

E-COMMERCE TAXATION

A KEY TO RESTRUCTURING THE INCOME TAX SYSTEM

A THESIS

SUBMITTED TO THE

STANFORD PROGRAM IN INTERNATIONAL LEGAL STUDIES

AT THE STANFORD LAW SCHOOL,

STANFORD UNIVERSITY

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS

FOR THE DEGREE OF

MASTER OF THE SCIENCE OF LAW

by

Hidenori Mitsui

2001 May 14

## **Abstract**

E-commerce has a variety of impacts on international and domestic income tax systems. Although many legal or economic analyses of e-commerce taxation have been published to date, there seem few interdisciplinary studies of how international and Japanese e-commerce tax systems interact with international and domestic politics and social pressures. This thesis focuses on the interaction between tax law, society, and politics in order to find feasible and practical ways to accomplish fundamental reform of the Japanese domestic and international tax systems. It goes on to examine the difficulty in applying current international tax rules to global e-commerce activities and the risk of double taxation or no taxation. This paper analyzes these problems from economic, political, and social viewpoints. Political processes and social pressures may limit the range of possible e-commerce tax schemes; more specifically, the general public or specific political processes may prevent tax reform that results in the most efficient e-commerce tax system from the viewpoint of economic theory. Furthermore, change in current international tax rules is likely to alter the international allocation of tax revenue among nations. This possibility makes it difficult for many nations to reach a consensus. In addition, each country's domestic tax system also faces the difficulty in

taxing e-commerce justly and efficiently, but a feasible solution may vary among nations because differences in their economic conditions and social and political features. This thesis analyzes the functions and limitations of international tax rules to explore a feasible and practical method to successfully reform the international tax regime. It proposes a case-by-case approach to find realistic rules acceptable to many governments, which may result in slightly enlarging the current permanent establishment definition and modifying current source rules.

With regard to Japan, an information collection system is indispensable to effectively prevent tax evasion where e-commerce is conducted globally without physical indicia; thus, traditional tax enforcement methods seem to be ineffective. However, current politics and people's preferences may impede accomplishment of this goal. This thesis analyzes the processes of past Japanese tax reforms to explore feasible methods to successfully implement Japanese income tax reforms. From these analyses, it presents several conditions for accomplishing tax reform in Japan, such as the comprehensiveness of tax reform, the necessity of a promising forum of tax reform debates, support by the general public, and a booming economy.

# Table of contents

	<b>Page</b>
<b>Introduction</b>	1
<b>I. Impacts of e-commerce on the current tax systems</b>	6
A. Unsuitability of current income classification for e-commerce	6
B. Difficulty in deciding the source of income and possibility of altering the international allocation of tax revenue among countries	10
C. Difficulty of enforcement and compliance of the tax system to e-commerce	19
D. Problems unique to Japan	23
E. Implications of these problems	27
<b>II. Desirable direction of tax reform</b>	29
A. Possible frameworks	29
B. International perspectives	30
1. Basic international tax system	30
2. Inter-governmental political perspectives	32
a. Source rules	32
b. Permanent establishments	35
c. Residence taxation vs. source taxation	35
i. Arguments in favor of residence taxation	35
ii. Pros and cons of an enhanced residence-based tax system	36
iii. Capital export neutrality vs. capital import neutrality	38
iv. Critiques of an enhanced residence-based tax system	45
v. Argument in favor of source taxation	55
3. Summary and possible directions of international tax reform	59
C. Japanese social and political reactions to e-commerce taxation	60
1. Overview of analyses	60
2. Interaction between society and politics	62
a. Necessity of the analyses of politics and society	62
b. Pessimistic view of future tax reform	65

c.	Political processes	66
d.	Cases in which consumers and the general public prevailed	69
	<i>(Tax cuts)</i>	69
	<i>(Tax reform distasteful to LDP supporters)</i>	70
	<i>(An example in another area—high consumer prices)</i>	73
e.	Implications of political processes and key points for future e-commerce tax reform	75
	<i>(Game theory suggests that comprehensive reform is better)</i>	75
	<i>(Promising forum of tax reform debates)</i>	78
	<i>(Support by the general public)</i>	80
	<i>(Timing and other issues)</i>	82
3.	Reform of the legal system	85
<b>III.</b>	<b>Possible tax reforms</b>	88
A.	Classification and redefinition of the permanent establishment Concepts	88
B.	Reorganizing the tax-withholding systems	95
C.	Reform of transfer pricing taxation	100
D.	Specific reform of Japanese income tax system	103
	<i>(Necessity to develop an information collection system)</i>	103
	<i>(The U.S.—developed information collection system)</i>	103
	<i>(Development of CFC rule)</i>	106
	<b>Conclusion</b>	108