

INTERNET TAXATION: AN OUTSTANDING ISSUE

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Abstract

The Internet has not only changed the way business is conducted but also raised issues such as Internet taxation that are awaiting to be resolved. Taxes are the major sources of financing for governments, which in turn, use them to provide public goods and services. Thus, each government has its own tax policies imposed on taxpayers within its boundaries. The Internet, on the other hand, diminishes the boundaries set forth by governments as well as dematerialising money, products and taxpayers which constitute the basis for taxation, making tax collection even more difficult than ever. Uncertain rules regarding the taxation of the Internet pose a crucial problem that calls for all governments to collaborate for a uniform solution. Unless there is a global perspective on the issue, the governments will be confronted with greater tax evasion, a larger underground economy and fiercer tax competition from other countries.

As put forth by the OECD, the U.S. and the European Union, the collaborative solution must ensure that fiscal sovereignty of governments are not undermined, double or no taxation of e-commerce is avoided and the tax base from e-commerce is shared fairly between countries. To achieve the aforementioned goals, the uniform approach should conform to the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. In line with the above discussion, the paper aims to discuss the issues underlying Internet taxation such as tax administration, tax treaties, transfer pricing, their implications, the existing approaches in the international commerce environment.

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I. An Overview of the Internet

The Internet, which has started as a specialized tool for the scientific community, has become a crucial part of business. It has transformed the way business is done and diminished national boundaries. The number of Internet hosts, that is the number of computers with direct connection, has increased to 51.8 million in 1998 from 14.4 million in 1995. It is estimated that this number will increase to 62.2 million in 2000 (Economist, 1999). The Internet has become the fastest growing tool of communication and trade. That is, the number of years it took to reach to 50 million users from its inception is 4 whereas it is 38 years for the radio, 16 years for the PC and 13 years for the TV (Economist, 1998).

Even though it is more difficult to estimate the number of Internet users accurately, Table 1 exhibits the number of Internet users based on the data provided by Nua, an Internet survey company for the period from 1995 to 1999 worldwide. As can be seen from the table, the number of Internet users has increased rapidly especially after 1997.

Table 1: Number of Internet Users Worldwide

Date	Number	% of Total Population
September 1999	201 million	4.78
September 1998	147 million	3.60
September 1997	74 million	1.81
December 1996	55 million	1.34
December 1995	26 million	0.63

Source: Nua Ltd., 2000.

Table 2 presents the breakdown of the total Internet users by their regional locations as of September 1999. As can be seen from the table the majority of the Internet users, 55.91% of all Internet users, are located in North America. However, it is estimated that by 2005, non-US web users will comprise 700 million of the total one billion users.

As the number of Internet users increased, the companies have started perceiving the Internet as a tool for marketing their products, selling them on line, communicating to their suppliers. As they have started utilizing the Internet for these purposes, they found out its other uses and the transformation to electronic businesses has started. Today, as Zarowin (1999) states the Internet is an integral part of business and can not be avoided any longer. Thus, electronic commerce is the way of doing business of the 21st century.

Table 2: Breakdown of Internet Users According to Regions

Region	Number	%
World Total	201.00 million	100.00
Africa	1.72 million	0.86
Asia/Pacific	33.61 million	16.71
Europe	47.15 million	23.45
Middle East	0.88 million	0.44
Canada/USA	112.40 million	55.91
Latin America	5.29 million	2.63

Source: Nua Ltd., 2000.

Urbaczewski and Jessup (1998) define electronic commerce as online exchange of value between organizations, their partners, employees or customers with the absence of geographical and time restrictions. That is, as also stated by Piturro (1999), electronic commerce forces companies to operate in real time. The development of electronic commerce has been rapid as can be seen from Table 3. The increase in the revenues generated by the Internet has accelerated especially after 1997. It is estimated that the global electronic commerce market will reach 1.2 trillion by 2001 (Internet Economy Indicators, 2000).

Table 3: Internet Generated Revenue

Year	US Dollars (Billions)
1994	0.008
1995	0.436
1996	2.900
1997	21.800
1998	73.900
1999	180
2000 (Estimated)	377
2001 (Estimated)	717
2002 (Estimated)	1234

Source: Nua Ltd., 2000.

It is also worth noting that the Internet does not only affect businesses, but it has an impact on the overall economy as well. As stated by DePrince Jr. and Ford (1999), the Internet i) decreases inflationary pressures by intensifying price competition and reducing unit labor costs, ii) increases economy's growth potential by reducing macroeconomic costs of carrying inventory of finished goods, iii) decreases searching and transaction costs throughout the economy by replacing labor intensive marketing and distribution activities with Internet search alternatives.

In summary, the Internet has become an integral part of the world economy. As the Internet rapidly expands and is of commercial interest, laws and regulations are needed in the areas of privacy, liability, enforcing local standards, intellectual property rights (United Nations, 1999). Since the Internet has no national boundaries, it makes enforcement of local standards and laws virtually impossible. Thus, Internet taxation has become a vital issue waiting to be resolved for governments. The following part will specifically focus on this issue.

II. Taxing the Internet

Muscovitch (1997) states that “the Internet can be likened to the Silk Roads of China (circa 2nd century B.C.) which constituted a brand new route for the international trade of a “brand new” commodity. The Silk Roads provided a new link between the East and West for the transport of a brand new commodity (silk), whereas the Internet provides a link between every country for the transport of a new commodity-information.” Thus, as the Silk Road, the Internet has gone beyond national boundaries and created the need to adapt laws to reflect the international transportation of goods and services. This necessitated the reevaluation of the existing tax laws to adapt to the changing nature of transactions. Since the Internet has no boundaries, it calls for a uniform approach by all governments and that it should be taxed in a way that the Internet transactions are not discriminated against the transactions of traditional commerce. The debate over Internet taxation still continues and it focuses on two major questions as i) Should the Internet be taxed ?, ii) If it is taxed, how will it be taxed?.

Opponents of Internet taxation base their argument on the negative impact of taxes on the development of the Internet. That is, they argue that taxing the Internet will hinder its development and there will be less purchases. Moreover, they argue that taxing the Internet will not provide substantial benefits. As stated by Wood (2000), according to a survey done on 3,500 online consumers to measure the impact of electronic commerce taxation by BizRate.com, 37% of the surveyed said they would not have made their purchases online if sales tax had been included, 37% said they would have and the remaining 26% said they did not know.

Goolsbee and Zittrain (1999) evaluate the costs and benefits of taxing the Internet and list them as follows:

a) Revenue loss from Internet Commerce: The proponents of taxing the Internet argue that even if it is minimum at the time being, as more transactions are carried out over the Internet, there will be a substantial level of revenue loss for governments if the Internet is not taxed (Lee, 1999). Contrary to this argument, a study done by Ernst & Young (1999) demonstrated that the effect of electronic commerce on tax revenues is minimal. Another issue that should not be overlooked is that electronic commerce creates its own trade. That is, some products such as online greeting cards might not have been purchased in a store were they not for the Internet.

b) Competition between the Internet Companies and Traditional Retail Stores: The proponents of taxing the Internet argue that not taxing the Internet puts it at an unfair advantage against their traditional counterparts, i.e. retail stores. However, to evaluate this view more accurately, an analysis of Internet purchases must be done. In other words, the purchases diverted from retail stores and new ones created by the Internet must be examined before accepting the validity of this argument.

c) Favoring the Wealthy and Educated: It is also argued that since the wealthy and educated ones have access to the Internet, not taxing electronic commerce will lead to distributional concerns. That is, not taxing electronic commerce will enable wealthy ones to avoid taxation and indirectly benefit them. However, as the number of Internet users increases and more people have access to the Internet, this concern will lose its power as an argument for Internet taxation.

d) Difficulty of Enforcement of Taxes: One of the most perplexing issues of Internet taxation is its difficulty. The costs of complying with taxes on Internet commerce are unlikely to be very large for most online transactions. Thus, the difficulty of enforcing taxes suggests that the tax rates should be low and a uniform approach by all governments must be taken.

In line with the above arguments, it can be suggested that in the short run, the Internet should remain to be tax free. However, in the long run it will be taxed to avoid discriminating it from traditional means of trade. It is worth noting that to find the appropriate way of taxing the Internet, issues that are waiting to be resolved must be examined. The issues underlying Internet taxation can be explained under the following headings:

a) Electronic Money: As Muscovitch (1997) states “the shift from a valuable substance (gold) to a representation of value (paper) can be compared to the current development of electronic cash as a modern market response to the growing acceptance of Internet commerce.” Thus, electronic money or digital cash is the medium that will ease and encourage trade on the Internet. Electronic money as Backhouse (1998) argues is needed for electronic commerce.

The existence of electronic cash is an important obstacle to be overcome for tax purposes since it can not be traced. It can be spent without any record of its use and can be carried on smart cards in very large quantities which eases money laundering and leads to higher levels of tax evasion. This in return increases the size of the underground economy. Cyberbanks that are set up in tax havens will be able to issue untraceable currency that could be exchanged internationally. Thus, the transfer of this currency can be completed directly between the banks and account holders through personal computers, not creating any traces for tax officials.

However, electronic cash is not without its limitations. To ensure its wide use, it must possess reliability and validity. In other words, a security system must be developed to avoid its possible duplication. As Backhouse (1998) argues, duplicating electronic cash is as easy as duplicating an electronic message.

b) Identification of Parties to Transactions: To tax a transaction, the parties to a transaction and their locations must be accurately determined. However, identifying either the parties or their locations is very difficult on the Internet. That is, as Hardesty (1998) and Muscovitch (1997) also state, the Internet makes it possible to sell and buy goods and services without either the buyer or the seller being identified.

In other words, the consumers can carry out the transactions anywhere in the world without leaving their house. This poses important implications for income taxes. That is, an individual may work in one country by not being physically present there and live in another country. In finding a solution to this problem, the privacy concerns form the main obstacle.

One may suggest that if individuals can not be located, companies can be. However, this is also not as easy as it seems. In this case, the issue of determining whether a company has a “permanent establishment” in a country arises. That is, in international trade, according to the bilateral tax treaties, a foreign owned company is not subject to tax on business profits in a country unless it has a permanent establishment. Permanent establishment is defined as

fixed location in a country from which business is transacted. Thus, the question of if the existence of a web server in a country or having an agent hosting a web server in a country creates a permanent establishment remains to be unanswered.

c) Nature of Products Traded: Besides the identification of parties to a transaction, the nature of the product traded determines the tax involved in a transaction. Both tangible and intangible products are traded over the Internet. In the case of sale of tangible or physical products, Internet commerce is not different than traditional trade. These products can easily be identified. However, the Internet enables the sale of intangible or digital products such as software and electronic delivery of such products. The key issue in this case is to determine if a digital product transaction is a sale of a product or a royalty (Glicklich et al., 1997; Muscovitch, 1997; Hardesty, 1999).

d) Transfer Pricing and Ease of Cross-Border Trade: The Internet diminishes national borders making it much easier to trade internationally. Companies can easily engage in global product development, collaboration and sales through their web sites. Thus, transfer pricing, which is used by multinational companies, whenever possible, to distort their income to pay less taxes becomes an important issue that should not be over looked. The Internet enables the companies to shift their revenues from high tax countries to low tax countries more easily. As stated by Hardesty (1999), the current rules of transfer pricing are difficult to apply to electronic commerce hence calls for attention.

In summary, the Internet dematerialises money, goods and tax payers. It provides ways of distorting income providing a potential tool for tax evasion. As once said by Louis XIV's treasurer Jean Baptiste Colbert (1619-1683), "the art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing." For governments to avoid flight of tax revenues to tax haven countries and to achieve effective tax treatment of the Internet, they should collaborate and pursue a uniform approach. Since the Internet has no national boundaries, the approach must ensure as Magaziner (1998) states tax neutrality, simplicity and transparency.

III. Approaches to Internet Taxation

As the Internet has developed and continues to expand, as explained in the preceding parts, the need for laws and regulations for the free for all Internet has become an important issue. In line with this need, governments and international institutions started working on the issues that are unique to the Internet. Taxation of the Internet is one of those issues that calls for specific attention from governments and international institutions.

The general approach to Internet taxation is not to tax it in the short run but take the time to find the most effective tax treatment of the Internet. In other words, taxation issues must be resolved internationally and tax neutrality must be maintained. The regulation on taxation must be simple and it should not be burdensome for anyone to comply with regulations. It should be simple and neutral.

In search for the approach to Internet taxation to be adapted, even though the aforementioned basic principles are similar, the approaches deviate from each other between the major players of the international arena. That is, the United Nations in the Report for Human Development (1999) urged governments to impose "bit taxes" on electronic transmissions which is opposed by many countries and international institutions. On the other hand, World Trade Organization (WTO) adopted a declaration that all its member countries will continue their current practice of not imposing customs duties on electronic transmissions. Countries such as the United States, Australia, the European Union, France,

Ireland, Japan and Republic of Korea have issued joint statements opposing special, multiple and discriminatory taxation of the Internet. As this ongoing debate is of great importance to the businesses and consumers, this part will focus on the approaches of Organization for Economic Cooperation and Development (OECD), European Union (EU) and the United States (US).

Organization for Economic Cooperation and Development (OECD)

The leading role is assigned to the OECD in the resolution of the issue of Internet taxation. The issue of Internet taxation has been first publicly identified by the Committee on Fiscal Affairs (CFA) of OECD at the informal business government round table titled, Electronic Commerce: the Challenges to Tax Authorities and Taxpayer in Turku, Finland in November 1997. At the conference in Turku, there was a call for an internationally coordinated approach and a partnership between governments and the business community to create a transparent and stable environment for electronic commerce. The CFA was subsequently assigned the job to develop taxation framework conditions applicable to electronic commerce (CFA; 1998).

CFA finalized the development of Taxation Framework Conditions in June 1998. The Framework Conditions set forth the governing principles and specified a detailed work programme that is intended to lead to a fiscal climate where electronic commerce can flourish. Both the Working Paper of CFA on Internet Taxation and the Taxation Framework Condition have lead to the following conclusions:

- a) The extremes of establishing a tax free environment for Internet or imposing new taxes are not appropriate.
- b) The existing tax regulations can be applied to electronic commerce. However, it requires further clarifications. The same taxation principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility should be the guiding principles for Internet taxation as well.
- c) The technologies underlying electronic commerce offer the governments to develop their taxpayer services.
- d) The fiscal sovereignty of countries must be maintained. That is, no taxation or double taxation must be avoided and each country should receive its fair share of the tax base.
- e) The implementation of these principles call for an intensified cooperation between businesses, governments and OECD.
- f) Taxation should take place where the consumption is.

In January 1999, five Technical Advisory Groups (TAG) are established for 2 years for thorough consideration of the following issues: i) technology, ii) professional data access, iii) consumption taxes, iv) business profits and v) income characterisation.

- i) Technology TAG: It will consider the feasibility and practicality of concrete steps to implement the framework conditions. These include the adoption of conventional identification practices for businesses engaged in electronic commerce, development of internationally acceptable guidelines on digital signatures to be considered as acceptable evidence of identification for tax purposes, developing internationally compatible information requirements related mainly to electronic records.

- ii) Professional Data Assessment TAG: This TAG will work on the feasibility and practicality of developing internationally compatible information and record keeping requirements, and tax collection arrangements. It will work closely with auditors especially involved in examining electronic records to identify difficulties, developments or practices relevant to the accessibility, authenticity and reliability of data. It will also examine and identify the desirable data elements for business and tax purposes expected in accountable trading, payment or transaction recording systems. It will report on digital notarisation, data recording techniques and recommend the most appropriate mechanism to be used.
- iii) Consumption Tax TAG: The framework conditions state that taxation must result in the place of consumption. This TAG, in line with this statement, will examine the application of this condition. It should work on ensuring that appropriate systems are developed to avoid problems in tax collection, to have efficient delivery of products, to maintain the revenue base and competitiveness of suppliers.
- iv) Business Profits TAG: The Business Profit Tag is to examine how the current tax treaty rules for the taxation of business profits apply in the context of electronic commerce and it will examine proposals for alternative rules. One of the major issues this TAG tackles with is the application of “permanent establishment” definition to electronic commerce.
- v) Income Characterisation TAG: This TAG mainly examines the application of the definition of royalties in the context of electronic commerce. It will work on providing the distinction that can be drawn between various types of payments in determining whether a particular electronic commerce payment is made for the sale or lease of property, for the provision of a service, or as a royalty.

The work on Internet taxation is still going on. International audit standards bodies are working with the OECD to specify the data requirements in the electronic commerce environment to meet both commercial and taxation needs. The OECD is considering a tax summit in 2001 after the Technical Advisory Groups complete their work plans.

European Union (EU)

The EU has stressed the need to ensure a clear and neutral tax environment and the importance of tax rules which avoid market distortions in its Communication “A European Initiative in Electronic Commerce”. The Communication emphasizes the need for tax systems to provide legal certainty and tax neutrality in order to enable electronic commerce to develop. In December 1997, the EU and the US had a joint statement on electronic commerce in which they accepted that taxes on electronic commerce should be clear, consistent, neutral and non-discriminatory.

Prior to the joint statement, in July 1997, 29 countries signed the Bonn Declaration which supports the principle of non-discriminatory taxes on use of global information networks and states that tax issues of electronic commerce calls for international cooperation and where appropriate coordination in order to avoid distortion of competition.

The main focus of the EU is to adapt its VAT system to electronic commerce transactions in a way that it provides legal certainty, simplicity and neutrality. That is, the VAT system should provide clear and consistent rules reducing the risks of unforeseen tax liabilities and disputes. It should keep the burdens of compliance to a minimum, and the consequences of taxation should be the same for transactions in goods and services regardless of the mode of commerce used or location of the seller. As stated in the Working Paper “Indirect Taxes and E-Commerce”, the EU considers having no new or additional taxes for

electronic commerce. That is, existing taxes will apply and they will be collected. However, there is still much to do in order to take all the measures necessary for changing and updating the VAT system.

The guidelines for Internet taxation are set by the EU in the Communication “E-Commerce and Indirect Taxation” as follows:

- a) There will be no new taxes. That is all efforts should be concentrated on adapting existing taxes and more specifically VAT to the developments of electronic commerce.
- b) Electronic transfer of products should be treated for VAT purposes, as a supply of services.
- c) To avoid unfair competition, services neutrality of the tax system between EU and non-EU suppliers and between online and offline consumers must be maintained.
- d) Compliance for all operators in the field of electronic commerce should be made as easy and simple as possible.
- e) The tax system and its control tools must ensure that taxation is enforceable on supplies of services received within the EU, by way of electronic commerce, by both businesses and private individuals.
- f) The tax system must be capable of being applied fairly and with certainty in a manner which allows the full benefits of electronic commerce to be realised.

In line with the guidelines set forth by the Commission, the EU is still in the process of adapting its VAT system. The question of how to adapt the VAT system within the framework of these guidelines still remains to be unanswered.

United States (US)

Internet taxation has been made a matter of public agenda by the Framework for Global Electronic Commerce in the US in 1997. Following the Framework, Internet Tax Freedom Act (ITFA) co-authored by Cox and Wyden is signed on October 21, 1998. ITFA provides a three year ban on taxing Internet access or online services. However, it is also noted that ITFA is not intended to give preferential treatment to Internet sales. Its aim is to prevent Internet sales from discriminatory taxes.

ITFA is based on the principle that information should not be taxed. The main points of the Act can be summarized as follows:

- a) Three year moratorium on special taxation of the Internet and Internet access.
- b) Three year moratorium on multiple and discriminatory taxes on electronic commerce.
- c) Establishment of a commission to study the complex tax issues raised by the growth of electronic commerce. The purpose of the commission is to examine international, state and local tax issues involving electronic commerce.
- d) No federal taxes.
- e) Making the Internet a tariff-free zone.

The ITFA calls to work aggressively through EU and WTO to keep electronic commerce free from tariffs and discriminatory taxes. Following the enactment of ITFA, which also named as Cox-Wyden II after its co-authors, the Cox-Wyden III is co-authored by Cox and Wyden,

aiming to extend the ban world-wide by directing the US to make a permanent ban on global Internet tariffs and discriminatory taxing practices a top priority. Cox-Wyden III, Global Internet Tax Freedom 423-1 passed on October 26, 1999 to promote global free trade on the Internet. The new bill includes three main provisions as:

- a) No tariffs on the Internet. It calls on WTO to enact a permanent moratorium on electronic commerce tariffs.
- b) No multiple, discriminatory or special taxes. It calls on OECD, which is considering issue, to subscribe to the principle of “no multiple, discriminatory or special taxes” on the Internet or electronic commerce.
- c) No bit taxes: It condemns the UN’s “bit tax” proposal and calls for a permanent ban on such taxes.

The latest legislation enacted regarding Internet taxation in the US is the Internet Non-Discrimination Act (INDA). INDA introduced on February 3, 2000, aims to make the existing Cox, Wyden moratorium on new, special and discriminatory Internet taxes permanent.

In addition to the above mentioned steps taken, the US Advisory Commission on Electronic Commerce continues its work on Internet Taxation. It accepts proposals from interested parties on taxation of electronic commerce. All these proposals focus and emphasize that the solution to the issues of Internet taxation will be reached by utilizing the technologies of the Internet (Atkinson and Court, 1999; Peha, 1999).

IV. Conclusion

The rapid expansion of the Internet and electronic commerce has lead to the need for laws and regulations for the free for all Internet. Taxation of the Internet is one of those issues that calls for specific attention from governments and international institutions. The Internet diminishes national boundaries, dematerialises money, products and tax payers, which form the bases for taxation. Thus, taxing the Internet becomes difficult and calls for a uniform approach by all governments to avoid tax evasion. The existing rules of taxation can not be applied to electronic transactions as they are so they need to be adapted to the Internet conditions.

The main issues of the Internet that require special attention are the use of electronic money, difficulty of identification of parties to a transaction, digitised products and the ease of cross border trade. In the search for a resolution of these issues, the general view of the countries and the international institutions is that there should be no discriminatory or additional taxes imposed on the Internet. The issues must be agreed internationally and tax neutrality should be sustained. The regulation on taxation of the Internet should not be burdensome.

There exists a consensus on the guidelines or principles of Internet taxation in the international arena, however, these international bodies are still in the process of examination and evaluation of possible ways of putting the guidelines into life. The question of whether taxation takes place in the country of origin or in the destination country, issues like compliance, characterization of income, residency, the concept of “permanent establishment” are waiting to be resolved. In light of these, the Internet will remain to be tax free in the short run.

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