

## EXECUTIVE SUMMARY

The digitalization of the economy is under rapid expansion as a technological revolution is under way. It continues to transform the way businesses function internally as well as externally. The purpose of this study is to examine whether the current Income Tax and VAT policies are capable enough to address the challenges made by the cross border and domestic e-commerce transactions and to discuss the future direction of them. The primary literatures were collected from text books, reports, past research papers, OECD & UN Model Tax Treaty Commentaries, EU VAT Directives and tax case law.

According to current international income tax principles on business profits, a foreign enterprise is taxable in Sri Lanka only if it has a permanent establishment (PE) in Sri Lanka, which is a fixed place of business through which the business of an enterprise is wholly or partly carried on. But in e-commerce the need for a physical presence virtually ceases, which creates problems in the enforcement of international tax rules. This paper outlined two key income tax issues in respect of cross boarder e-commerce: difficulty in determining physical presence and difficulty in characterisation of income. Taxing profits according to value creation has been detected as the new paradigm in international taxation. Based on this concept, this paper suggested imposition of equalization levy as the first solution for the issue of income taxation on e-commerce transactions conducted by non-residents without a physical presence in Sri Lanka. It further proposed a framework to refine transfer pricing guidance in order to come closer to the goal of aligning profit taxation with value creation.

E-commerce causes problems regarding consumption tax too. Under the current rules applicable in Sri Lanka, VAT is due if the taxable supply takes place in Sri Lanka or any article is imported into Sri Lanka. In the case of internet-based transactions, capturing of import of digital goods and services becomes an issue in the absence of relevant information for the tax authorities. Under BEPS Action Plan the OECD accepted the destination principle for imposition of VAT. Therefore, this paper proposed to impose VAT on import of digital goods and services based on the settlement of payments to the foreign parties through the Banking System.

With respect to domestic e-commerce the major problem could be introduction of new administrative efforts to effectively capture e-commerce transactions more fully. With this regard the author identified the urgent need for enhancement of competencies of Sri Lankan tax authorities.