



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. The GBDe recognizes that tax policy must address governments' legitimate need to collect tax revenues to fund public services and eliminate competitive distortions faced by local industries. To find tax solutions that balance these national interests with global realities, the GBDe is committed to participating in government/industry dialogues on this critically important issue on an international, regional and national basis.

### BASIC TAX PRINCIPLES

The 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 whether within a country or outside of a country. Tax authorities should also 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 & Technological Efficiency:** The emerging networked marketplace creates difficult enforcement challenges for today's tax systems. The GBDe recognizes the competitive issues that may result and believes that government and industry must take care to develop credible compliance models to secure effective tax collection. Such models should be reasonable, technologically feasible, and free of undue burdens or economic distortion. The 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 & consistency:** Tax policy worldwide must be coordinated and consistent with a model that can be implemented on a global basis. Again, the GBDe endorses the OECD as an appropriate venue for this

coordination to occur. Unilateral action on the part of individual governments should be consistent with OECD guidelines and Model Tax Conventions.

**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 with global activities. Furthermore, governments should not hinder companies from educating and preparing their employees for the revolutionary changes of the information society.

## GLOBAL INDIRECT TAXATION

The GBDe recognizes governments' legitimate right to enforce consumption taxes on transactions involving customers within their borders. 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. 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 and will understandably seek to prevent competitive distortions, ensure a tax-neutral market environment and protect existing revenues.

The GBDe urges the EU, the US 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

governments in applying globally accepted e-commerce taxation principles to national tax systems and avoiding a patchwork of inconsistent national tax laws.

### **Americas**

Both Canada and the United States' subnational transaction/consumption tax systems illustrate the difficulties inherent in imposing cross-border tax collection obligations in the context of remote sales. The issues faced by these two countries highlight the importance of ensuring that any global consumption tax collection regime be able to address variations in the consumption or transaction tax systems of countries at both the federal level and subnational levels.

In the United States, the policy focus has been on whether remote vendors (i.e., vendors that do not have a physical presence in a particular state) should be obligated to collect and remit sales and use taxes for the benefit of states in which they sell goods to consumers but otherwise have no physical presence. A vendor currently is only obligated to collect and remit sales taxes on sales to customers in states in which the vendor has a physical presence 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 - it appointed an advisory commission which was unable to achieve sufficient support for any formal recommendations, and therefore 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 October 2001 deadline for the moratorium's

expiration, however, is creating momentum for numerous competing proposals in the U.S. Congress to extend the moratorium and reform state sales and use taxation. The pressure of impending Congressional action has spurred a voluntary state tax reform effort involving over half of the states, which are considering model legislation to simplify and modernize sales and use tax administration.

The GBDe endorses an extension of the current U.S. 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. The GBDe supports substantial simplification of state sales tax systems, as well as clear jurisdictional standards. The GBDe also endorses efforts to eliminate taxes on Internet access.

### **Europe / Africa**

According to the current intra-community VAT rules, businesses established within the EU must charge VAT on downloadable products delivered to businesses or end-users, regardless of whether they are located inside or outside the EU. On the other hand, non-EU businesses do not have to charge VAT on downloadable products delivered to end-users established within the EU. This situation concerns European governments and businesses 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) the creation of 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 controversial 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.

The 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 proposed Directive leaves some critical issues unresolved, including liability issues for companies making good faith efforts to collect taxes given the limited technological capabilities in existence today, the enforceability of an essentially voluntary system and the continued presence of competitive distortions for some stakeholders. More specifically, a single point of registration approach does not fully harmonize the rates that EU and non-EU companies must apply to consumer transactions involving digital products. The GBDe also remains concerned that the proposed taxation of digital information is inconsistent with the principle of neutrality in that online and offline versions of similar products will be treated differently for tax purposes even though consumers would purchase the products for the same purpose.

For this reason, the GBDe urges the EU to review the so-called Annex H of the Sixth VAT Directive, so as to ensure fair and non-discriminatory VAT treatment of goods and services ordered online whenever off-line substitutes are subject to a lower VAT rate for various policy reasons.

As the issue of majority voting on taxation issues regrettably was left undecided by the Nice Treaty we also urge the Member States to tackle this issue at the forthcoming Intergovernmental

Conference in 2004, with the objective of harmonizing VAT rates in Europe, or alternatively to use the procedures of enhanced cooperation to achieve this purpose within a first group of Member States. The GBDe also invites the EU to identify potential ways to eliminate or reduce any competitive distortions, such as applying a single rate for all digitized sales into the EU by all vendors. From a broader perspective, the GBDe supports the EU's goals of achieving simplification and easing the burden of compliance, but remains concerned that the current draft Directive will discourage tax authorities from efforts to develop a global solution to these issues, and will create an unfortunate precedent for other jurisdictions.

The GBDe recognizes that recent proposed amendments have been 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. In this context, the GBDe would welcome the opportunity to enter into a direct dialogue with the EU and separately with any other governments around the world to discuss the kind of tax regime for e-commerce that would benefit all stakeholders.

#### **Asia / Oceania**

China recently announced its intent to ensure its consumption tax system is applied to online sales. Regulations are currently being developed toward this end.

The Government of Japan (GOJ) officially agreed to the recommendations of the OECD Working Party 9 on Consumption Taxes and OECD Consumption Tax Technical Advisory Group (TAG), namely, a simplified registration-based collection system for the business to consumer transactions. Japan, as one of the major consumption tax system countries, shares European concerns, which are the potential for (i) distortion of competition, and (ii) significant present or future revenue loss. However, even when the GOJ decides to implement national legislation to adopt the OECD-recommended simplified registration system, it will find it difficult given the conditions set out by the

OECD for establishment of such a system. These conditions are (i) minimization of compliance burdens, (ii) application of registration thresholds, and (iii) control and enforcement measures to ensure compliance. Given the current situation where a simplified registration system will be hard to implement in practice, it would be worthwhile to undertake a study of technology-based options for medium-term tax collection systems, as the OECD recommended. Otherwise, other stakeholders in countries without consumption tax systems will press for a permanent standstill (i.e., no indirect taxation of digital goods on a cross-border business to consumer basis).

The Ministry of Economy, Trade and Industry of Japan (METI) recently submitted a proposal for such technology-based options to the OECD, in response to the OECD's request for public comments on the Working Party 9 and Consumption Tax TAG reports. The Japanese proposal focuses on reducing burdens for tax collection for business and consumers, and also aims at minimizing complex national sovereignty problems. In its proposed "Multinational Hybrid" concept, a vendor who transacts with a consumer submits a transaction report to a newly established "Global Vendor Registration Body" based on multinational agreements as an alternative to the usual national registration model.

The "Global Vendor Registration Body" then forwards the notices with the transaction report to both the taxation authorities of the countries of the vendor and consumer, and to the consumer in the consumption country. The Trusted Third Party (TTP) in the consumption country collects the consumption tax from the consumer and remits it to the taxation authority in the consumption country. The taxation authority then matches the amount remitted with the transaction report received from the Global Vendor Registration Body. In this proposed system - in contrast to those called for under the EU Sixth VAT Directive or the simplified registration system as recommended by the OECD - the vendor does not necessarily have to register in each taxation authority in the more

than 100 VAT countries (thereby reducing compliance burdens on business). Moreover, the vendor is not subject to the direct enforcement powers of the taxation authority of the consumption country, thereby minimizing sovereignty problems.

The GBDe appreciates and understands the concerns of Asian countries with a VAT system (e.g. China, Japan) regarding the distortion of competition and possible revenue losses. The GBDe is committed to working with all governments in Asia (and around the world) to develop the tax regime that advances and promotes e-commerce while at the same time addressing governmental concerns.

The GBDe also seeks to continue work with the OECD in its examination of the mid-term technology-based options (including METI's proposal), in order to move beyond the current de-facto moratorium as soon as possible.

## **OECD**

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 that benefit both 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 TAG has identified four collection model options, including self-assessment, tax at source and transfer, registration of non-resident vendors, and the use of third party intermediaries. The TAG has recommended the tax-at-source option for business-to-consumer transactions combined with a trusted third party clearinghouse system. It observed that registration of nonresident vendors raises significant problems with regard to verifying the location of consumers. These

recommendations require and merit further study by all stakeholders in industry and government.

The OECD Working Party 9 on Consumption Taxes and the OECD Consumption Tax TAG have issued similar reports calling for a clearer definition of taxation in the place of consumption, and recognizing the practical difficulties inherent in the application of traditional consumption tax principles to the delivery of services in electronic commerce, and in the registration and collection process. For business-to-business transactions, the reports support jurisdiction to tax based on the location of the recipient's location, with a reverse charge or self-assessment collection system. For business-to-consumer transactions, they recommend jurisdiction based on the recipient's usual residence, and a simplified registration-based collection system, but recognize the difficulties in identifying an online customer's jurisdiction. The reports suggest the interim use of technology-based collection mechanisms, such as trusted third parties or digital certificates, but recognize the lack of effective technological tools at this time.

The GBDe supports the conclusions of both reports that further efforts are required to define the place of consumption, particularly regarding businesses with multiple locations and the definition of "usual place of residence" for consumers. We urge tax authorities to cooperate on such definitions and any anti-avoidance measures to limit the possibility of double taxation. We urge the adoption of safe harbor provisions that protect businesses from liability once they have taken reasonable steps to identify customers and jurisdiction. The GBDe cautions that international cooperation is needed to ensure that the obligations placed on multinational businesses are consistent with the principles and goals of other international organizations. We caution that evolutionary changes in the tax system should not force businesses to make frequent and costly business changes or technological investments for tax reasons alone. Consequently, short-term solutions to difficult issues such as verification of residence must be balanced with the burdens and costs imposed by

compliance methodologies. We urge a renewed focus on simplification as a vital means of achieving widespread compliance. Finally, the GBDe applauds the recommendation in both reports that the business community plays an active and important role in the ongoing work in developing consumption tax standards for the networked economy.

## **GLOBAL DIRECT TAXATION**

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, how to characterize income earned online, and transfer pricing.

### **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.

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

Interpreting PE rules is already a complex endeavor, even in traditional commerce (i.e., the definition of 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.

The Committee on Fiscal Affairs of the OECD, on recommendation of Working Party 1, has adopted changes to the commentary language on Article 5 of the OECD Model Treaty regarding permanent establishment. The GBDe is encouraged by the language indicating that Internet service providers do not constitute dependent agents or PEs for enterprises that carry on business through a hosted web site. The GBDe is also encouraged by the conclusion that the mere presence of a web site alone will not create PE for its owner. However, the GBDe is disappointed that the CFA has taken the aggressive and unprecedented position that the mere presence of “machinery or equipment”, such as a server, may constitute a PE when it performs an essential or core part of the taxpayer’s business activity, terms which remain undefined. This controversial proposal deserves further examination with input from the business community and the Business Profits TAG.

Moreover, this conclusion that a server can constitute a PE is a threshold to further complex issues for the Working Party as to how income is to be allocated to a server which has been determined to be a PE. In conjunction with its work on permanent establishment, the Business Profits TAG has issued a discussion draft noting that the CFA is considering changes to the Model Treaty commentary urging the application of the arm’s-length principle in a manner that reflects economic reality, although it notes the lack of consensus as to how much and which profits can be attributed to a PE, and the many difficult practical questions yet to be addressed in applying the arm’s-length principle.

The GBDe notes with interest and concern the adoption by the Committee on Fiscal Affairs of the OECD of recommendations by Working

Party 1 to supplement the commentary on article 5 of the OECD Model for Tax Conventions relating to the definition of permanent establishment in the context of electronic commerce. Their conclusions raise several issues that may have dramatic consequences for businesses.

As in the transfer pricing area, the GBDe believes that the governing principle should continue to be the elimination of double taxation in a manner which minimizes compliance burdens. The GBDe urges the Business Profits TAG to work closely with the business community as it considers these difficult issues.

### **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. The 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. The GBDe endorses the clarification work of the OECD Income Characterization TAG as it identified the range of e-commerce transactions and worked to reach consensus on how each should be classified for income tax purposes.

The GBDe remains concerned, however, with unilateral 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. The GBDe prefers the facts and circumstances approach being utilized by the Income Characterization TAG as a more thoughtful means to classifying Internet-related activities, and cautions that uniform characterization principles are essential to avoid double taxation.

### **Transfer Pricing**

The Business Profits TAG has reported that it will continue its ongoing work regarding transfer pricing issues relating to the allocation of income between affiliated companies engaged in electronic commerce. The TAG has yet to publish proposals in this area, which in any event we presume will be substantially shaped by the existing OECD guidelines and the ongoing efforts of Working Party 6. The TAG has stated that its work will be informed by feedback from the business community as to the priority issues.

The GBDe believes that the existing arms-length principles continue to be relevant in the networked economy, that the focus should continue to be the elimination of double taxation, and that efficient dispute resolution and compliance burdens continue to be key issues in the transfer pricing area.

### **GLOBAL TAX PAYER SERVICE**

Several governments and government organizations are attempting to make use of available technology in the administration of their tax systems in order to improve taxpayer services and collections. The OECD's Forum on Strategic Management has issued a report: "Tax Administration Aspects of Electronic Commerce, Responding to the Challenges and Opportunities" in February 2001, which deals with:

- taxpayer service,
  - tax administration, identification and information needs; and
  - tax collection and control;
- as elements of tax administration.

As implementation options with respect to taxpayer services, the FSM identifies:

- developing Internet web sites where information, such as tax legislation, rulings, case law, revenue statistics and forms can be viewed and down loaded.
- interactive telephone answering systems for many standard inquiries.
- a single e-mail access point for highly mobile taxpayers.
- receiving and responding to taxpayers' service enquiries by e-mail.
- direct deposit programs for tax payments and refunds.
- accepting tax return data and other information by use of the new technologies.
- automated payments of social security, payroll taxes and other similar deductions.

Similar approaches are being discussed globally by national tax authorities.

The GBDe supports current work on taxpayer service models as an important complement to existing discussions on national income and consumption tax regimes. The GBDe urges government to prepare a roadmap from which unilateral national taxpayer services can be multilateralized on the basis of globally agreed standards. The GBDe is prepared to start work on these models with governments and government organizations and to contribute to the technical possibilities for making such taxpayer services systems a reality.

### **CONCLUSIONS**

The 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.