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E-COMMERCE AND TAXATION: THE CASE
OF BRAZIL

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1 INTRODUCTION:

A rapidly changing world is forcing governments to constantly redefine their role in society. Population growth, advances in technology, the evolution of the Internet, globalization and economic crises are the main driving forces behind such change.

One of the most important factors concerns the evolution of the Internet, which has dramatically altered social and economic relations. The manner of conducting business, therefore, has also evolved.

To meet these challenges, a government is compelled to be innovative, flexible, and efficient in all its activities, including the collection of taxes in all productive sectors of society, such as the business sector and, more recently, electronic commerce, the subject of this project.

1.1 DEFINITION OF ELECTRONIC COMMERCE

Electronic commerce, commonly known as 'e-commerce', is the term used to describe a new type of commercial relationship that uses the World Wide Web (the Internet) to carry out business transactions, in whole or in part.

Business transactions are to be understood as the purchase and sale of information, products, and services. The term 'commerce' would be inadequate to describe the provision of services, since commerce typically refers to intermediation in the purchase and sale of goods. Nevertheless, the term will also be used here to denote the purchase and sale of services.

1.2 THE IMPORTANCE OF ELECTRONIC COMMERCE TODAY

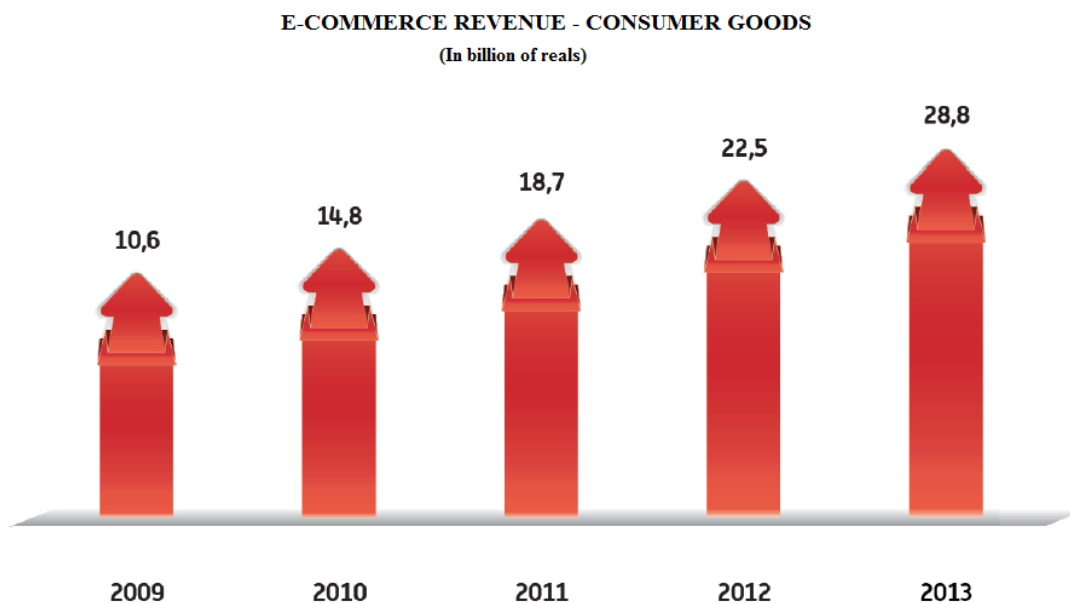
The study of this subject is important, especially for tax authorities, due to the rapid growth of e-commerce in the last decades. The use of the Internet as a vehicle for conducting business has been increasing year after year in Brazil and all around the world.

The main factors propelling this increase, besides the current tendency of people to place a greater value on their free time - which explains their ready

acceptance of any time-saving service or product - include: the growing number of web surfers and on-line consumers, the diminishing prices of microcomputers and greater ease and confidence in Internet shopping, the wider use of broadband, the advances in digital certifications, which improve the security of transactions, the ease of locating products and the development of cell phone applications for online shopping.

1.3 EVOLUTION OF E-COMMERCE in BRAZIL

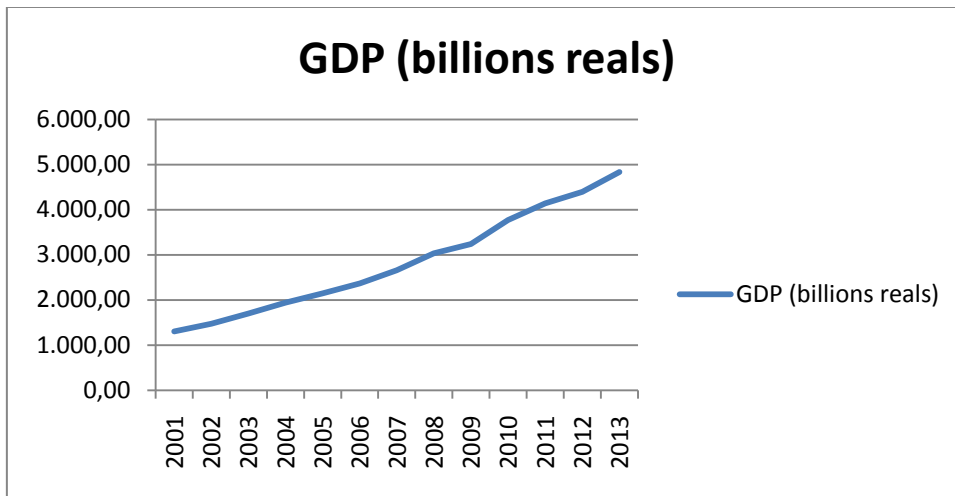
When it started in Brazil in 2001, e-commerce accounted for a little over R\$ 540 million in revenue. Lately, however, this sector has increased at a constant rate, reaching R\$ 10.6 billion in 2009 and R\$ 28.8 billion in 2013, according to data from E-bit, a website that monitors change in digital retail in the country since 2000.



Source: www.ebitempresa.com.br

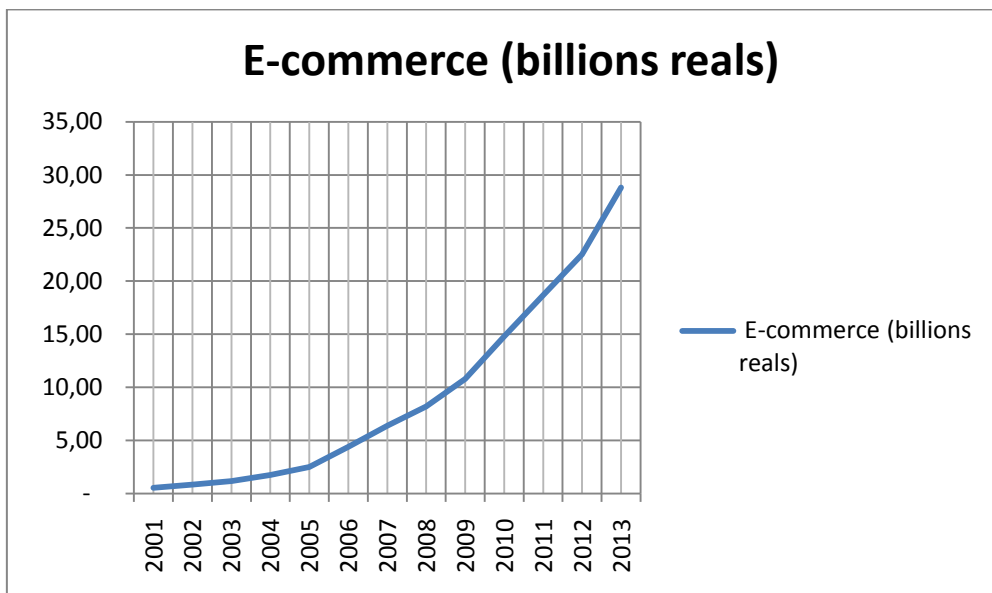
E-commerce involves two separate aspects: online purchases from large companies and stores, which dominate the retail sector thanks to their presence in the media and optimized electronic purchasing and selling processes that supplement physical sales; and online purchases of intangible goods, which do not require physical delivery, such as software, music and video.

Another aspect of the development of e-commerce in Brazil can be seen in comparison to the growth of the country's GDP, which rose from R\$1.3 trillion in 2001 to R\$4.8 trillion in 2013, as shown in the following graph:



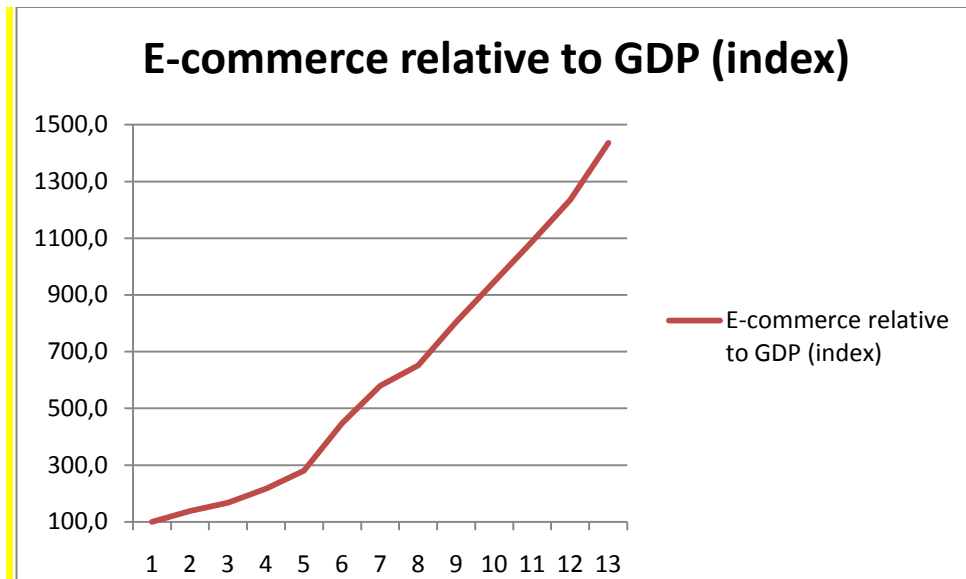
Source IBGE

During the same period, e-commerce sales rose from R\$ 0.54 billion to R\$ 28.8 billion.



Source e-bit (www.ebitempresa.com.br)

The growth curve of each reveals that, in the last decade, the GDP increased in a linear way, while e-commerce grew exponentially, as shown in the following chart.



Comparing the growth of e-commerce and that of the Brazilian GDP shows that the former increased at a much faster rate than the country's economy. This suggests that e-commerce grew as a result of the transfer of sales from the traditional business model, providing one more reason why tax administrations should understand this new way of doing business and engage in it.

1.4 IMPORTANT CONCEPTS FOR ELECTRONIC COMMERCE

Electronic commerce presents some peculiarities or features that differentiate it from traditional commerce. One is the way in which goods or services are delivered and another relates to the parties involved in the transactions.

Certain concepts must be defined in order to understand how products are delivered. The first one deals with the difference between tangible and intangible goods. By tangible goods, we mean physical products that can be touched, whereas intangible goods are products that have value but no physical presence, i.e., cannot be seen or touched.

Another important concept relates to how goods marketed via the Internet are delivered. This is achieved both "off-line" and "on-line". Off-line deliveries

involve tangible products that, despite being electronically marketed, still require physical delivery procedures, just as in traditional commerce.

As to the “on-line” transactions dealing with intangible goods, these are delivered to the buyer through software or e-book downloads to a computer.

In terms of delivery, “off-line” transactions are similar to the traditional buying and selling of merchandise in that, from a fiscal standpoint, a tax invoice must be issued for each shipping operation.

In terms of “on-line” transactions, tax authorities find it extremely difficult to collect taxes due to the fact that commercial operations are entirely conducted electronically, through a virtual medium.

1.5 E-COMMERCE: TYPES OF OPERATIONS

E-commerce transactions are classified into four different types according to the parties involved:

1.5.1 BUSINESS-TO-BUSINESS (B2B)

B2B describes the sale and purchase transactions engaged in by two businesses. Operations can involve the purchase of merchandise, with physical delivery (off-line), or the purchase of software with virtual delivery (on-line). Nowadays, companies use the Internet more and more for their purchases, creating a direct relationship between the buyer and the supplier. With B2B, client information is already on file, so that returning customers simply need to place their order and the seller issues them the tax document along with the products. Payment in advance is not required. The pre-set agreements between the parties stipulate the payment and delivery methods and schedules. This is usually handled through electronic transfer or bank order.

1.5.2 BUSINESS-TO-CONSUMER (B2C)

B2C describes the commercial relationship existing between businesses and consumers, as in traditional retail. It implies a direct relationship with customers, the products can be tangible or intangible and delivery can be on-line or off-line.

Everyday more and more traditional shopping malls and large retailers are engaging in e-commerce transactions, supplementing their traditional direct sales model. A key factor of this relationship focuses on intangible goods, such as software, music and video products, which do not depend on physical delivery.

1.5.3 BUSINESS-TO-GOVERNMENT (B2G)

B2G describes the commercial relationship between government and businesses. Transactions vary from complex operations, such as official calls for tenders via the Internet, also known as government e-procurement, to simple operations, such as airline ticket purchases. Some positive aspects relating to electronic purchases in the public sector are worth mentioning: a high level of transparency, confidentiality of information, efficient customer service, and standardized savings and services.

1.5.4 CONSUMER-TO-CONSUMER (C2C)

This type of electronic commerce involves electronic transactions between individual consumers. Merchants are not involved in these transactions, which take place between consumers directly, i.e., sold by one consumer to another, without a middleman. In Brazil, Internet auction sites are the main representatives of C2C commerce. Fiscal and legal circles pay little attention to this type of transaction, since it does not represent a significant economic value. However, as observed in other countries, the figures generated by virtual auctions show that this market already accounts for 10% of C2C sales of online consumer goods in Brazil. Even though Brazilian law does not consider the occasional sale of goods between individuals to be a tax-generating activity, the substantial and recurrent sale of goods, even by individuals, constitutes a commercial activity that is therefore subject to taxation. Therefore, these transactions should merit a more careful scrutiny on the part of tax authorities.

2 POSITION OF ELECTRONIC COMMERCE IN THE WORLD

Countries, as well as international organizations, have approached the subject of electronic commerce in a variety of ways. While some of them tax it and others do not, all share a common concern inspired by the new economic and social reality brought about by the Internet on a large scale.

In this chapter, we will examine the positions of the organization for Economic Cooperation and Development (OECD), the United States, the European Union, Canada, the Latin American Association for Integration (ALADI) and Brazil.

2.1 OECD

Discussions on the possible impact of electronic commerce on world business were initiated by the OECD at the Ottawa Conference of 1998, which formulated guiding principles and criteria for the structuring of electronic commerce taxation. Among these, the following stand out: neutrality, justice, certainty, simplicity, effectiveness and efficiency.

The main conclusions of the Ottawa Conference¹ were as follows: the guiding principles should be incorporated into the tax rules and regulations already in force; the tax authorities should take advantage of new technology in order to provide a better taxpayer service; changes should preserve the fiscal sovereignty of countries, achieve a fair sharing of the tax base between countries, and avoid double taxation and non-taxation. Finally, these principles should apply also to communities outside the OECD.

Among the various principles governing electronic commerce, that of **neutrality** is the one which affects tax administrations most directly. An important consequence deriving from its application has to do with the avoidance of fiscal distortion in the case of transactions involving the provision of goods or services, regardless of the marketing system employed – be it traditional or the Internet – and whether or not delivery is made on-line.

At the Ottawa Conference, the OECD also established an agenda for the analysis of the challenges created by electronic commerce. Working groups

¹ OECD. <www.oecd.org>.

were set up to deal with five different areas: taxpayer service; tax administration, identification and information; collection and control of taxes; consumption taxes; and international tax agreements and cooperation.

These directives were adopted by other non-member countries of the OECD, including Brazil, through cooperation agreements.

2.1.1 CHALLENGES

Technical advances that shorten distances create virtual relationships and affect the way of life of many people raises a challenge for tax administrations in terms of how to fit into this new reality embodied by electronic commerce.

For an analysis of these challenges, it is essential that we examine a few basic topics, such as the mobility of consumption, of economic agents and of commercial activities. As some supporting concepts are relevant in the case of electronic commerce, new ways have to be found, adapted and applied to the existing legislation. Finally, it is necessary that we study the consequences they may have in regard to taxation.

- **Mobility of consumption** - With e-commerce, the consumption base is wider and globalized, and this produces a new type of consumer, one who can buy goods and services from anywhere in the world. Whether the consumer is a natural person or a business, the Internet is a source of opportunities in the search for better prices, quality, variety, and other benefits.
- **Mobility of economic agents and activities** - The Internet makes it possible for persons in different locations to hold a virtual meeting in order to render or provide a particular service, in a way that differs from the traditional concept of location as the place where a particular service is actually provided.
- **The problem of supporting concepts** - Tax law calls on concepts that belong to other legal areas, such as criminal or civil law, or to sciences such as Economics. These concepts, which were designed with traditional activities in mind, need now, in view of the development of the Internet, to be replaced, redefined or broadened, just as cybercrime had

to be defined in criminal law. In the case of tax law, this involves important concepts, such as that of territoriality, sovereignty and right of establishment, which are directly impacted by the existence of the Internet.

- **Implementation of existing legislation** - At first, opinions concerning the law to be applied to electronic commerce were split between two options: the writing of a new and specific law for electronic commerce transactions, or the adaptation of the existing law with the addition of new concepts and the modification of older ones. The OECD recommended that the existing legislation should be retained and adjusted where necessary.
- **New taxation arrangements** - Concerning the tribute to be levied on Internet use, it was at first suggested to institute a new tax, but in the end the prevailing proposal was for the Internet to be tax-exempt, the rationale being that it should be considered as a medium for conducting business, while the existing taxes would continue to apply to the transactions themselves.

2.1.2 RISKS

Due to the ever-wider utilization of the Internet, tax authorities encounter new risk situations in the course of their activities. One of these arises from the fact that Internet operators may be national or foreign, while the operations of tax authorities are limited to the territory over which their jurisdiction extends. A typical example can be found in companies that manage registers of domain names, which may operate internationally. With globalization, it is now possible to find countries that obey the rules of the game and others that opt for unfair fiscal competition.

2.2 EUROPEAN UNION

After long discussions on electronic commerce taxation, the EU approved an amendment to its Sixth Directive, called Directive No. 2002/38/EC², according to which transactions made via the Internet should henceforth be considered

² PINTO, Ana Pinelas. **Comércio Electrónico e Fiscalidade Indirecta- Algumas Considerações a Propósito da Aplicação do IVA às Transacções Electrónicas “On Line”**.

services (on-line) subject to VAT. If “off-line” sales were not mentioned in the Directive, it is because they are taxed in the same way as traditional commerce.

This decision presented no difficulty concerning the collection of the consumption tax (VAT within the European Union), as their tax’s base includes transactions on merchandise as well as on services. Nevertheless, tax collection on Internet transactions required a few adjustments, taking into account the specificities of electronic commerce, such as the definition of tax collection at the place of destination, or the issue of services provided to individual persons, which constitutes a major difficulty for tax administrations and requires new regulations in practice.

2.3 UNITED STATES

In a 1997 document entitled “A Framework For Global Electronic Commerce”³, the United States argued in favor of the postponement of the collection of tax on the Internet in order to give a boost to that new technology. Besides the non-introduction of new taxes on the Internet, it was stated in the document that the rates applicable to electronic commerce should be consistent with existing international principles, that double taxation should be avoided, and that any taxation levied on Internet sales must neither distort nor hinder commercial operations; at the same time, tax systems should not discriminate between various types of commerce nor create incentives to modify the nature or localization of transactions.

Another motive for the North American postponement proposal relates to the fact that the tax system is not compatible with the main characteristic of electronic commerce, namely the lack of physical borders. In the American tax system, the collection of taxes is decentralized, so that each tax jurisdiction applies its own tax regime to the Internet. Consequently, the country would be confronted with a situation of real normative chaos due to the absence of general guidelines.

On the basis of these considerations, in 1998 the American Congress passed the “Internet Tax Freedom Act”, which instituted a three-year moratorium,

³ White House, 1997: 3

subsequently renewed, on Internet access taxes only and not on sales made via the Internet, in order to incite technological progress as well as new forms of relationship between merchants and consumers.

Furthermore, the 1998 document prohibited the charging of new tributes on Internet access as well as the imposition of discriminatory tributes on electronic commerce, making an exception for state taxes already in force at the time.

Concerning electronic commerce per se, the United States is still confronted with important challenges, such as long distance sales issues.

The taxes involved in e-commerce in United States are **Sales** and **Use** taxes. The Sales tax is paid by the seller in the location where the transaction occurs. And the Use tax that it just levied when the Sales tax has not been paid; for this reason it is also known as complementary tax.

However when the sale is made by e-commerce between different states, in consequence of the United States Supreme Court decision there must be a sufficient nexus between the state and the seller. It must be a substantial nexus, i.e., the seller has some sort of establishment or office in the state of consumption of the good. If this link does not exist the tax cannot be charged to the seller. In this case, the tax will be charged to the end-user. However the difficulty of this collection has led to failure to pay Sales tax on e-commerce transactions between different states.

According to Monique Poggiali de Sousa⁴ “In spite of the fact that the U.S. has not yet solved the problem of taxation on e-commerce, a potential solution in place involves considerations of the burden of compliance imposed on business, simplification of the tax system and cooperation among governments and the business community”.

⁴ SOUSA, Monique Poggiali. “THE CHALLENGES OF TAXATION ON E-COMMERCE IN BRAZIL: LESSONS LEARNED FROM THE UNITED STATES”. Washington, Minerva Program (fall 2013).

2.4 CANADA

Following the guidance given by the OECD, in 1998 Canada issued a report entitled “*Electronic Commerce and Canada’s Tax Administration*”⁵, in which the country states its decision not to create new taxes concerning the Internet, but instead to adapt its legislation to the specific requirements of Internet commerce. As justification for that decision, it was explained that the creation of new taxes could potentially stifle the freedom of commerce and discourage companies from doing business in Canada.

Consequently, the Goods and Services Tax (GST) collected in Canada found its scope was broadened to also include intangible property, defined as any property, whether real or personal, movable or immovable, tangible or intangible, material or immaterial, including interest revenues of any kind, and shares, the only exception being cash⁶.

In Canada, the GST is levied on downloads and transfers of digital products, considered as equivalent to intangible goods. On the other hand, the hosting of Websites and software management contracts have been classified as services and are subject to taxation in the same manner.

2.5 LATIN AMERICAN ASSOCIATION FOR INTEGRATION – ALADI

The ALADI is an intergovernmental organization entrusted with the mission of promoting greater regional integration in order to ensure the economic and social development of its members and, ultimately, to create a Latin American common market. The following countries make up the ALADI: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela, Cuba and Panama.

In 2002, the ALADI published a report entitled “*Estudio sobre La Situación Tributaria del Comercio Electrónico*”⁷, dedicated to the impact of electronic commerce on taxation, or lack of it, in such transactions.

⁵ ASSUNÇÃO, Matheus Carneiro. “PANORAMA INTERNACIONAL DA TRIBUTAÇÃO NO COMÉRCIO ELETRÔNICO”. www.agu.gov.br/page/download/index/id/2048797

⁶ *Excise Tax Act*: <<http://laws.justice.gc.ca/en/ShowFullDoc/cs/E-15///en>>

⁷ [http://www.aladi.org/nsfaladi/integracion.nsf/eeeeed45bc6cbdcf7032574fd00627b37/5fbcdb034af3cb6b032574bb0061631d/\\$FILE/150Rev2-P.pdf](http://www.aladi.org/nsfaladi/integracion.nsf/eeeeed45bc6cbdcf7032574fd00627b37/5fbcdb034af3cb6b032574bb0061631d/$FILE/150Rev2-P.pdf)

The study contained recommendations concerning, for example, the implementation of the neutrality principle and the necessity of making legislative adjustments in order to pre-empt measures which could be detrimental to the expansion of e-commerce.

The report underscored a problem that is inherent to e-commerce, namely the sale of intangible goods via the Internet, and recommended that it should be dealt with in the same way as traditional commerce of similar goods. The necessary adaptations should render present tax systems more attuned to the reality of e-commerce in order to avoid shortcomings and to prevent legal disputes. Simplifying the calculation of tax makes its payment easier for the taxpayer and facilitates the correct enforcement of any relevant penalty by tax authorities.

Another aspect dealt with in the report has to do with the definition of various supporting concepts, such as that involving the sale of intangible goods or services, and the assignment of rights. It is also stressed that a difficulty deriving from the variety of legal systems is the magnitude of the concept of merchandise connected to tangible goods.

Finally, as far as the position of the ALADI is concerned, one must point out that the problems and solutions discussed in the report have led to what are essentially recommendations addressed to the member countries.

2.6 BRAZIL

In Brazil, the issue of taxation in connection with e-commerce is still in need of further research and extensive studies. One can say that the matter came to the fore in Brazil in 2000, when the first relevant legislation was adopted and the Convênio ICMS 51/00 took place (it dealt with the direct manufacturer to end-user sales of vehicles via the Internet). The Federal Revenue Office (Receita Federal) discussed this question at the “Seminário Internacional de Comercio Eletrônico e Tributação”⁸ (International Seminar on Electronic Commerce and Taxation) that same year.

⁸ GUARAGNA, Paulo Ricardo Saldanha. “Tributação indireta do comércio eletrônico no Brasil: Os princípios de Ottawa e a legislação tributária brasileira na perspectiva do ICMS e do ISSQN”, Page 53, 2006.

In Brazil, e-commerce taxation requires a two-fold analysis. First, the jurisdiction regarding tax collection on Internet operations is a major point of legal contention between States and Municipalities, since the latter consider that such operations amount to the provision of services. For this reason, Municipalities would be competent to collect the ISS. For their part, States argue that the use of the Internet is a kind of telecommunication service subject to the ICMS, which is a State tax. The legal disputes generated by this lack of agreement were examined by The Brazilian Higher Court of Justice- STJ, which decided against charging both the ISS and the ICMS, leaving out any tax collection on these operations.

The second question concerning electronic commerce, which will be discussed in more detail in the next chapter, deals expressly with the sales transactions made via the Internet, their repercussions on traditional commerce and the need for tax authorities to fit into this new environment.

In this case, the relevant tax is the ICMS. However, the specificities of the Internet raise other problems concerning, for example, sales involving a consumer and a seller located in different Brazilian States. This was also the source of legal disputes, and a fiscal war broke out between States about the distribution of revenues derived from these transactions. The problem lies in the shortcomings of the legislation, which, at the time, did not foresee the vast expansion of the Internet and failed to apportion the tax revenues from these operations among the State of origin and the State of destination.

3 The ICMS in the BRAZILIAN TAX SYSTEM

The aim of this chapter is to provide an overview of the basic concepts of the ICMS (tax on the circulation of goods and transportation and communication services) in the Brazilian tax system. We will first examine the system's foundations, and then the ICMS's role within it.

3.1 The Tax System in the Federal Constitution of 1988

The foundation of the Brazilian tax system lies in the Brazilian Federal Constitution, promulgated in 1988. The Constitution determines that Brazil is a Federative Republic, formed by the indissoluble union of the States, Municipalities and the Federal District⁹.

The Constitution of 1988 established the principle of federalism. In this way, Brazil is a federation deriving from the union of States giving birth to a new state (the Federal State), distinct from its constituents (Member States). The Member States relinquished certain prerogatives in favor of the Union, the most important of which is sovereignty. Accordingly, the Member States do not possess international identities and cannot be parties to international treaties.¹⁰

The Constitution of 1988 apportioned the power to tax among the following political entities: Union, Member States, Federal District, and Municipalities. It also sub-divided fiscal contributions into taxes, levies, and benefit charges (from public Works)¹¹.

The national constituent assembly designed the tax system in such a way as to allocate public revenues among the political entities, thereby giving them financial autonomy to manage and fulfill their constitutional obligations.

In matters of taxation, the "Magna Carta" of 1988 assigned the competence to institute taxes between the Union (art. 153), the States and Federal District (art.155) and the Municipalities (art. 156).

⁹ Article 1 of the Constitution of Brazil (1988).

¹⁰ CARRAZA, Roque Antonio. **Curso de Direito Constitucional Tributário**. 12. ed. São Paulo: Malheiros, 1999, p. 100.

¹¹ Article 145 of the Constitution of Brazil (1988).

The ICMS is a tax coming under the remit of the States and Federal District only. Taxation is allocated to these respective bodies as follows:

3.1.1 Federal Taxes

- I - Importation of products
- II - Exportation of products
- III – Income
- IV - Industrialization of products
- V - Financial transactions, money exchange and insurance operations
- VI - Rural properties
- VII - Large fortunes

3.1.2 State Taxes

- I - Inheritance of properties or donation of assets and rights
- II - Circulation of goods, interstate and intermunicipal transportation services and telecommunications services - ICMS**
- III - Property of motor vehicles

3.1.3 Municipalities Taxes

- I - Urban properties
- II - Real estate transfer by dealing
- III - Supply of services in general, excluding the services taxed by State Governments.

3.2 ICMS

The ICMS is a tax that falls under the competence of the Member States and the Federal District. It is their main source of income and it is also the tax with

the highest return in Brazil¹² and, consequently, it is a matter of utmost prominence on account of the repercussions it has on the state governments.

In this chapter, we will examine a few general concepts and important characteristics of this tax in order to analyze the impact of e-commerce on the collection and monitoring of the ICMS.

3.2.1 DEFINITION

The Brazilian Constitution defines the ICMS as “*a tax on transactions relating to the circulation of goods and interstate and intermunicipal transportation and communication services*”¹³.

As previously mentioned, it is a tax that falls within the competence of the States and the Federal District, as established in the 1988 Constitution. The ground rules and regulations governing it are contained in the Complementary Law 87/96. The Complementary Law was instrumental in modernizing the tax, which became a “consumption” (sales) tax, close to international standards, as is the case of the European VAT (Value Added Tax).

Among other things, the Complementary Law, with regards to the ICMS, established its general provisions for the nation as a whole, standardizing it at the national level, and leaving the task of defining its more specific regulations to the States. Every Member State of the Federation institutes its own ICMS law, in order to adapt it to the particularities of the economy of each federated entity. As Brazil is made up of 27 Member States and the Federal District, a huge number of fragmented rules concerning the ICMS can be found in each State.

An organ was created known as Brazil’s Finance Policy Council - CONFAZ for the purpose of holding discussions on the elaboration of policies and the standardization of procedures and guidelines regulating the exercise of tax competence by the States and the Federal District. CONFAZ is a deliberative organ established by the Complementary Law 24/75, and its members are the Secretaries to Treasury, Finances or Taxation of each member State and the

¹²Source: Instituto Brasileiro de Planejamento Tributário. [HTTPS://www.ibpt.org.br](https://www.ibpt.org.br)

¹³Article 155, section II of the Constitution of Brazil (1988).

Federal District, as well the representative of the Union itself in the person of the Finance Minister.

CONFAZ is backed by a Permanent Technical Committee, COTEPE, which can call on various specialized working groups to discuss necessary changes and modifications to the ICMS legislation. A specific working group, GT-12, was created to deal with the problems regarding e-commerce.

3.2.2 HYPOTHESIS OF ICMS OCCURRENCE AND TRIGGERING EVENT

Having conceptualized the ICMS as a tax falling under the jurisdiction of the States and the Federal District, it is now necessary to define its constituent elements.

First, it must be emphasized that a tax is but one of the tributary species. According to the Brazilian Federal Constitution, tributes are classified as follows: taxes, levies, and benefit charges.

A tax is a monetary tribute that stands on its own, as it is due from the taxpayer regardless of any provision of consideration from the public authorities. Taxes cover the costs of services intended for the public interest, unlike levies and benefit charges that are due when a specific service is provided by the public authorities¹⁴.

This means that the purpose of the collection of taxes is to supply the State with the necessary resources to pay for the government's general expenditures. However, the tax can only be demanded by the political entity to which the Federal Constitution has assigned the tax competence.

The term 'tax', then, can be taken as being the imposition of a financial burden on the **taxpayer** (natural or legal person) by a **political entity** that has been legally assigned the task of covering the general costs of government.

For a tax liability to exist, the law has conceived a theoretical situation, named the "hypothesis of occurrence", the material manifestation of which is called a "triggering event", and it is the moment at which the obligation to pay tax originates. In other words, such obligation arises only when the taxpayer

¹⁴ Carrazza, Roque Antonio in "Curso de Direito Constitucional Tributário", 12ª edição, Malheiros Editores, 1999, p. 348.

performs the act (**triggering event**) foreseen by law (**hypothesis of incidence**).

For its part, the amount of the tax will be calculated by applying a certain rate (or percentage), to the amount of the transaction (**basis of computation**).

From the above concepts, we can draw the following elements of a tax: taxpayer, rate, basis of computation, and hypothesis of occurrence.

The taxpayer is the natural or legal person who accomplishes the acts stipulated by law as being necessary to create the obligation of paying tax.

The basis of computation is the amount of the transaction. The rate is the percentage applied in the computation to determine how much tax is to be paid.

The triggering event of a tax is the occurrence of a situation provided for by law, called **hypothesis of occurrence**, from which the obligation to pay tax arises.

For our study's purposes, the most important element constituting a tax is the hypothesis of ICMS occurrence, which is defined in the Federal Constitution¹⁵ itself and in the Complementary Law 87/96¹⁶:

- **Circulation of goods**

The term **circulation** is understood as any transfer of ownership of movable assets, implying the physical, or simply legal, movement of the property; in the latter case, ownership is transferred without any actual movement of property. As to the term **goods**, it is understood as any movable asset with economic value that can be sold. By law, the concept of goods extends to electric energy, liquid and gas fuels, lubricants and minerals.

- **Transportation services**

The tax is also levied on the actual provision of interstate or intermunicipal transportation services, by any means, of persons, assets, goods or valuables.

- **Communication services**

This relates to the provision, against payment, of communication services by any means, including the production, broadcasting, reception, transmission,

¹⁵ Article 155, section II of the Constitution of Brazil (1988).

¹⁶ Article 2 of the Federal Complementary Law No. 87/1996.

relay, duplication and amplification of any type whatsoever, such as: fixed or mobile telephony, pay-tv, and broadband service.

This type of hypothesis of occurrence has given rise to a number of legal disputes concerning the collection of fees from Internet providers. As the Internet is a new and complex tool, the lack of technical knowledge on the part of legislators reflects on the legislation, which is poor and confusing. In this context, Municipalities have been claiming the right to collect the ISS (service tax), even without reference to the Complementary Law. At the same time, the States were also recovering the proceeds from the ISS as a service. This dispute was settled in court with the decision relating to the non-recovery of both the ISS and the ICMS from Internet providers¹⁷. Only the States are entitled to recover fees for communication services.

- **Delivery of goods with provision of services outside the competence of municipalities**

In this case, the hypothesis of ICMS occurrence is governed by a process of exclusion, because the provision of services is taxed as an ISS, a municipal tax. However, the ISS will be levied only on those services specifically mentioned in the Complementary Law 115/00. If the relevant service is not mentioned in said law, it will then, by exclusion, be subject to ICMS imposition.

- **Entry of foreign import goods**

The ICMS will be levied on goods imported from abroad upon their entry into the Brazilian territory, regardless of whom is importing the merchandise, be it a natural person (individual) or a legal person (corporate body).

- **Service provided outside Brazil or initiated abroad**

Even though the tax on services is generally within the competence of Municipalities, if such services are provided or initiated abroad, they are subject to ICMS taxation.

3.2.3 ICMS CHARACTERISTICS

The ICMS is a selective, indirect, multi-phase and non-cumulative tax¹⁸.

¹⁷ Superior Court of Justice Decision REsp 511390/MG, 2005.

¹⁸ Article 155, § 2 of the Constitution of Brazil (1988).

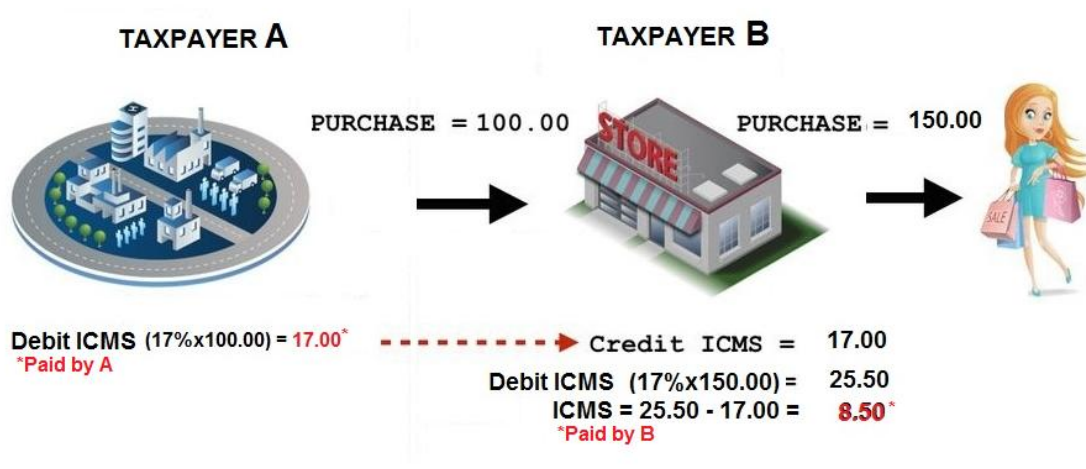
Selectivity means that the rate charged on the merchandise, in order to determine the tax amount, may vary according to the essential nature of the goods.

An **indirect tax** is one that is levied on consumer goods and services. Although it is charged to producers and merchants, it indirectly affects consumers in the long run, because it is carried over to the prices of said goods and services, forming part of the basis of computation of the tax itself. For this reason, it is not noticed by the consumer.

The ICMS is **multiphase**, since it involves all stages of the circulation of goods and services, from the producer/manufacturer, through the middleman, to the end-user. Each phase is independent, with its own triggering event.

The characteristic of **non-cumulativity** means that, at each stage of the circulation of merchandise or services, the amount of the corresponding ICMS must be compensated by the amount charged during the preceding stages. In this way, the taxpayer pays, at each stage of the merchandise or service sale/purchase activity, his/her portion of the total amount, according to a system of debit and credit in which the next activity receives the credit of the previous one, so that the final amount paid is only the difference corresponding to the value added to the merchandise, as in the case of the value-added tax. The following figure provides a better illustration of this characteristic:

Figure 3.1



Even though the characteristic of non-cumulativity has merit in that it does not produce a “cascading” tax, it created a problem in terms of transactions

between two Member-States. The ICMS levied on interstate transactions, between two States, for example the sale of merchandise initiated in one state (producer state) and finalized in the other (consumer state), needs to be split between the two. A zone of interstate conflict becomes inherent within this allocation of the tax proceeds.

In order to understand how to allocate the proceeds from the ICMS levied on interstate transactions, we must deepen our understanding of the ICMS rates.

There are three types of rates: internal (transactions within a State), interstate (transactions between two States), and export. The latter will not be discussed here, as it has no bearing on the theme of this study.

Internal rates, established by the States themselves, vary according to the essential nature of the goods, as a result of the aforementioned principle of selectivity. For example, goods which form the basis of the foodstuffs consumed by the population are charged at a rate of 2%, while products such as beverages and cigarettes may be charged up to 27%.

The competence to determine interstate rates belongs to the Federal Senate, which is the organ of political representation of the States, acting by virtue of a Senate Resolution, as established in art. 155, par. 2 of the Federal Constitution.

The Constitution gave the Senate competence to establish interstate rates and entrusted it with the following two-fold mission: 1) prevent conflicts from arising between States through the use of rates as a fiscal bargaining chip; and 2) pursue one of the basic objectives of the Federation, i.e. the reduction of social and regional inequalities through the application of rates, on interstate transactions, so that a higher percentage of the tax be earmarked for those States that are deemed “poorer”¹⁹.

The Southern and Southeastern States are considered “rich”, while those of the North, Northeast, Central West, and the State of Espírito Santo (which was included in that group in this context, even though it belongs to the Southeastern region) are supposed to be “poorer”. On the basis of this

¹⁹ Article 3, section III of the Constitution of Brazil (1988).

definition, the Federal Senate, through its Resolution No. 22 of 1989, established the ICMS rate on interstate transactions, as follows:

1. When the consignee is the final consumer:
 - Internal rate of the originating State.
2. When the consignee is also a merchant:
 - The rate will be 12%, except for transactions originating in the Southern and Southeastern regions destined for the Northern, Northeastern and Central West regions and the State of Espírito Santo, for which it will be 7%.

Besides setting the rate applicable to interstate operations, the Constitution also determined how the income deriving from the ICMS should be distributed among the States. In this way, the merchant who initiated the transaction collects the ICMS at the interstate rate applicable to the originating (producer) State. The difference between the internal rate and the interstate rate, called **rate differential**, will be collected by the merchant located in the destination (consumer) State.

Interstate transactions can be quite diversified, depending on the parties involved. A transaction may take place between merchants, or between merchants who sell directly to consumers located in another State. These two situations do not have the same fiscal repercussions.

To better understand interstate transactions between two merchants, let us examine the example given in figure 3.2, where part of the ICMS is paid to the State of origin (in this case, the State of São Paulo), and the remaining part is paid to the destination State (the State of Pernambuco, in this case).

Figure 3.2

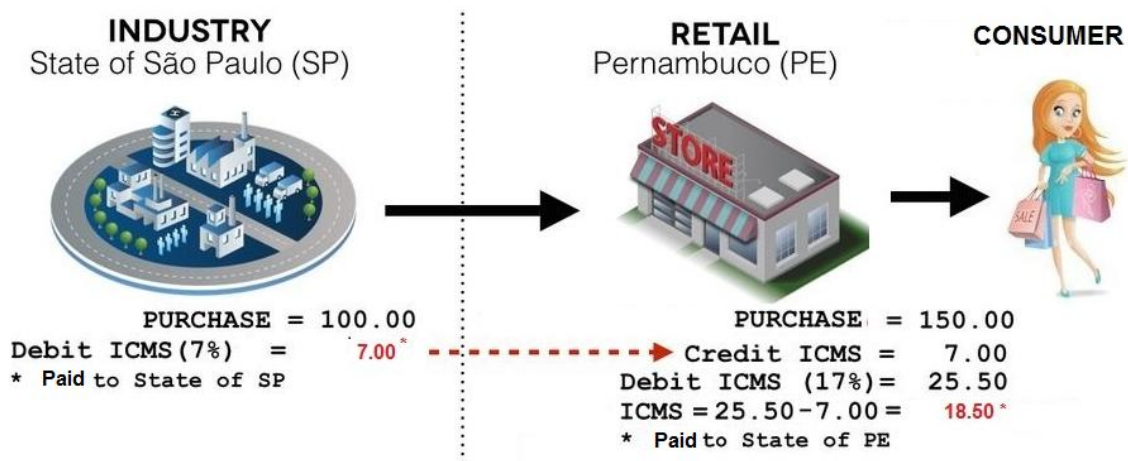
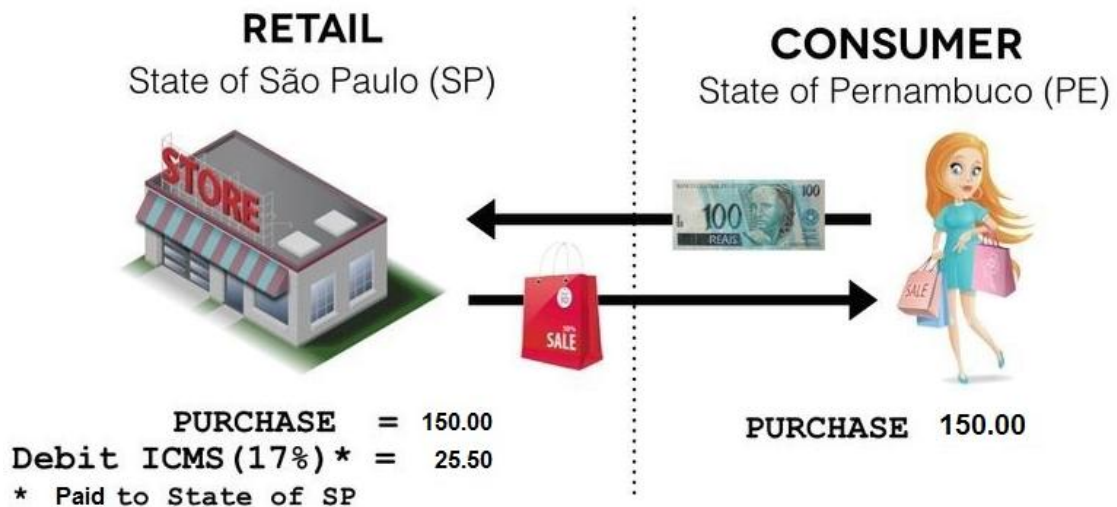


Figure 3.3 describes an interstate transaction between merchants (State of origin) and final consumers (destination State). The rate applied will be the same as the internal one of the State of origin, and the total amount collected will likewise go to the State of origin (here, the State of São Paulo).

Figure 3.3



Due to the expansion of e-commerce, this type of activity has greatly increased during the last few years, causing imbalances in how the ICMS is apportioned among the States. In particular, the tax revenue of consumer States is diminishing, while that of producer States, which are the richest in the Federation, is increasing. This is, in fact, a transfer of monies from the poorer to

the richer States, contrary to one of the objectives stated in the Brazilian Constitution²⁰. This outcome will be analyzed in more detail in the next chapter.

²⁰ Article 3, section III of the Constitution of Brazil (1988).

4 ELECTRONIC COMMERCE AND ITS EFFECTS ON THE ICMS

This is one of the most relevant and widely discussed topics in Brazil today with regard to the tax reform required for the country's development.

In Brazil, one of the first forums to take up the subject of electronic commerce was the "International Seminar on Electronic Commerce and Taxation", convened in 2000 by the Federal Revenue Office. Its conclusions describes the main difficulties posed by the taxation of electronic commerce in the context of the Brazilian Tax System, and suggests a few alternative courses of action. In his paper on the subject²¹, Paulo Guaragna stresses that the conclusions of the Seminar were guided by a fundamental tenet, that of promoting a tax reform thanks to which taxes on electronic commerce would take on the characteristics of the tributes for which the Union has competence and no longer those of the States or Municipalities.

The Brazilian Federal Constitution, promulgated in 1988, did not mention electronic commerce. At the time, the Internet had little significance as a way of making direct sales to end-users. Consequently, the authors of the Constitution gave priority to the simplification of the tax system, entrusting the collection of the ICMS entirely to the seller's State of origin.

The scene has changed since then. During the past few years, electronic commerce has grown exponentially. The use of the Internet as a selling means to conduct business marked the end of the paradigm according to which consumers and sellers had to be close to one another or located in the same Member State of the Federation. It so happened that the taxation of such operations remained in the hands of the State where the seller was located and that the system of apportionment of the ICMS among States was no longer balanced.

The problem of apportioning the ICMS revenues levied on interstate electronic commerce transactions in Brazil gained visibility around 1998, when car manufacturers innovated by selling popular cars directly to end-users, taking

²¹ GUARAGNA, Paulo Ricardo Saldanha. "Tributação indireta do comércio eletrônico no Brasil: Os princípios de Ottawa e a legislação tributária brasileira na perspectiva do ICMS e do ISSQN", pages 48-52, Brasília: ESAF, 2006.

advantage of the Internet to reach the whole territory of the country. The expansion of this new way of making sales led to the problem of apportioning the ICMS revenues.

In 2000, an agreement “Convênio ICMS 51” turned out to be the first piece of legislation dealing with the issue of the apportionment of the ICMS levied on direct manufacturer to end-user car sales over the Internet. This agreement set out how to distribute the ICMS levied on sales of vehicles between a producer State (which keeps 55%) and a buyer State (which receives 45%), and the result was a balanced distribution of the ICMS revenues from sales of vehicles.

Brazil’s Finance Policy Council (CONFAZ) has led the way in the attempts to resolve the question of the apportionment of the ICMS levied on Internet operations in general – and not just on sales of vehicles – and its efforts were directed at standardizing the interests of the States involved. However, the States of origin have benefitted from the simplification induced by the Constitution and are reluctant to accept the division of tax revenues for a quite simple reason: the ICMS is the biggest revenue-producing tax within the Brazilian tax system.

Since 2010, the working group on electronic commerce (CONFAZ - GT12) has held meetings with the purpose of solving the issue of the apportionment of the ICMS, but did not reach a consensus. States where electronic commerce firms are located, specifically the producer and “richest” States, do not agree to concessions regarding the distribution of the ICMS revenues and contend that their rights are upheld by the Federal Constitution, even though the injustice of such a situation is widely recognized.

With no prospective agreement in sight, the eighteen (18) States harmed by the absence of apportionment of the ICMS signed the ICMS 21/2011 Protocol on April 1st, 2011, which required that the rate differential of the ICMS charged on interstate transactions made directly with end-users via the Internet be paid at the moment of entry of the merchandise into the territory of the consumer State.

Such a measure goes against the principle of federalism and opens another chapter in the so-called “fiscal war”, provoking distortions in the collection of

taxes, increasing the complexity of the system and leaving taxpayers in uncertainty.

The 21/2011 Protocol is a blatantly unconstitutional instrument, since the tax already paid to the State of origin is levied again at the border(double taxation). The electronic commerce firms did not agree to the Protocol, and many States denounced it because of its negative repercussions and on account of the judiciary decisions enacted against the collection of the rate differential.

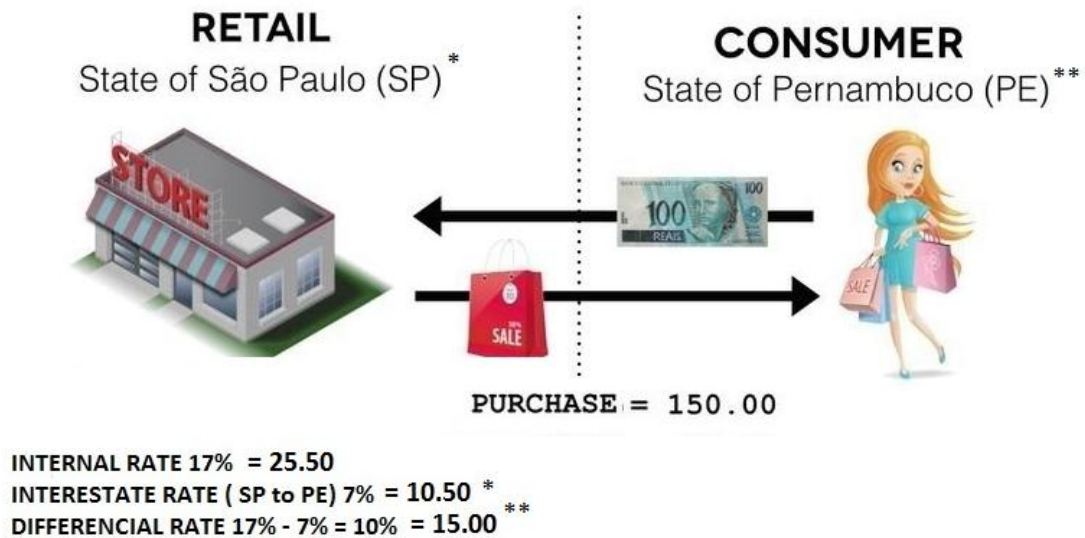
Finally, at the 153rd regular meeting of the CONFAZ of March 21, 2014, the terms of a historic agreement were accepted by the Members States of the Federation. The State of São Paulo, which hosts the greatest number of electronic commerce firms and is also the State which collects the highest revenues from the ICMS in the country, agreed to share out the relevant ICMS revenues, provided that the implementation of such a measure went through a gradual process over several years in order to minimize the loss of revenue incurred by the States of origin.

For computation purposes, tax revenues levied on sales to end-users, whether these are taxpayers or not, located in a State other than the seller's, will be apportioned according to the formula used in interstate operations. The State where the consignee is located (end-user) will receive the portion of the tax that matches the difference between the internal rate of the State of destination and the interstate rate. This method is similar to that which uses the rate differential applied to transactions between merchants located in different States, like traditional transactions.

The difference between the two situations resides only in the fact that the responsibility for the payment of the tax, either to the consumer State or to the State of origin, will lie with the seller located in the State of origin of the transaction. As this system of payment is already used in other circumstances, its implementation should not be problematic.

The following figure 4.1 provides a better illustration of the solution described in the agreement:

Figure 4.1



The method of apportionment among the States of origin and destination of revenues from taxes levied at the interstate and internal rates will be implemented in stages during a five (5) year transition period starting in 2015 with 20% of the rate differential going to the State of destination and 80% to the State of origin. Each year, the share of the State of destination will increase by 20% until the year 2019, when it reaches 100%.

This accepted solution sets out the political conditions necessary for implementing the legislative changes regulating the apportionment of the ICMS revenues from electronic commerce.

A proposed Constitutional Amendment, which was already under examination by the Federal Congress since 2011 (initially under No. 103/2011), was modified in Protocol No. 197 of 2012, after being accepted by CONFAZ; it finally received the favorable opinion of the Federal Senate Committee on April 2nd, 2014, and submitted for vote to Congress.

The conclusion of the legislative process regarding the Constitutional Amendment Proposal (197/2012) will mark the settlement of the conflict created by electronic commerce as regards the ICMS, as well as the end of one episode in the “fiscal war” waged between States.

5 CONCLUSION

The purpose of this project was to analyze the challenge represented by the expansion of electronic commerce today, its resulting effects on traditional commercial channels and its effects in relation to the ICMS (Tax on the Circulation of Merchandise and Services).

The issue of electronic commerce in Brazil was fraught with problems due to the complexity of the Brazilian tax system. First, there was the legal dispute between Municipalities and States regarding tax competence over the use of the Internet. The Brazilian Higher Court of Justice- STJ ruled against both the collection of the ISS (tax on any kind of service) and of the ICMS for Internet provider services, authorizing the collection of the ICMS on telecommunication services only.

Another electronic commerce challenge examined in this project specifically concerns the repercussions of Internet sales of merchandise on traditional commerce and on the collection of the ICMS. The conclusion was that State tax administrations must modernize in order to overcome this difficulty.

Furthermore, the sale of intangible goods delivered via downloads to the buyer's own computer is an issue that has not yet been satisfactorily resolved by tax authorities, precisely because the challenge resides in putting up inspection mechanisms for auditing all these operations.

As regards Internet sales of tangible merchandise, Brazil, on account of the specificity of its federative configuration, is confronted by a major challenge: how to apportion the ICMS derived from these operations revenues among producer and consumer States. The legal disputes and the "fiscal war" that broke out were harmful to the full development of electronic commerce, as they entailed unnecessary costs, such as the payment of the rate differential levied as a result of 21/2011 Protocol, or the court proceedings instituted against it, leaving merchants with uncertainty.

The present apportionment of the ICMS revenues from interstate sales has revealed the lack of flexibility of the Brazilian tax system as regards its

adaptability to change, since solving this tax distribution issue requires amending the Brazilian Constitution.

In an historical agreement, orchestrated by CONFAZ in March 2014, Brazilian States decided on the apportionment of tax revenues levied on interstate sales made to end-users (including telemarketing operations in addition to Internet sales) among the States involved: they adopted the same criterion of rate differential used for interstate operations involving taxpayers. This change will be implemented in states over five (5) years starting in 2015, with 20% of the rate differential going to the State of destination and 80% to the State of origin, the figure increasing each year by 20% for the State of destination, to reach 100% in 2019.

The above-mentioned agreement was referred to a Federal Senate Committee that examined a proposed Constitutional Amendment (PEC No. 197/2012), due to be sent for Congressional vote.

When PEC No. 197/2012 is passed, one can hope that its approval will settle the dispute generated by electronic commerce in relation to the apportionment of the ICMS revenues derived from interstate transactions, and will mark the end of one more episode in the fiscal war waged between the States.

One must not forget that the Internet does not just represent a problem for tax administrations but that it is also a challenge of our times. The dynamism inherent in electronic commerce transactions makes it imperative for tax authorities to design a new taxation model using the Internet as a tool against tax evasion. Similarly, the aim of the Internet must be to increase efficiency and to reduce costs incurred by tax administrations as well as by taxpayers, without hampering tax collection.

Finally, from a broader perspective, one can conclude that the Brazilian tax system needs to be reformed so as to become simpler and more neutral, fair and efficient. Its present complexity is undoubtedly one of the factors that hinder Brazil's economic development.

Anyway, a reform of such magnitude requires political circumstances that simply do not exist in Brazil today (just look at how difficult it is to adjust the rate differential of interstate electronic commerce operations!).

As long as the political circumstances necessary for structural reform are absent, the latest conflicts should be settled on the basis of principles making for a much improved tax system. However, one cannot help but notice that the reforms that have been carried out seek only to increase or secure the income of the collecting entities: Union, States, or Municipalities. This is precisely the same problem that prevents the making of a wider ranging and structured reform of the Brazilian tax system.

Faced with the challenge of electronic commerce, each country reacted differently, in accordance with its objectives and the flexibility or rigidity of its taxation systems. The European Union added an amendment to its Directives to collect e-commerce related taxes, thereby increasing the complexity of its tax system. Canada, having greater agility and flexibility, increased its Goods and Services Tax (GST) to cover intangible goods (downloads and transfer of digital products), thereby resolving the issue of tax collection. The United States, faced with the complex challenge of collecting tax on e-commerce transactions for end-users located in a different state than the seller, resolved to maintain the practice of leaving the payment to the end-user, with the effective result that the tax is not collected. In Brazil, despite the OECD's recommendations and faced with its own complex and inflexible tax system, only a few States approved 21/2012 Protocol which calls for double taxation on electronic commerce transactions, but this measure was repealed by judgment decision of the Brazilian Supreme Court²².

In the meantime, even in light of the OECD's recommendation that, since 1998, "tax authorities should take advantage of new technology in order to provide a better taxpayer service" there still has not been a significant change in the tax authority and taxpayer relationship, proportional to the advances in electronic commerce. The changes introduced and implemented by tax administrations still have, as their main objective, greater tax collection but they are not taking

²² ADINs 4628, DJe (2014). Retrieved from: WWW.STF.JUS.BR in 17 of September of 2014.

advantage of new technology to create a simpler and more efficient relationship with the taxpayer.

In light of this conclusion, we observe that the matter is not yet resolved, on the contrary, and further studies should be conducted with the aim of constructing a tax system that maintains the specific characteristics of each country, taking into consideration that commercial relationships will be more and more electronic-based, international, and without intermediaries.

Finally, the challenge faced by tax administrations is a monumental one, which must be addressed with courage and intelligence.

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