

# GLOBAL BUSINESS DIALOGUE ON ELECTRONIC COMMERCE



## TAXATION

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## INTRODUCTION

Tax policy will greatly impact the potential growth of the emerging networked economy. To ensure this growth, government and industry must work together to create a tax system that stimulates this digital marketplace. Tax policy must also address governments' legitimate need to collect tax revenues and eliminate competitive distortions faced by local industries. To find tax solutions that balance these national interests with global realities, GBDe is committed to participate in a government/industry dialogue on an international, regional and national basis.

## BASIC TAX PRINCIPLES

GBDe recommends that governments rely on the following basic principles as they develop tax policies for the networked economy:

- 1) **Neutrality:** Tax policy must not penalize businesses and consumers who choose to conduct transactions electronically rather than through traditional channels of commerce. Goods or services should receive the same tax treatment regardless of delivery method, and compliance burdens should not be heavier for businesses and consumers who conduct business electronically than for those who engage in traditional commerce. Double taxation, double non-taxation (e.g. instances where consumption taxes applied to a set of transactions must be collected by vendors in one country but not collected by vendors in other jurisdictions on the same transactions) and other competitive distortions should be avoided.
- 2) **Simplicity:** The rules for taxing all forms of commerce, including Internet-enabled transactions, should be simple, clear and easy to apply. Governments must dramatically simplify their tax systems, and ensure that compliance burdens do not discriminate against businesses and consumers who conduct transactions electronically. Tax authorities should take advantage of new technology to reduce the costs of complying with tax rules.
- 3) **Fairness:** No single category of e-commerce operators should be penalized by the allocation of tax burdens. The liability for collecting taxes on virtually traded goods should not be forced upon financial intermediaries, providers of electronic infrastructure or other parties who are not liable for taxes on similar conventional transactions. Research should be undertaken to investigate the technical possibilities of developing automated tax systems that would efficiently distribute compliance burdens.
- 4) **Enforceability and Technological Efficiency:** The emerging networked marketplace creates difficult enforcement challenges for today's tax systems. GBDe recognizes the competitive issues that may result and believes that government and industry must take care to develop credible compliance models to secure tax collection. Such models should be reasonable, technologically

feasible, and free of undue burdens or economic distortion. GBDe endorses the ongoing work of the Organization for Economic Cooperation and Development (OECD) to address this issue in a systematic and global fashion.

- 5) **International coordination and consistency:** Tax policy worldwide must be coordinated and consistent with a model that can be implemented on a global basis. Again, GBDe endorses the OECD as an appropriate venue for this coordination to occur.
- 6) **A tax framework adapted to the networked economy:** Governments should understand the impact of taxation policies on the growth of the networked economy. For instance, one of the most important tools companies have is the manner in which they compensate employees. Employee participation in companies' profits and value-creation is today indispensable, and equity compensation such as stock options is used by a large number of global enterprises. In this respect, the tax treatment of equity compensation in many countries is a serious concern for companies having global activities. Furthermore, governments should not hinder companies seeking to educate and prepare their employees for the revolutionary changes of the information society. Thus, free computers given by companies to all employees and their families should not be treated as income imputed to the employee.

### GLOBAL POLICY ENVIRONMENT

The GBDe recognizes governments' legitimate right to enforce consumption taxes on transactions involving customers within their borders. As electronic commerce – such as digitally delivered goods and services – challenges enforcement of these taxes, governments will understandably seek to prevent competitive distortions, ensure a tax-neutral market environment and protect existing revenues.

In the United States, the policy focus has been on whether remote vendors (i.e. phone, Internet, mail order etc) should be obligated to collect and remit sales and use taxes to states in which they sell goods to consumers but otherwise have no physical presence. Vendors currently are not obliged to collect and remit sales taxes on remote sales because of a U.S. Supreme Court decision that said such an obligation would pose an unconstitutional burden on interstate commerce, due in part to the complexity created by differing state and local sales tax laws.

State governments, concerned about the potential loss of revenue from remote sales, have urged the United States Congress to require that remote vendors, including those doing business via the Internet, collect and remit sales and use taxes in all states. To date, the U.S. government has taken a wait-and-see approach to this issue and previously passed a moratorium on the imposition of new or discriminatory taxation of electronic commerce. This moratorium does not address or change current rules governing sales tax collection.

The GBDe endorses an extension of the current moratorium on new and discriminatory taxes on the Internet. Such a moratorium is not intended to avoid tax responsibilities or the collection of consumption taxes legitimately owed, but would allow for a thoughtful and global response to Internet taxation and give states and localities time to dramatically simplify their sales tax systems. GBDe also endorses efforts to restrict taxes on Internet access.

In Asia, Latin America, and Europe, most nations currently have some form of national consumption tax that is applied to both online and offline sales. China, notably, recently announced its intent to ensure its consumption tax system is applied to online sales. Japan also applies a national consumption tax to both domestic online and offline sales, and is examining how it can be enforced in a cross-border online environment.

For most electronic commerce transactions, consumption taxes can easily be levied on goods ordered online but physically delivered to consumers. For business-to-business sales there similarly are no substantial compliance concerns.

However, when sales occur directly between an online vendor of digital goods (music, video, software, books etc.) in one country and individual consumers in another country, governments will be challenged to collect consumption taxes on these sales.

Companies are generally not obliged to collect consumption taxes on online sales made directly to consumers in other countries. This situation concerns governments for two reasons: 1) the potential loss of revenue, which is now widely acknowledged to be quite small (regardless of the importance of the underlying turnovers for the respective company); and 2) it creates a non-neutral environment. For example, a German provider would be obligated to charge consumption taxes on a sale of software downloaded to a German consumer. However, a United States vendor of a similar product would have no obligation to collect the VAT. Hence, there is a competitive distortion based on tax treatment.

The European Union, through its proposed Amendment to the Sixth VAT Directive, is the first government to attempt to address this issue legislatively.

The EU directive would require online sellers of digitized goods and services to register for VAT collection purposes in a single EU member country. The non-EU vendor would be obligated to collect and remit VAT to the country in which it registered for all sales to EU consumers. EU authorities have recognized that the amount of tax revenue that would be collected from business to consumer sales of digitized goods is currently quite small. However, they have said their primary intent is to address the issue of competitive distortion.

For this reason, GBDe appreciates and understands the EU's rationale for amending the Sixth VAT Directive in order to collect taxes that are legitimately owed.

However, the draft Directive leaves some critical issues unresolved, including the enforceability of an essentially voluntary system and continued presence of competitive distortions for some stakeholders. For instance, a single point of registration approach does not fully harmonize the rates that EU & non-EU companies must apply to consumer transactions involving digital products. Nevertheless, the Commission proposal is a positive step in that it is intended to provide simplification and ease the burden of compliance. We note as a first step to achieve VAT harmonization in the EU the possible introduction of majority voting in Council taxation issues as currently under discussion in the framework of the Intergovernmental Conference (current rules mandate unanimous approval). The GBDe also invites the EU to identify potential ways to eliminate or reduce these competitive distortions, such as applying a single rate for all digitized sales into the EU by all vendors.

GBDe recognizes that the recent draft amendments are a first step in a long process, and that a great deal of continued dialogue will be necessary to adequately resolve the range of concerns. We invite the EU and other governments to move forward to create a system that is enforceable, fair and globally viable. We endorse the ongoing work of the OECD to assist the EU and other governments apply globally accepted e-commerce taxation principles to national tax systems and avoid a patchwork of inconsistent national tax laws.

International consensus is critical to ensure that e-commerce taxation is neutral, enforceable and easily administered. If each of the 100+ VAT jurisdictions (e.g. Japan, Australia, Canada) impose different collection systems, businesses would face a high level of complexity and the potential for double or discriminatory taxation. This would discourage the kind of cross-border transactions that e-commerce enables to the benefit of consumers and businesses alike.

To prevent this outcome, government and industry must continue to work toward long-term solutions for indirect taxes. For example, the OECD Technology Technical Advisory Group (TAG) has identified four options, including self-assessment, tax at source and transfer, registration of non-residents, and the use of third party intermediaries. These approaches require and merit further study.

## **FUTURE POLICY ISSUES**

### *Direct taxation of electronic commerce*

Direct (e.g. income) tax rules governing traditional commerce typically required some degree of physical presence before taxation can occur. The Internet allows enterprises to conduct business in remote jurisdictions, causing authorities to re-examine these rules and their application in an online environment. Areas under scrutiny include permanent establishment and how to characterize income earned online.

### *Permanent Establishment*

A company must have a minimum threshold of activity and presence to be liable for income taxes in a tax jurisdiction. In the international tax arena, this threshold is known as permanent establishment (PE) and is governed by international treaties and domestic law. PE typically includes a fixed place of business (e.g. factory, office, workshop) used by a foreign enterprise for more than some minimal period of time. However, an enterprise can also establish PE if it uses agents to conclude contracts on its behalf in a jurisdiction where it otherwise has no physical presence. For example, if a vendor hires a contractor to close sales in a foreign country, that vendor can have PE. Activities that are preparatory or auxiliary in nature to an enterprise's core function are generally excluded from any determination of PE.

Interpreting PE rules is already a complex endeavor, even in traditional commerce (i.e. how does one define a "fixed place of business" or "preparatory or auxiliary" activities?) The ability of enterprises to reach new markets using the Internet, without the large-scale infrastructure investments common to traditional commerce, raises even more questions regarding PE rules. GBDe notes with interest the ongoing work of the OECD Working Party 1 to supplement the commentary on article 5 of the OECD Model for Tax Conventions. Their work raises several issues that may have dramatic consequences for businesses. For instance:

- Is the mere presence of a server or a Web page hosted on a server sufficient to create permanent establishment? For example, if a French merchant hosts its Web page on a server in the United Kingdom, does the merchant have PE and become liable for UK income taxes?
- Do Internet Service Providers (ISP) or telecommunications carriers that host Web pages serve as agents for their customers? For example, if a Swedish vendor hires an Irish ISP to host its Web site, does the vendor have permanent establishment in Ireland as a result of its agency relationship with the ISP?

Electronic commerce does not require fundamental changes to PE rules. Abandoning existing tax principles could lead to discriminatory tax treatment of Internet-related activities.

The mere presence of a server or Web sites hosted on a server should not constitute a "fixed place of business" for purposes of determining PE. In the era of network computing, where data may be input and processing can occur at several computing locations, the placement of a particular server in and of itself is irrelevant. Data can be easily moved from one server (and tax jurisdiction) to another, and is not the e-commerce equivalent of warehouses, offices or even vending machines that traditionally trigger permanent establishment.

GBDe does not consider that providers of web hosting services serve as agents of their customers, as these providers merely transmit and store information on behalf of their customers, and are not concluding contracts in their name.

OECD Working Party 1 is developing clarifications to the commentary language on OECD model treaty regarding permanent establishment. GBDe is encouraged by recent drafts indicating the working party's opinion that Internet service providers do not create a PE for enterprises whose web sites they host. GBDe is also encouraged by the working party's position that the mere presence of a web site alone will not create PE for its owner. However, recent drafts indicate that the mere presence of "machinery or equipment" (including servers), could trigger PE. These proposals deserve further examination.

### *Characterization of Income*

Many types of products can be digitized and transferred electronically, including computer programs, books, music and other types of images (e.g., motion pictures, videotapes, etc.). These types of transactions have occurred for many years in more traditional formats and going forward will increasingly continue to occur in electronic and non-electronic form. Accordingly, any changes to be effected in the tax rules involving these data transfers must accord neutrality of treatment to non-electronic transactions as well as to their electronic counterparts.

Rules governing income characterization should treat similar products and services neutrally. GBDe does not believe that new rules to govern the classification of income are necessary. Instead, a facts and circumstances approach would ensure equal treatment of business activities, and would decrease the likelihood of double taxation of e-commerce generated income. GBDe endorses the ongoing clarification work of the OECD Income Characterization TAG as it identifies the range of e-commerce transactions and works to reach consensus on how they should be classified for income tax purposes.

GBDe also remains concerned about efforts to sweep the full range of digital products into one particular category, as doing so can lead to non-neutral tax treatment of these products. GBDe would prefer a facts and circumstances approach as a more thoughtful means to classifying Internet-related activities.

## **CONCLUSION**

GBDe encourages governments to work with industry to craft a long-term tax system that eliminates competitive distortions and adheres to the principles of simplicity, neutrality and global viability. We strongly recommend extensive government-to-government discussions, which will minimize the likelihood of potentially conflicting national

approaches. By fostering the continued growth of our networked economy, such international dialogue will benefit governments, merchants and consumers alike.