Taxation of e-commerce in Hong Kong: applying UK and US experience

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Abstract
Due to the rapid growth of electronic commerce worldwide, the traditional approach of taxing business profits in Hong Kong, a source-based common law jurisdiction, warrants a close review as to its compatibility with such a modern way of doing business. Although the Inland Revenue Department of Hong Kong has issued its views on the taxation of electronic commerce profits as Departmental Interpretation and Practice Note 39, much of the treatment of such profits follow the conventional wisdom of taxing business profits as set in the source-based rules. This paper reviews the present situation of taxing profits arising from electronic commerce transactions in Hong Kong and compares it with the cases of the UK and the USA. Problems in formulating water-tight tax law, accounting standards for intangible assets, and coping with cross-border fraud, indicate that progress may not be straightforward. Issues as to fairness, and the difficulty of taxing such receipts are raised, followed by recommendations.

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Introduction

Electronic commerce (EC) is widely projected to be the fastest growing way of conducting business in the new century. Although in leading economies such as the USA, EC accounts at present for less than one per cent of total retail sales, the US Department of Commerce has estimated that it will soon grow at an astonishing rate by hundreds of billions of dollars every year (Nellen, 2001). On the other hand, the rapid growth of EC also implies a corresponding loss of tax contributions, not only in the form of sales and consumption taxes, but also business profit taxes. Solid and clear-cut guidelines must be formulated by the tax authorities in order to deal with EC's rapid growth. For example, the Organization for Economic Cooperation and Development (OECD) has promulgated guidelines on the taxation of EC for its member countries to follow. However, most of the countries that have issued practice statements in line with the OECD guidelines are residence-based tax jurisdictions. Relatively little has been heard of source-based tax jurisdictions, such as Hong Kong (Norris *et al.*, 2001).

Turning to the situation in Hong Kong, EC has also been growing quickly with a number of listed Hong Kong companies expanding their involvement in EC. Also, Hong Kong is highly favoured by foreign companies to conduct EC operations due to her free port status and freedom in foreign exchange control and information technology activities (Law and Lam, 2001). To cope with the rapid development of EC in Hong Kong, the Inland Revenue Department (IRD) of Hong Kong has explicitly stated its views on the taxation of EC profits. This resulted in the publication of the *Departmental Interpretation and Practice Notes (DIPN)* (IRD, 2001) in July 2001.

According to DIPN No. 39, since the Inland Revenue Ordinance (IRO), the main revenue legislation of Hong Kong, does not contain any specific provisions that deal with the taxation of EC, references should be made to *DIPN No. 21: Locality of Profits* (IRD, 1998) (concerning the taxation of profits of traditional businesses) and *DIPN No. 17: The Taxation of Persons Chargeable to Profits Tax on Behalf of Non-residents* (IRD, 1989). The IRD adopts the principle of neutrality. That is, the same basis of treatment will be provided to both EC business and conventional forms of business. Therefore, no particular business form can have either an advantage or a disadvantage as far as taxation is concerned and this approach conforms with Hong Kong's simple tax system (IRD, 2001).

However, the salient characteristic of Hong Kong taxation is its source-based rather than residence-based approach as seen in most OECD member countries. In Hong Kong, according to IRO section 14, the basic charge to profits tax is applied when the following three conditions are satisfied:

1. the person concerned must carry on a trade, profession or business in Hong Kong;
2. the profits to be charged must come from such trade, profession or business carried on by the person in Hong Kong; and
3. the profits must be arising in or derived from Hong Kong (IRD, 2001, p. 1).

The "operations test" as established in the classical case of *CIR* v. *The Hong Kong & Whampoa Dock Co. Ltd* (1960)[1] is commonly applied to identify the source of the profit in question. Although the test has been subject to various challenges during the last 40 years or so (see for example, *International Tax Review*, 1995), and controversially, the IRD had to publish revised versions of DIPN No. 21 (IRD, 1998) to explain its position concerning the question of source of profits, the traditional operations test remains. Generally speaking, the most relevant and immediate transaction that gives rise to the profit earned and the place where such a transaction took place should indicate the source of the profit. Logically, if the source is in Hong Kong, the profit is fully taxed. If the source is outside Hong Kong, the profit is fully exempted. Furthermore, the question of apportionment of taxable profit has been clearly stated in the DIPN that only manufacturing profits, but not trading profits, can enjoy such a concession.

However, the IRD admits in DIPN No. 39 (IRD, 2001) that EC transactions may be conducted in many different ways and can involve a wide range of goods and services. Therefore, instead of having simple and straightforward formulas, a 'totality of facts' approach must be taken in determining whether a person engaged in EC is carrying on a trade or business in Hong Kong. Factors such as the place where the firm stores its inventories, delivers its goods, maintains its bank account or where it keeps its computer server capable of sealing contracts, processing transactions via credit cards and even giving delivery instructions, should be considered (IRD, 2001, p. 2). The need to examine all the circumstances surrounding a case implies that foreign businesses which plan to set up EC operations in Hong Kong will have to consider thoroughly all the possible tax implications which can lead to high costs for tax compliance. Also, local EC operators should carefully consider whether by simply locating certain operations or infrastructure abroad can bring tax benefits or not.

The concept of permanent establishment as source of profit

In discussing the taxation of EC, concepts such as "server", "permanent establishment (PE)", and some other technical terms should be explained. Here, the position of the OECD, which has substantial significance for international taxation, is important. Many OECD member states and also some non-member countries are likely to take guidance from the commentary when interpreting the PE and permanent representative concepts in their tax treaties (Lambooij, 2001, p. 46).

The OECD regards a server at the disposal of a business as a PE of the business if essential and significant business activities are conducted through it (IRD, 2001, p. 3). A server at the disposal of the business includes one that is owned or rented by it. That is to say, the server is a specific identifiable physical asset controlled by the business. However, a web site run by a web hosting service provider is not necessarily regarded as a PE because there is no specific identifiable physical asset put at the disposal of the business. The existence of human intervention that was previously considered has now been dropped from the OECD commentary since March 2000 (Lambooij, 2001, p. 47). In other words, even if no personnel of the business are required to operate the server at its location, the mere presence of technical equipment in a country can determine the fixed place of business. The need to have staffs from the business or contracted from outside to set up and to maintain the server or the fixed place of business has therefore also become irrelevant.

Lambooij (2001, p. 49) further pointed out that the "place of business" is a physical concept. Therefore, a web site is not a PE because it is not a physically existing place. On the other hand, a Web server may be a place of business because it consists of physical equipment and machinery. As such, the former represents a mere communication function, but the latter is itself a core business function. As stated in the OECD Model Tax Convention, "the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole". Nevertheless, it should also be noted that the OECD admits that a case-by-case analysis is sometimes required for taxing EC profits.

Back in Hong Kong, according to DIPN No. 39 (IRD, 2001), the IRD holds a rather different opinion from that of the OECD. The mere presence of a server in a place, even without human intervention, would not generally amount to the carrying out of a business there. This extends to intelligent servers that can automatically conclude contracts, process payments, and deliver digital goods such as software for download. In determining whether a business is being carried out in Hong Kong, the IRD would look beyond the server, and examine the extent of the other operations of the business, such as human intervention, in Hong Kong. The IRD believes that the physical location of the business, rather than that of the server, is more important because human control remains important in carrying out the overall business operations (IRD, 2001, p. 4). As such, the taxation of EC profits is determined in a similar way as other types of profits are taxed. The key questions are to find out what underlying physical operations have been carried out to earn the profits in question and where did these operations take place. In other words, the operations test comes into action. It also follows that the IRD regards the mere presence of a server as not constituting a PE, but the existence of physical operations and personnel does. In the case of a non-resident person operating a branch in Hong Kong, there can be no doubt that he or she is carrying on a trade or business in Hong Kong. The appointment of an agent in Hong Kong will not fall into the category of a PE unless the agent has authority to negotiate and conclude contracts on behalf of the non-resident and habitually exercises it.

The IRD focuses more on what and where the underlying physical operations were carried out by the taxpayer to earn the profits in question than on what has been done electronically. DIPN No. 39 carried two general illustrations (IRD, 2001, p. 5):

1. A company which has all of its business operations in Hong Kong, apart from operating a server (intelligent or otherwise) which is at its disposal and located outside Hong Kong for EC purposes, will be liable to profits tax.
2. A company which has all of its business operations outside Hong Kong, apart from operating merely a server which is at its disposal and located in Hong Kong, will not be liable to profits tax. The DIPN then went on to provide specific examples involving trading, servicing, and manufacturing businesses.

Finally, DIPN No. 39 also relates to section 15(1) of the IRO concerning deemed Hong Kong-sourced trading receipts. Of particular interest to EC transactions would be sections 15(1)(a) and 15(1)(b) which deal with receipts from the exhibition or use of films, tapes, or recordings, and royalties from intellectual property rights. This is exemplified in the ordering and downloading of digital products such as software programs or video or music files. The IRD recognises the importance of differentiating a payment made for the use of the copyright of say, a software program, and a payment for the use of only the software program itself. The former would allow the right to make copies for distribution to the public, the right to prepare derivative programs, the right to make a public performance of the program and the right to publicly display the program (IRD, 2001, p. 7). Generally speaking, a payment made for the mere use of the software program should not fall within the meaning of deemed Hong Kong-sourced royalties in section 15(1)(b) for profits tax purpose, but should induce only a 1.6 per cent withholding tax obligation as stated in IRO section 20B. However, if the transaction is treated as a sale rather than the earning of royalties, the receipt after deduction of allowable deductions is subject to the ordinary 16 per cent corporate profits tax. Nevertheless, Norris *et al.* (2001) reckoned that the situation is not so simple, and stricter definitions of terms such as 'exhibition', 'use', and 'copyright material' need to be provided or some terms replaced with more appropriate ones.

Value-added tax as an example of e-commerce tax problems

As discussed earlier, the OECD has adopted the concept of PE to the new business environment of EC. It has concluded that a computer server could constitute a PE, depending on the functions that it performs. The UK Inland Revenue (IR) has also adopted this concept and made more specifications on applying the concept of PE to EC, stating that the definition of a PE that is ultimately agreed on must follow certain cardinal principles. It must allow EC to flourish, keep compliance costs manageable, and be enforceable. In principle, the mere establishment of a web site is not a PE. Instead, the source of profits depends on whether a server has been located in the UK but it is insufficient in itself to constitute a PE (Burns, 2001, p. 101). Also reported in Burns (2001, p. 101), the UK Chartered Institute of Taxation has also supported the Inland Revenue's view, stating that it is insufficient for a server to constitute a PE, since it is unlikely for a server itself to undertake functions over and above activities such as the display of goods, collation of information, and other activities of preparatory nature.

In our view, the IR's opinions concerning the server for EC taxation are reasonable. Since there are servers which simply perform the functions of providing information about products or the display of goods, the servers themselves cannot be adopted as the ultimate conclusion that the business is conducting EC on the server. So, it is appropriate to set some additional specifications to determine when a server should be considered as a PE. However, judging on whether the server possesses the characteristics of these specifications may often be difficult to determine and time-consuming.

Another area of debate is the application of value-added tax (VAT) to EC activities. Administered by the VAT Office of HM Customs and Excise, VAT is applied to transactions of goods and services including intangible products. Currently, the two main types of VAT are output VAT and input VAT. The former is charged on sales whereas the latter is charged on most goods and services purchased by a business or person. A registered trader must charge customers output VAT on any sales. The value of input VAT can be offset against output VAT. The excess output VAT is thus paid over to Customs and Excise. Tax reclamation is possible when there is an excess of input VAT over output VAT. Value-added tax is also applicable to the sale of digital products such as software programs. Of course, the customers who buy digital products will be charged VAT. However, the responsibilities to charge VAT on customers, collect, and pass the collection to the taxing authority rest with the online sellers or suppliers. Thus not only persons who sell digital products or services are charged VAT, but also customers who buy, and as such, sellers would naturally include this tax in the price of the digital products sold. Under the European Council Directive 77/388/EEC, the chargeability of digital product consumers mainly depends on the location where the electronic services are supplied. So, regarding the issue of charging VAT on EU customers buying digital products, all EU members including UK are required to charge VAT on online customers within and outside the EU whereas non-EU companies selling digital products to EU customers are not required to follow this rule. It means that the EU sellers need to charge and collect the tax from their customers regardless of where the customers are located (Hardesty, 2002). With this arrangement, it appears that non-EU sellers may have certain competitive advantages over their European counterparts.

In fact, there have been unceasing discussions and debates on this issue since the year 2000. Some EU members, for example Sweden, have been proposing that non-EU companies selling digital products to EU customers should also be liable to VAT on their sales, and that the sale of electronically delivered services should be taxed based on customer location. The purpose of this proposal was obviously to create more balanced competition between EU and non-EU sellers. However, serious objections and criticisms have been raised about the proposed system (*International Tax Review*, 2001). One major criticism was that the non-EU sellers would have to file a VAT registration with at least one of the 15 EU member countries. Then the VAT would be collected based on the rules applicable to the customer's country. VAT rates vary from country to country within the EU, for example, from 15 per cent in Luxembourg to 25 per cent in Sweden. This simply implies a very high cost of tax compliance (Hardesty, 2002). Another issue is clearly that non-EU sellers' enthusiasm for seeking customers in Europe will be depressed leading to possible discrimination of EU customers from non-EU customers. This will impede the growth of EC within a fair and competitive global business environment. Moreover, it is difficult to determine the source of the customers buying electronic products. The technology at present does not allow an online seller to verify the location of its customers. The proposal to allow customers to self-identify their tax status and the related VAT tax rules and rates in their domestic country will only lead to fraudulent or inaccurate information. It appears that taxing VAT based on the place where products or services are provided is more feasible. Not withstanding these criticisms and possible loopholes, the EU introduced an amendment to the existing VAT Directive which required non-EU sellers to apply VAT when selling to EU customers starting July 2003 (Fairpo, 2002). As expected, non-EU, especially US sellers, have raised strong concerns on this issue. Preoccupations are mainly centred on the technical difficulties with locating and proving the place of the customers given the technological constraints, the problem of customers setting up email accounts in a low tax rate country, and naturally the expected high cost of tax compliance (*International Tax Review*, 2002b).

Despite such expected difficulties, the application of VAT for non-EU businesses which supply electronically supplied services to EU customers became effective from 1 July 2003. In order to reduce procedural complexities, a special scheme has been introduced. HM Customs and Excise (2003) provided an example whereby a US seller selling to customers located in the UK, Italy, and Spain, will only have to electronically register within one single EU country, for example the UK. Then the US seller can charge UK, Italian, and Spanish VAT on the respective customers. The final payment is then made to Customs and Excise who will retain UK VAT and pass on to the Italian and Spanish authorities their appropriate VAT. This clearly saves the US seller a lot of administrative efforts in dealing with passing VAT to various countries' tax authorities. However, the questions of global competitiveness and potential discrimination between EU and non-EU consumers still remain.

Simply banning e-commerce tax?

In the USA, it has been realised that various features of EC do not fit well within the rules and theories underlying the current tax system created in a world involving tangible properties and the ability to physically observe transactions (Nellen, 2001). So the farther they divert from the traditional business model, the more problems arise. Caldwell (1996) pointed out that the most basic problem is the way states deal with products bought from out-of-state sellers. The States have all recognised the problem related with the charging of a sales or use tax which was originally intended for 'transmission' channels such as telephone, satellite, and cable. However, they have never been able to solve the problem of collecting that tax in the context of EC. There are difficulties in determining when online transactions constitute sales, what constitutes the taxable base for online transactions, whether an online transaction is tangible property, a service, or intangible property, and so on. Nevertheless, the States continue to persuade out-of-state sellers to do the collection in order to minimise administrative costs. So the basic problem remains.

Furthermore, Frieden and Porter (1996), in an Arthur Andersen report, criticised the lack of uniformity in the approaches taken by the various States as having created confusion. Many of them are adopting a mid-twentieth century tax regime developed for sellers of tangible personal properties to a now technologically advanced service industry. This demonstrates "shoe-horning" rather than facing the issues head on. Some professions have also recognised that the high cost of collecting use tax by the vendors will impede inter-state commerce. Even if vendors are mandated to collect use tax, complete compliance may not be guaranteed unless simplifications and changes are made to the current legislation. For example, current proposals exclude small vendors from compliance. Also, such legislation would not enable states to require non-US vendors to collect and remit use tax. The most fundamental problem still remains with the nature of the sales and use tax itself. Nellen (2001) pointed out that the sales tax laws of many States apply only to tangible personal property. Thus, digital products are often not subject to sales tax because they are viewed either as intangibles or non-taxable services. However, some States have changed their sales tax laws to include digital products, such as software programs transferred via telecommunications. Therefore, taxpayers need to review the laws in any state in which they have tax obligations to determine if a particular digital product is subject to sales tax. In reality, it is also often arbitrary as to the classification of a certain digital product as tangible personal property, a non-taxable intangible, or a service. Due to different treatments in different States, a same digital product can be subject to different kinds of sales or use tax or even not taxed. As such, with the lack of uniformity, EC transactions will eventually shrink the existing sales and use tax base of certain State and local governments.

Another difficulty with inter-state sales and use tax obligations is with the question of nexus between the State and the vendor. Nexus can be considered as a connection between the vendor and the State, such that subjecting the vendor to the State's sales tax rules is neither harmful nor unfair to inter-state commerce (Nellen, 2001). In other words, if the vendor has no nexus with the State, there is no obligation to collect and remit sales or use tax. At present, the situation is regulated by the rules as defined in the classical case of *Quill Corporation* v. *North Dakota Supreme Court of the United States* (1992)[2]. Quill was a vendor in Delaware. It did not have any properties or employees in North Dakota where it sold merchandise through sending catalogues to customers there. Quill was required to collect use tax on the sales made to North Dakota customers. North Dakota justified this by insisting that a company does not need salespersons in a state in order to obtain a sale. A catalogue and a mail-order sales system can be equally effective as sending salespersons. The Court stated that if an out-of-state business purposely avails itself of the benefits of an economic market in the state, it need not have a physical presence in the State to be subject to tax collection requirements in the State (Nellen, 2001). The question here is whether sales resulting from mailing catalogues is the same as those resulting from EC transactions through a web site. Nellen (2001) cited the example of a store in California joining a "virtual mall" in Michigan. Can the Quill decision be applied here equally? Is the virtual mall operator a mere advertiser or a sales solicitor of the store? Does this create enough nexus? These questions are not expected to be answered easily in the near future without more litigation. It was Adam Smith who in his classic 1776 *Wealth of Nations* proposed four criteria for a sound tax:

1 it should reflect a person's ability to pay;
2 it should be certain;

3 it should be convenient; and
4 it should be administratively efficient and not cause economic distortion.

It is clear that criteria 2 and 4 are not so easily satisfied in the present case. Tax law can be notorious for its uncertainty, and this contravenes an important principle in the drafting of legislation, but one which in reality is often compromised. Where taxes have to be re-established on an annual basis, which applies to several UK taxes, and where tax regimes are part of annual budgetary cycles suffering a rushed timetable, it is unsurprising if legal uncertainties remain. The tax authorities do have the advantage, unusual in law generally, of retrospective legislation. This permits loopholes to be plugged after the event, although this is neither the most efficient nor effective means of operating a tax regime. Of course with the present issue, time is taken out to issue consultation documents, and attempt a more measured and rational approach. Even here the annual tax cycle forces courses of action prior to full consideration. Solace is not to be obtained when one castes an eye on the problems observed in the accounting profession in the various initiatives in national and international accounting to account for intangible assets. There remain imprecisions and scope for manipulating profit and other figures to quite significant margins, which will not please the public already smarting over the revelations pre- and post-Enron (Vinten, 2002). There are also not unrelated issues of chasing another world-wide intangible – fraud – across international boundaries with less than full success.

We now turn to a brief discussion of the issue of the source rule on corporate income tax in the context of EC. Usually, if the digital product is regarded as tangible personal property, the usual source rule applies. That is to say, the tax is sourced at the destination where the customer is located. However, many States regard digital products as intangibles or services. In this case, most State rules will indicate that the place where the income generating activities were performed, which in most cases is the place where the vendor is located, will be the source (Frieden and Porter, 1996). Even if the tax falls on the jurisdiction of the customer's place, technical problems arise. First, the impossibility to trace the place of the customer due to technology constraints as discussed earlier. Second, the case of customers who use mobile or wireless telecommunication devices. Third, the difficulty of knowing where the product is actually used by the customer.

In any case, the US senate has extended a ban on internet taxes until November 2003. States are banned from collecting taxes unless the retailer has a physical presence there (*International Tax Review*, 2002a). The move can be considered appropriate due to the fact that the already complicated sales and use tax will only be made more complicated with EC transactions. Most important of all, before attaining uniformity among the various states' systems, forcing EC sellers to collect taxes will only aggravate the problem. The ban on internet tax does not mean that EC transactions will not be taxed. Some 33 States are already participating in a Streamlined Sales Tax Project, attempting to design and implement a simplified and coordinated sales and use tax regime.

Discussion

EC is still in its infancy but growing at an astonishing rate. There is indeed an abundance of problems, both conceptual and technical, for taxing authorities worldwide to solve. Hong Kong, although a source-based jurisdiction, can consider adopting some of those principles in force in OECD countries. But there are even more commentaries and proposals which Hong Kong should not adopt, due to their arbitrary and incomplete state in the current situation.

Since in determining the source of EC profits, all the circumstances of a case need to be considered. This means that foreign businesses which plan to set up EC operations in Hong Kong will have difficulties knowing all the tax implications before they structure their businesses. As a result, this will discourage foreign businesses to set up high-tech operations in Hong Kong. It is therefore suggested that the IRD explicitly lists out the factors that it will consider in determining the source of EC profits. For example, the amount of sales conducted, and the number of personnel existing in Hong Kong that will be considered as having substantial activities in Hong Kong, and therefore subject to Hong Kong profits tax. In this way, potential foreign investors may roughly know in advance the chance that they will be caught under Hong Kong profits tax.

After a brief review of the existing UK tax system on EC, it is suggested that the application of VAT on customers buying digital products is not advisable in Hong Kong. The implementation of such system will involve very high administrative costs.

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Besides, with existing technology, it is still quite difficult to determine the source of those customers buying digital products. What is more, the introduction of VAT on customers will certainly discourage consumption given the recent economic recession period (Zhan *et al.*, 2002).

Due to geographical, technological, legal, and political differences between Hong Kong and the US, there appear to be very few aspects that can be brought into the Hong Kong context concerning EC taxation. Indeed, the EC tax system in the US is not perfect in the sense that consistency is lacking among the States. The State taxation of EC is in its infancy and there are many unresolved issues and statutory and regulatory ambiguities. This is evidenced by the recent ban on internet tax. Discussions among the professions, State governments, and merchants can be taken into consideration when we propose solutions for Hong Kong.

Although the IRD stated that no specific provisions are made to the taxation of EC profits, and reference should be made to the traditional source rule, careful inspection of the IRD's view on EC shows that the traditional locality of profits rule (mainly the operations test) has not been applied to the taxation of EC profits. In fact, the IRD takes the totality of facts approach by considering all of the taxpayers' substantial activities conducted in Hong Kong (besides the existence of server, personnel, and other infrastructure will also be considered). For example, if a foreign investor sets up a web site in Hong Kong for selling digital products, according to the operations test, the point where a customer places an order should be the most immediate and important cause for the profit to arise. Most likely the "click" action of the customer on the good purchase will be regarded as the most immediate and important activity in the transaction because EC transactions are conducted in cyberspace, without any paper contractual documents, and outside defined territorial boundaries (Biscontri *et al.*, 2001, p. 58). Consequently, as long as customers do not use their computers in Hong Kong to buy goods online, the sale will not have a Hong Kong source. However, under the existing IRD's view on EC, the mere existence of a web site is not enough for the determination of its source and other factors such as personnel and infrastructure should also be considered. Even the IRD itself has contradictory points of view on this issue. Therefore, it is recommended that the IRD will separate its tax focus into two parts. That is, applying the operations test to traditional forms of businesses, and the totality of facts approach to non-traditional businesses, such as EC. Then EC will be taxed based on its unique characteristics.

We also recommend the IRD to explicitly and concisely define the term EC. Only by clearly defining the term will the IRD be able to determine the corresponding source and tax accordingly. For instance, most of us will agree that the electronic transfer of some digital products is a kind of EC, but how about e-payments for non-digital products? Meanwhile, should online consultancy services be considered as EC? As within the EC literature, there exist so many different possible forms, should all these forms be governed under one source of determination and one tax rate? One suggestion is to include goods or services purchased from the internet and products or services that can be bought only through internet. Any products falling into this category will be considered as internet sales and hence they will be taxed specifically, regardless the products' forms (Zhan *et al.*, 2002).

The OECD is having frequent and comprehensive discussions about the determination of source of EC profits. As in the current situation in Hong Kong, some of the decisions of the OECD are followed, while others are ignored. In order to promote the globalisation status of Hong Kong, and to enhance its co-operation with members of the OECD, staying in line with decisions of the OECD will be an advantage in the long run. However, instant and complete compliance with OECD decisions may result in frequent modifications and instability since the OECD has not been able to find ideal, complete, and ultimate solutions for the many problems of EC.

E-commerce activities involve high technology and some technical experts may use their knowledge and expertise to illegally evade tax. It is therefore suggested that the IRD can consult and hire professionals in this field in order to combat this problem. As EC becomes more and more popular, solving this problem is a must and certainly is cost-justified in the long run. Moreover, since Hong Kong is small in terms of size, and comparatively simple in terms of the tax system, the consultancy fees for these professionals should be affordable.

The paper has reviewed the situation of EC taxation in Hong Kong, Europe, and the USA. With EC still at its infancy, but given the rapid globalisation of cross-border transactions, time is ripe for the IRD to systematically study the possible inclusion of new and solid provisions in the IRO to cope with EC's exponential growth. The publication of DIPN No. 39 only represents an

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expression of the IRD's views on the phenomenon and is in no way legally binding. It appears that a fundamental reform in the taxation system has high priority in the Special Administrative Region's agenda. It will also be an indispensable need to watch closely at the next stage for internet tax in the US following the possible lifting of the ban after November 2003, as well as taking note of any further developments in the OECD's position. Problems in formulating tax law, establishing consistent accounting standards for intangible assets, and in combating cross-border fraud indicate that the way forward may not be without obstacles.

Notes

1 *CIR* v. *The Hong Kong & Whampoa Dock Co. Ltd* (1960) 1 HKTC 85 (CA).
2 *Quill Corporation* v. *North Dakota Supreme Court of the United States* (91-0194) (1992), 504 US 298.

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