world in the production of goods and services online, would be the greatest beneficiaries. The imbalance in tax revenue sharing may violate the equal fiscal sovereignty of countries (Pinto, 2007).

Double or unintentional non-taxation may arise when the taxation for digital economy of Hong Kong changes to residence-base. As stated in the Internet Retailer Hot 100 Retailers – Preview Edition (2014), the total web sales of China in 2013 is $305.8 billion, which represents the top Internet retailer around the world. The rapid growth of digital economy in China can be
attributable to the rise of Alibaba Group Holding Ltd., Taobao as well as the Tencent Holdings Ltd. Many of these Chinese corporations have a very close business relationship with Hong Kong customers that may constitute as commercial activities being carried on in Hong Kong. The profit hence derived may likely be regarded as Hong Kong sourced in the perspective of Mainland’s tax authority under a source basis regime. But on the other hand, if Inland Revenue Department of Hong Kong switches from source-based jurisdiction to residence-based, such profit, theoretically, is unlikely to generate Hong Kong profits tax liability as the company is of Mainland residency. Confusion therefore arises in terms of who has the right in taxing the income due to the adoption of different tax systems.

To conclude, while there are advantages of a residence-based taxation such as avoiding complications arise from determining PE and administration simplicity, the disadvantages analyzed above are likely to overweigh. Specifically, the unfair sharing of tax base implies the unlikeliness for Hong Kong to adopt a residence-based jurisdiction. In addition, the difficulty of finding an internationally accepted test for corporate residence should be first overcome at the international level before Hong Kong starts to consider using this approach for digital economy taxation.

2. **Bit Tax**

Despite the potential benefits such as recapturing tax revenue arising from digital economy, an introduction of bit tax in Hong Kong may not be appropriate. This is mainly because of its current environment in Internet usage.

According to the statistics report published by the Census and Statistics Department (2013), there are almost 96% of Hong Kong people who aged 10 or above use internet services for information searching. This include reading newspapers, magazines or news about current affairs, finance, entertainment or sports online; looking for leisure or entertainment guide; browsing and downloading information from Government websites; as well as searching for jobs and online recruitment (Census and Statistics Department [CSD], 2013). Online digital entertainment is another major reason for Hong Kong people in accessing the Internet. More than 66% of them use the internet for “listening songs/radio programmes online, watching video programmes online,
playing online games, and reading online/books/fiction/comic” (CSD, 2013, p. 10) All of these activities are indeed transfer of information and for self-enjoyment rather than commercial in nature.

As information search and online entertainment have accounted for a large proportion of Internet usage in Hong Kong, it induces high Internet data flow that falls into the tax net of bit tax. Without differentiating it with commercial transactions, an imposition of bit tax in Hong Kong will not be appropriate as it inevitably result in taxing knowledge, “which many believe ideologically should be free” (Pinto, 2006, p. 49).

It should also be noted that the success of a bit tax is dependent on international cooperation and consistency. If other countries refuse to implement while leaving Hong Kong one of the few, if not the only, place to adopt the bit tax approach, businesses may be driven to operate at those jurisdictions that do not impose such tax. This can be particularly harmful to Hong Kong as it may adversely affect Hong Kong’s reputable business-friendly environment.

3. **Value added taxes and other indirect consumption taxes**

For the past two decades, there have constantly been discussions about broadening the tax base in Hong Kong. Concerns include an over-reliance on direct taxation leading to considerable revenue volatility. It was argued that a better balance between direct and indirect taxation should be attained (Hong Kong Institute of Certified Public Accountants [HKICPA], 2007). Hong Kong government has particularly brought up good and services tax (GST) over the years, but it is not well received by the public.

Hong Kong’s existing narrow tax base, which is mainly comprised of corporate, property, and salaries taxes, is the major reason that urges Hong Kong government to put GST into practice. Under this limited tax base, Hong Kong’s tax revenue is prone to economic uncertainties as reflected during the Asian economic crisis and SARS (SCMP Editorial, 2015). The fast-aging population has been placing an upward pressure on the current tax system and the tax paying population is expected to drop, resulting in losses of salaries tax (Economic Analysis Division, 2013). GST therefore provides an alternative form of revenue that is more resistant to economic
and demographic changes, yet should not cause market distortions nor affect Hong Kong’s international competitiveness.

If VAT or GST for electronic transactions is to be applied in Hong Kong, it may be more practical to first levy the tax on final consumption of goods and services that do not include those arising from digital economy. Since consumption tax has never been implemented in Hong Kong’s tax system before, it may be unrealistic to apply the tax on both conventional and electronic transactions all at once. Putting GST into practice requires a step-by-step approach.

Nevertheless, a sales tax will adversely affect low-income earners and therefore impose an unfair tax burden since many items, which were previously not taxed, would be taxed. The long-term price shift and its effect on inflation should be closely monitored. The rate of GST is also of critical importance in determining the impact to the daily living expenses of those low-wage earners. To address this issue, a set of compensatory measures should be provided to reduce the burden on low-income households. For example, lowering direct taxes such as salaries tax and profits tax; giving special payments to low income earners annually; increasing Comprehensive Social Security Assistance (CSSA) payments; reducing or eliminating indirect taxes (e.g. vehicle first registration tax, hotel accommodation tax); or giving payments into individual MPF funds. (HKICPA, 2007)

If the introduction of a GST is brought up again, lessons should be learned not only from New Zealand and Singapore, where GST has been implemented relatively smoothly, but also from Australia and Japan which encountered problems in implementation. Hong Kong government will need to carry out more forecasting work as well as detailed economic and fiscal modelling to test the proposed GST system thoroughly. This is to avoid any unanticipated adverse impact on the course of implementation. As a free port, however, there is a lack of effective controls over the cross-border flow of goods in Hong Kong currently. Both Customs and Excise Department (CED) and HKIRD, which are key revenue departments, have no prior administration experiences in relation to broad-based consumption taxes. Introducing GST into the existing tax system will hence require a long time (HKICPA, 2007). Most importantly, Hong Kong may also lose its international attractiveness and competitiveness to business investors, which are built upon its low and simple tax regime (Hong Kong Economic and Trade Office London, 2015).
All in all, although GST may provide Hong Kong a taxation system that is less vulnerable to economic cycles, the idea is still in the preliminary stage. As a result, it may be difficult, if not impossible, for Hong Kong to apply GST on electronic transactions in the near future so as to accommodate the rapid and unpredictable growth of digital economy. Oppositions from the general public would create even greater challenge to the government as no one would want to bear additional tax burden.

4. Preserving the Current Source-based Taxation

In January 1999, the OECD Committee on Fiscal Affairs (CFA) set up the Technical Advisory Groups on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (Business Profits TAG) to advise the way of applying current tax treaty rules for the business profits taxations in the context of e-commerce and look for alternatives. “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?” included suggestions for clarifying the PE definition (OECD, 2004). The major insights are as follows:

- Websites do not constitute PEs;
- Website hosting facilities should not produce PEs for the entity carrying on business through the website;
- Internet service provider will not represent an agency position and give rise to PE;
- Whilst a place where computer equipment, such as a server, is located may in certain circumstances constitute a PE (OECD, 2004).

In the opinion of OECD, the location of a server maintained by an enterprise may construe PE when “the automatic functions carried out by the equipment have been set up by the principal enterprise and continue to be operated, controlled and maintained by the same principal enterprise” (Dautrich, 2012, para. 14). “The server should be appropriately permanent, fixed and at its own disposal” (Dautrich, 2012, para. 16). The lack of human presence at where the server is located can still be a PE.
In 2005, another report named “Treaty Rules and E-Commerce: Taxing Business Profits in the New Economy” (as cited in OECD, 2014) suggested several modifications of PE definition. For example, amend the definition to provide that “a server cannot, in itself, constitute a PE”; and eliminate existing exceptions relating to preparatory or auxiliary business activities included in paragraph 4 of Article 5 of the OECD Model Tax Convention (OECD, 2014).

Nevertheless, the report considered inappropriate to apply any dramatic changes at that time due to several reasons. First, it believes that e-commerce and other business models resulting from advances in communication technologies should not departure from the existing tax rules significantly. Second, fundamental changes should be carried out only when it is generally agreed that an option was apparently superior to current rules and these rules can no longer cope with that condition. The report also recognized the need of monitoring the way that revenues from direct taxation can be affected by business models changes resulting from new communication technologies. To achieve neutrality, it is important to consider the impacts of the proposed options on all types of business activities. Hence, the effects of different alternatives should extend beyond e-commerce (OECD, 2014).

HKIRD also shares the view with respect to preserving the current tax framework. Given the long history of source-based taxation being implemented in Hong Kong, it is likely to be the most appropriate and successful tax practice in the past, present and future due to its clarity, stableness and simplicity. This source-based principle is easy to comprehend and relatively less costly to operate, providing a unique tax framework to Hong Kong. Regardless of the nature of the transaction, be they real business or electronic transactions, HKIRD will uphold the three conditions included in the Inland Revenue Ordinance (IRO) section 14 to determine whether a person is liable to Hong Kong profits tax. First, the person has to carry on a trade, profession or business in Hong Kong. Second, profits should be derived from such trade, profession or business. Third, such profits must arise in or be derived from Hong Kong (Ho, Mak, & Wong, 2002).

Among the aforementioned conditions, the third one has generated most controversies. In ascertaining the source of profits, HKIRD views it is as “a hard, practical matter of fact” and there is “no universal judge-made test” that applies to all cases (Hong Kong Inland Revenue Department, 2012, p. 6). Despite OECD’s different clarifications on the PE throughout the years, Hong Kong
tax authorities will still examine the context of the business’ nature and the business model under which it is being conducted when dealing with electronic transactions.

With the spread of digital economy, there are relatively less physical human activities being performed as business operations are commonly automated and complicated. In HKIRD’s point of view, core business operations such as “the operations arising from the need to automate, manage and control the virtual shop-front or back-office”, which are usually conducted within a physical office, should be weighed against the use of server in performing these automated activities when determining the source of profits (HKIRD, 2001, p. 5). Human control and management will remain important in executing overall business operations in the era of digital economy. As a result, the practice of looking at the location of physical business operations rather than the server is more preferred by IRD. Treating electronic form of transactions as if they are normal business transactions by looking at the underlying physical profit-generating operations will be the way for Hong Kong in determining the locality of profits.

VI. CONCLUSION

Digital economy has been increasingly rising into prominence. The widespread of ICT across the world brings the way of conducting businesses into a distinctively new level. These developments have inevitably changed the taxation environment for tax authorities and raised challenges to them, including Hong Kong.

In dealing with these associated taxation issues, neutrality principle remains significantly important to Hong Kong in face of digital and non-digital economy. Same principles of taxation should apply to all forms of businesses. Source-based tax regime is still the most applicable approach to Hong Kong as it is relatively easy and less controversial comparing to other alternatives. Nonetheless, HKIRD still needs to monitor the developments of digital economy, the challenges it poses to Hong Kong’s tax system, and its impact to existing tax rules for dealing with business profits. The proposals of OECD have always served as a template for many, if not all, income tax treaties in the world and Hong Kong has always taken OECD’s suggestions into account. Hong Kong shall continue to keep an eye on any relevant updates from OECD as well as examine the economic situation of Hong Kong before implementing OECD’s recommendations.
VII. REFERENCES


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