



Discussion Paper

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DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMMITTEE ON FISCAL AFFAIRS

Or. Eng.

ELECTRONIC COMMERCE: A DISCUSSION PAPER ON TAXATION ISSUES

A discussion paper prepared by the Committee on Fiscal Affairs

The attached paper is presented for discussion at the OECD Government / Business Dialogue on Taxation and Electronic Commerce to be held in Hull, Quebec on 7 October 1998

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The Committee on Fiscal Affairs welcomes comments on this discussion paper. They should be sent to Mr. Jeffrey Owens, Tel: (33-1) 4524 9136, Fax: (33-1) 4524 1884, E-mail: jeffrey.owens@oecd.org

Or. Eng.

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ELECTRONIC COMMERCE: A DISCUSSION PAPER ON TAXATION ISSUES

Preface

This Discussion Paper has been prepared by the Committee on Fiscal Affairs of the OECD and will be used as the basis for discussions at the OECD Government/Business Dialogue on Tax and Electronic Commerce to be held in Ottawa on 7 October. The Paper complements the documentation which will be presented at an OECD Ministerial level meeting, *A Borderless World – Realising the Potential of Global Electronic Commerce*, hosted by the Government of Canada and held in Ottawa on 7-9 October 1998. It has benefited from inputs by the European Commission and the World Customs Organisation in the area of indirect taxes and from a first exchange of views with the business community.

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ELECTRONIC COMMERCE: A DISCUSSION PAPER ON TAXATION ISSUES

A Discussion Paper by the Committee on Fiscal Affairs

Executive Summary

This Discussion Paper is designed to form the basis of discussion and exchange of views at a government/business tax dialogue to be held in Ottawa, Canada on 7 October 1998. It complements the documentation which will be presented at an OECD Ministerial level meeting, *A Borderless World - Realising the Potential of Global Electronic Commerce*, in Ottawa on 7-9 October 1998. Governments recognise that more work is needed on these issues and that views may develop further, especially in the light of further input by the business community.

Electronic commerce has the potential to be one of the great economic developments of the 21st Century. Electronic commerce and the information and communication technologies which underlie this new way of doing business will provide opportunities to improve the global quality of life and economic well being and have the potential to spur growth and employment in industrialised, emerging and developing countries.

Revenue authorities have a role to play in ensuring that this potential is realised. Governments must provide a fiscal climate within which electronic commerce can achieve its proper place in the global marketplace, weighed against the obligation to operate a fair and predictable taxation system that provides the revenue required to meet the legitimate expectations of citizens for publicly provided services. Striking the right balance between these objectives is the aim of the Committee on Fiscal Affairs (CFA) of the OECD.

To achieve this the CFA reaffirms that the widely accepted general tax principles of neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility should apply to electronic commerce.

The CFA also believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles, although new or modified measures are not precluded provided that they are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions. In this context, it is also important to avoid an unfair distortion of competition which would result from a de facto double or non-taxation of electronic commerce via-à-vis fully taxed 'traditional' commerce carried out via conventional 'physical' means.

Revenue authorities consider that the impact on Small and Medium sized Enterprises (SMEs) will be an area that requires close attention, both because businesses in this sector of the economy may greatly contribute to the economic growth through electronic commerce and because many of these businesses may find themselves operating in the comparatively more complex international taxation environment for the first time. Further, Revenue authorities may need to consider how they will respond to the challenge of a potentially substantial increase in the number of taxpayers with international taxation issues.

The implementation options outlined in this Discussion Paper cover the areas of taxpayer service, tax administration, consumption tax and international taxation norms. The options are designed to stimulate discussion and cover matters such as Revenue authority Internet web sites, taxpayer

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identification, tax information and collection and consumption tax, transfer pricing and tax treaty issues. It is recognised that the options are not comprehensive and other matters under these broad headings are identified as part of a future agenda.

The CFA is committed to creating an intensified working relationship with business to take forward the post-Ottawa agenda. This will involve partnership working groups between business and government to examine issues such as place of consumption rules and administrative provisions for consumption taxes, attribution of income to permanent establishments, electronic payment systems and technology protocols and standards. The Discussion Paper also indicates that, in addition to working with the business community, the European Union and the World Customs Organisation, the OECD looks forward to involving non-Member countries in the future work and welcomes input from bodies representing non-business taxpayers.

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Introduction

1. Electronic commerce has the potential to be one of the great economic developments of the 21st Century. Electronic commerce and the information and communication technologies which underlie this new way of doing business (the new technologies) will provide opportunities to improve the global quality of life and economic well being and have the potential to spur growth and employment in industrialised, emerging and developing countries.

2. Revenue authorities¹ have a role to play in ensuring that this potential is realised. Governments must provide a fiscal climate within which electronic commerce can achieve its proper place in the global marketplace, weighed against the obligation to operate a fair and predictable taxation system that provides the revenue required to meet the legitimate expectations of citizens for publicly provided services. Striking the right balance between these objectives is the aim of the Committee on Fiscal Affairs (CFA) of the OECD.

3. The CFA recognises that electronic commerce raises significant matters for Revenue authorities in a number of areas including: improved taxpayer service, reduced administration costs and reduced compliance burdens; effective tax administration and issues surrounding consumption taxes and international taxation norms like those found in the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.

4. These areas were first publicly identified by the CFA in a discussion document, *The Communications Revolution and Global Commerce: Implications for Tax Policy and Administration* (the Turku paper) for an informal business-government round table titled, *Electronic Commerce: the Challenges to Tax Authorities and Taxpayer*, on the impacts of electronic commerce, held in Turku, Finland in November 1997.

5. At the Turku conference, there was a call for an internationally co-ordinated approach and a partnership between governments and the business community to create a transparent and stable environment for electronic commerce. It was also acknowledged that the OECD was the international body best placed to co-ordinate and progress work on taxation matters, in close consultation with the European Union (EU) on Value-Added Tax (VAT) issues and the World Customs Organisation (WCO) on the cross-border shipment of physical products. The CFA was subsequently mandated to develop taxation framework conditions applicable to electronic commerce.

6. The CFA believes that a principles-based approach will be required in developing the taxation framework conditions and has reaffirmed that the following widely accepted general tax principles should apply to the taxation of electronic commerce:

¹ “Revenue authorities”, as used in this paper, means whichever Government departments or agencies are responsible for tax policy and/or administration in a country. Where those functions are divided between more than one department or agency, the term should be read as a reference to whichever of those is responsible for the particular function under discussion.

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- a) *Neutrality* - Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation;
- b) *Efficiency* - Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible;
- c) *Certainty and Simplicity* - The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted;
- d) *Effectiveness and Fairness* - Taxation should produce the right amount of tax at the right time. The potential for evasion and avoidance should be minimised and counter-acting measures should be proportionate to the risks involved; and
- e) *Flexibility* - The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

7. Hence, the taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. The CFA also believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles.

8. This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.

9. The CFA further believes that any arrangements for the application of these principles to electronic commerce adopted domestically and any adaptation of existing international taxation principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double taxation and unintentional non taxation.

10. In the year since the Turku conference the CFA has concentrated on a more in-depth analysis of the issues raised in the areas of taxpayer service, administration costs and compliance burdens, tax administration, consumption tax and international taxation norms. The intervening period has also been used by Revenue authorities to develop a better understanding of the underlying infrastructure of the Internet and the protocols, standards and features which will govern or influence the way in which the new technologies are used for commercial purposes. A productive dialogue has taken place with business both to assist in gathering knowledge about likely future business and technology developments and to understand the legitimate views and concerns of the business community regarding tax developments.

11. This period of analysis and dialogue has allowed the CFA to identify the areas for inclusion in the taxation framework conditions for electronic commerce. These include:

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- a) *Improving Taxpayer Service* - Communications facilities and access to information can be enhanced to assist taxpayers and to improve response times. Revenue authorities should make use of the available technology and harness commercial developments in administering their tax system to improve continuously taxpayer service. Tax registration and filing requirements could be simplified and norms promoted for the acceptance of electronic material. Electronic assessment and collection of tax could be encouraged and easier, quicker and more secure ways of paying taxes and obtaining tax refunds could be facilitated;
- b) *Tax Administration* - Revenue authorities should maintain their ability to secure access to reliable and verifiable information in order to identify taxpayers and obtain the information necessary to administer their tax system. Countries should ensure that appropriate systems are in place to control (audit/verify) and collect taxes, and international mechanisms for assistance in the collection of tax should be developed;
- c) *Consumption Taxes* - Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction. The supply of digitised products should not be treated as a supply of goods for the purpose of consumption taxes. Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms, when needed. Countries should ensure that appropriate systems are developed in co-operation with the WCO and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers; and
- d) *International Taxation Norms* - While the CFA believes that the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing (through the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines) are capable of being applied to electronic commerce, there should be a clarification of how the Model Tax Convention applies with respect to some aspects of electronic commerce. This is discussed at implementation option 21.

12. Revenue authorities consider that the impacts on small and medium sized enterprises (SME's) will be an area that requires close attention, both because businesses in this sector of the economy may greatly contribute to the economic growth through electronic commerce and because many of these businesses may find themselves operating in the comparatively more complex international taxation environment for the first time. Further, Revenue authorities may need to consider how they will respond to the challenge of a potentially substantial increase in the number of taxpayers with international taxation issues.

13. While this paper principally describes actions regarding taxation which governments can take so that electronic commerce can achieve its proper place in the global marketplace, it must be recognised that taxpayers, and especially business, are governments' partners in this effort. Even the best-intentioned actions by government will not succeed unless they are supported by taxpayers. Taxpayers' support in this regard includes, but is not limited to: voluntary compliance with the applicable tax rules; co-operation in the detection and resolution of tax evasion; and participation in efforts, such as this, to improve the design and administration of tax system

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Implementation Options

14. In each of the areas identified in the previous section, the CFA has outlined some implementation options to stimulate the discussion with business. The CFA recognises that these areas do not comprehensively address all of the issues and that the discussion within the areas may not necessarily be complete. This is recognised later in this Paper by some preliminary identification of other matters which the CFA already considers will need to be examined in a future phase of work and by the inclusion of a proposal on how to take forward the work.

15. Further, it should be noted that even if these options develop into more formal proposals or recommendations there will need to be latitude in their implementation in some instances, reflecting the particular circumstances of individual countries.

16. For ease of reference, the implementation options are clearly marked in bold text in the following sections of this Paper.

Improving Taxpayer Service

17. Revenue authorities recognise that the new technologies may provide a means to improve taxpayer service, including ways to reduce administrative and taxpayer compliance costs and to enhance voluntary compliance. Revenue authorities are exploring these possibilities, evaluating the benefits of the various options and assessing the costs and requirements of implementing them. Revenue authorities are eager to realise the benefits of the new technologies in taxpayer service, though the timing and extent of implementation will depend greatly upon the resource demands (cost, personnel, etc.) of the various options and the resource constraints of governments. In assessing the new technologies, Revenue authorities will also take into account that for government use there may be different requirements, for instance specific standards of certainty and confidentiality, than are needed in business-to-business transactions. A number of these possible improvements to taxpayer service are discussed below.

18. Already a number of Revenue authorities have electronic data interchange (EDI) and other technology based programs that are making their operations significantly more efficient, while improving both the quality and timeliness of service to business clients. These facilities mean that businesses do not need to spend as much time complying with tax regulations and both the tax administration and its client use less paper. Other benefits include timely updating of clients accounts, faster processing, quicker refunds and improved productivity.

19. The most recent technological developments offer possibilities for improved taxpayer service, (e.g. more timely avenues for taxpayers to obtain information via e-mail or the Internet). In addition, these new technologies may help Revenue authorities to reduce administrative costs by:

- a) offering lower cost methods of processing information;
- b) allowing further automation of periodic processes, such as payments; and
- c) reducing physical storage costs.

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Implementation Option 1

Revenue authorities may consider developing Internet web sites offering up to date information and providing taxpayer guidance

- a) Many Revenue authorities have established web sites where information, such as tax legislation, rulings, case law, revenue statistics and forms can be viewed and downloaded.
- b) In addition, the new technologies may allow for 'intelligent' electronic tax forms to be produced which guide a taxpayer through the form, providing context sensitive help or explanations, automating calculations and ensuring that all necessary details are included before finalisation. Such technologies offer the potential for reduced information processing costs by ensuring completeness and accuracy of data entered into Revenue authority systems as well as providing taxpayers with assistance and a degree of assurance in meeting their tax obligations.
- c) Further, Revenue authority web sites could be configured to provide taxpayer specific responses to appropriately qualified taxpayers, providing the potential for private advice to be provided remotely or to mobile clients at a faster speed than can be achieved with conventional mail.

20. In progressing towards a comprehensive and interactive Revenue authority web site, a number of intermediate steps may be taken.

Implementation Option 2

Revenue authorities may consider interactive telephone answering systems for many standard inquiries

- a) Some simple client inquiries may now be capable of being answered without human intervention on the part of the Revenue authority, although the responses tend to be generic. By use of appropriate identifiers to protect privacy and taxpayer confidentiality, interactive telephone systems linked to the database of the Revenue authority could be used to provide taxpayer-specific information.
- b) Developments in telephone technologies and their convergence with information technology could extend the versatility of widely-accepted telephone technology to allow the taxpayer to have timely access to the most current information tailored to the specific circumstances of that taxpayer.

Implementation Option 3

Revenue authorities may consider a single e-mail access point for highly mobile taxpayers

- a) Many taxpayers change address frequently and this can lead to instances where important mail does not reach them. Where a taxpayer has an e-mail address this could be used to deliver Revenue authority mail, avoiding the cost and inconvenience of mis-directed mail. While security and integrity issues would need to be considered, these might be addressed

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by the taxpayer accessing the e-mail using password, digital certificate or smart card authentication.

- b) Alternatively, Revenue authorities, alone, or as part of a single entry point initiative, could establish e-mail post-boxes for clients to which government mail could be delivered, relieving the taxpayer of the cost of maintaining an e-mail post-box and of the need to redirect e-mail due to changes in e-mail providers.

Implementation Option 4

Revenue authorities may consider receiving and responding to taxpayer service enquiries by e-mail

- a) E-mail offers the advantages of physical mail to address privately a specific matter, to allow for full discussion and consideration of the particular circumstances associated with that matter. However, e-mail also can offer the advantage of faster delivery, particularly over long distances and, within an organisation, to route more quickly the correspondence to the most appropriate officer.
- b) Issues such as confirming the identity of the taxpayer to ensure privacy and confidentiality and to ensure the integrity of the messages need to be considered.
- c) In addition to providing a service to taxpayers, such technologies may allow for more flexible or lower cost work practices such as telecommuting or e-mail 'call centres'.

Implementation Option 5

Revenue authorities may consider direct deposit programs for tax payments and refunds

- a) Direct deposit could be used for issuing refunds for taxpayers who have accounts with financial institutions. Direct deposit, depending upon the national implementation, has a number of advantages over the traditional methods of government payments. It can offer clients a safe, convenient, dependable, and time-saving way of receiving payments, and can reduce government costs through reduced fees and postage. Business clients can also have their VAT refunds and rebates deposited directly.
- b) Enhancing the capacity of Revenue authorities to accept electronic forms of payment and encouraging the use of electronic forms of payment (e.g. taxpayer authorised direct debits, automated periodic payments and electronic funds transfers) can also reduce administrative costs and public debt interest.

21. Reducing the tax compliance burden may contribute to the growth of existing businesses and the commencement of new businesses. A reduction in compliance costs can be achieved through simplification of procedures or requirements, or by streamlining similar requirements so that two or more requirements can be completed in one step.

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Implementation Option 6

Revenue authorities may consider accepting tax return data and other information by the use of the new technologies

- a) Many Revenue authorities accept tax returns in electronic form, on magnetic media or via dedicated telecommunications channels. The advantages of electronic filing can include accuracy of tax data, reduced costs to the public and to tax authorities, reduced paper use and fast processing of returns. Electronic filing can be used by individuals, companies and other entities who complete their own returns, or by those who use the services of a tax professional. Appropriate security measures are needed to ensure that tax information remains confidential and that Revenue authority computer systems are secure.
- b) One of the issues associated with electronic transmission of such forms (as opposed to physical transmission on magnetic media) has been the costs and capacity of transmission. Revenue authorities could only operate a limited number of connections and so these tended to be allocated to tax professionals or other service providers who could transmit tax information on behalf of their clients. This allowed these service providers to spread the costs associated with the transmission facilities over a large client base, reducing the cost for individual taxpayers. The new technologies reduce the costs of electronic transmission to within the reach of individual taxpayers and, where businesses are using the new technologies for commerce, the cost of using them for taxation filing will be marginal. As such Revenue authorities may consider accepting tax data electronically to reduce the costs of this existing obligation.
- c) Further, where current practices limit the variety of forms which can be accepted electronically or where electronic forms are only acceptable from a certain class of taxpayers, Revenue authorities may consider increasing the range of forms that can be accepted electronically and the range of taxpayers entitled to file electronic forms.

Implementation Option 7

Revenue authorities may consider automated payments of social security, payroll taxes and other similar deductions

- a) Where there are regular, relatively constant, periodic payments from a business, such as for payroll deductions, Revenue authorities may consider accepting electronically payments from any employer who elects to forward them in this manner. Where such procedures have been implemented by Revenue authorities, the need for employers to file tapes or paper is substantially reduced.

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Implementation Option 8

Revenue authorities may consider working with other arms of Government to investigate the benefits of single Government registration points on the Internet

- a) A number of Member countries are considering initiatives such as a single registration form for a range of government services. One way of translating this to the electronic commerce environment may be for governments to establish a single website entry point for clients that allows common registration information to be sent to relevant Government agencies such as Revenue authorities, superannuation and corporate registration agencies, for example, in a single process.
- b) This streamlining across agencies can also be reflected within agencies with the information being automatically updated by relevant sub-sections within an agency, in the consumption tax and payroll tax areas of a Revenue authority for example.
- c) By creating a single registration point, duplicate paperwork is reduced for initial registration and for other events such as change of address notifications.

22. The new technologies will enable more smaller enterprises to engage in international trade. While these enterprises may have easier access to the international business environment, some of them may not be as well prepared as larger business for the comparatively more complex international tax environment.

23. Revenue authorities look forward to using the new technologies at their disposal to assist taxpayers to comply with their tax obligations.

Tax Administration

24. Revenue authorities must be able to identify taxpayers conducting electronic commerce and the jurisdiction within which a business operates so that relevant taxation laws can be correctly applied. Just as in traditional commerce, reliable identification of a taxpayer engaged in electronic commerce is necessary to avoid double or unintentional non-taxation. Inadequate identification mechanisms could prejudice enforcement of tax even at the domestic level.

25. Identification of the parties to a business transaction (and the party responsible for remitting the tax revenue) is a fundamental consideration if credits or rebates of tax are to be allowed or if remedial action is required in the event of a default. Adequate identification is also likely to be important for non-tax reasons, such as consumer protection.

26. The information reporting requirements and tax collection procedures applicable to taxpayers conducting electronic commerce must be neutral and fair, meaning for example that the level and standard of identification required is comparable to what would be required of a taxpayer engaged in traditional commerce. However, there may be differences in the ways in which the requirements are achieved, since electronic commerce may pose special challenges or unique mechanisms.

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Taxpayer Identity

27. The identities of parties to a business transaction may be more difficult to determine as the current institutional relationships between an Internet business identity (e.g. a domain name or uniform resource locator) and the physical business identity (e.g. registered company name) are not uniformly reliable. This may make it impossible to identify the owner of a web site conducting Internet business.

28. Given the ease with which such sites can be located offshore, identification and registration requirements will require careful consideration.

29. Revenue authorities should maintain their ability to secure access to information to identify taxpayers. This maintains taxation neutrality with physical business enterprises.

Implementation Option 9

Revenue authorities may consider requiring that business engaged in electronic commerce identify themselves to Revenue authorities in a manner that is comparable to the prevailing requirements for businesses engaged in conventional commerce in a country

- a) The existing process of identification may include, for example, the requirement to complete and submit a tax return, to notify a liability to taxation, to notify changes of name or address, to register for instalments of company tax, or as an employer for employee withholding tax, or for exemptions from tax or for consumption tax purposes.
- b) In conjunction with Implementation Option 8, above, (single Government registration point), this option may offer a mechanism by which enterprises engaged in electronic commerce can meet some of their tax obligations in a cost effective manner.

Implementation Option 10

Revenue authorities may consider encouraging business practices that identify businesses engaged in electronic commerce

- a) Revenue authorities recognise that many businesses will provide information on their web sites and other electronic places of business which can be used to accurately identify the business and its physical location, (e.g. registered trading name, a physical or mailing address, telephone and facsimile numbers etc.) so as to engender consumer confidence amongst other things. As this is the type of information which Revenue authorities have traditionally required of businesses, it would be helpful if it is provided as a matter of common business practice.

Implementation Option 11

Revenue authorities may consider mechanisms facilitating tracing, for tax purposes, of inadequately identified web sites and other electronic places of business

- a) While the majority of enterprises engaged in electronic commerce adequately identify the legal entity operating the web site or electronic place of business, a small but significant percentage of web sites have inadequate identification for tax purposes. Revenue authorities, in common with other bodies, require appropriate mechanisms to allow tracing of the legal

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entity operating a business through a web site or other electronic place of business. (e.g. through Internet Protocol (IP) number allocation records.)

Implementation Option 12

Revenue authorities may consider making their views on user identity known to other bodies with a role in determining the identity of parties engaged in electronic commerce

- a) Revenue authorities will need to keep themselves informed about developments in bodies such as those dealing with the Internet domain name system and involved in issuing or setting standards for digital certificates or other technological means by which taxpayers may identify themselves for electronic commerce. Revenue authorities could make their views about the identification of parties engaged in electronic commerce known to these bodies.
- b) Alternatively, Revenue authorities may collectively, through international organisations such as the OECD, hold themselves out to provide guidance to parties developing identification standards or protocols for electronic commerce.

Tax Information

30. To administer properly the tax system, Revenue authorities require the ability to secure access to reliable and verifiable information. The taxpayer is generally the primary source of information and this should remain the case. However, Revenue authorities also make use of secondary information from other sources for verification purposes or to identify those taxpayers who fail to make themselves known to the Revenue authority.

31. Revenue authorities have extensive powers to obtain information within their own jurisdiction. Exchange of information through tax treaties supplements this. However, where books and records are maintained in a jurisdiction beyond the reach of domestic law or treaties, as may be more easily achieved with electronic commerce technologies, disclosure requirements will become difficult to enforce.

32. The primary tax administration effect of 'disintermediation' is to eliminate certain existing tax collection points, particularly for withholding taxes. Disintermediation may also remove sources of secondary information, such as suppliers. This disintermediation can present challenges for tax administration. It is recognised that electronic commerce may also create new intermediaries.

33. In addition, where the secondary source of information is the payment system, as is often the case, 'unaccounted' electronic payment systems may not provide the audit trails created by conventional payment systems. 'Unaccounted' electronic payment systems enhance the risks associated with the existing cash economy by providing instantaneous global access to offshore banking facilities.

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Implementation Option 13

Revenue authorities should express their views to the appropriate bodies to ensure that features of electronic payment systems do not exacerbate the challenges associated with the cash economy

- a) In conventional commerce, cash does not provide a very good audit trail and cash transactions are thought to account for a significant amount of the transactions that are untaxed in an economy. The tax not collected from the conventional “cash economy” is an enduring concern for Revenue authorities.
- b) In the context of electronic commerce, cash-like electronic payment systems or unaccounted electronic payment systems, represent the same types of concerns as physical cash does in conventional commerce. However, unaccounted electronic payment systems raise additional concerns in that they can be used to conduct transactions over large distances, unlike physical cash, and they do not have the bulk of large quantities of physical cash, making the value easier to conceal.
- c) While Revenue authorities do not have jurisdiction over the banking, finance and payment system sectors of the economy, they should express their views to the appropriate bodies to ensure that features of electronic payment systems do not exacerbate the challenges associated with the cash economy. For example, Revenue authorities might press the appropriate bodies to ensure that electronic payment system providers operate their systems in a way that enables the flows of funds to be properly accounted according to prevailing legislation. In addition, Revenue authorities may seek limits on the values attached to unaccounted electronic payment systems.

34. Nonetheless, while Revenue authorities have identified challenges to the reliability and verifiability of information, they also recognise that the electronic commerce environment offers the prospect of increased use of computerised accounting systems and the completeness, reliability and integrity of records associated with many of these systems.

Implementation Option 14

Revenue authorities should co-operate with businesses developing codes of practice or other instruments which would encourage the widespread application of appropriate technologies, such as message digests and digital notarisation, to ensure the integrity of electronic records

- a) Revenue authorities recognise that there are a number of elements of the new technologies which will mean that electronic records which are authenticated may provide much more information than is currently possible from records in conventional commerce; and in a form that is easier to utilise and less expensive to produce and store.
- b) Electronic records have been produced since the advent of electronic accounting. However, the expected increase in the number of electronic records requires that the issues associated with them be re-examined. Revenue authorities recognise that electronic records are capable of being more secure and detailed than records produced by conventional means. Accordingly they should individually and collectively co-operate with businesses developing codes of practice or other instruments which would encourage the widespread application of

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appropriate technologies, such as message digests and digital notarisation, to ensure the integrity of electronic records.

Implementation Option 15

Revenue authorities may consider expressing their views on information requirements to appropriate bodies developing standards or protocols for electronic commerce

- a) Revenue authorities have, wherever possible, used or adapted commercial developments for taxation purposes so as to avoid the creation of a separate and burdensome tax regime. However, modifying systems after they have been finalised is costly and should be avoided where possible. Revenue authorities could co-operate with business initiatives to create protocols for trade that facilitate electronic offers, delivery, payment and documentation and express their views in a timely manner to the bodies developing such protocols or standards so that they can be developed, taking into account the views of Revenue authorities.
- b) Further, private sector groups aiming at the introduction of new technical standards or protocols for electronic commerce could co-operate by contacting Revenue authorities, e.g. through the OECD, at an early stage to enhance a constructive dialogue designed to find mutually acceptable solutions.

Implementation Option 16

Revenue authorities may consider encouraging taxpayers that utilise encryption or security technology to also consider key recovery, trusted third party or other arrangements to guard against inadvertent loss of encryption keys

- a) For legitimate security reasons, electronic commerce technologies often introduce encryption and other security technology into transactions, distinguishing the audit trail of electronic commerce transactions from those of conventional commerce by the fact that the former may be easily encrypted.
- b) Cases may arise where a taxpayer cannot recall the key to decrypt an encrypted transaction or where a taxpayer decides not to provide the key or decrypted transactional data. To reduce the occurrence of the first case, Revenue authorities could encourage taxpayers that utilise encryption or security technology to consider also key recovery, trusted third party or other arrangements to guard against inadvertent loss of an encryption key. In many countries, the loss of a key will not excuse a taxpayer from providing information to the Revenue authority and having the onus of proof in regard to any encrypted transactions.

Tax Control (Audit/Verification) and Collection

35. Revenue authorities must be able to efficiently and effectively collect tax from electronic commerce activities. Some of the options are considered later in this paper (see implementation options 19 and 20 on consumption taxes and implementation options 26 and 27 in relation to international co-operation).

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36. While Revenue authorities will continue to explore options that make it easier to deal with taxpayers, there is also a need to have appropriate enforcement arrangements for those taxpayers that do not meet their obligations.

Consumption Tax Issues

37. The discussion in this section relates only to consumption taxes at the national level and not to other taxes. Attention will need to be given to issues presented, in the international context, relating to sub-national consumption taxes. Any decision concerning liability to tariffs is a matter for the World Trade Organisation (WTO), which has responsibility for agreements on the application of tariffs to trade.

38. The problems concerning the application of consumption taxes are generally recognised as having more immediacy than the issues concerning direct taxation.

39. For consumption taxes the implications of electronic commerce can be examined in relation to three broad categories of transaction, namely:

- a) supplies of physical goods to both business and private consumers;
- b) supplies from business to business (and domestically exempt organisations such as public bodies and charities) of services and intangible property; and
- c) supplies from business to private consumers of services and intangible property.

40. At present the vast majority of e-commerce based supplies falls into the first two categories. The third category of transactions – supplies of services and intangible property to private consumers – while currently small in volume presents potentially the greatest tests to effective administration of consumption taxes particularly when the products are delivered on-line across international borders. Currently, with a few isolated exceptions, there are no provisions for the collection of consumption taxes on these supplies.

41. Consensus is necessary at an international level if Member countries are to ensure the effective application of consumption tax systems to electronic commerce that:

- a) prevents double and unintentional non-taxation;
- b) protects tax revenue generally;
- c) does not increase the opportunity for avoidance, evasion or fraud;
- d) minimises the cost of compliance for business; and
- e) does not hinder the development of electronic trade.

42. Addressing issues such as this will be a key element of the further work following the Ottawa Ministerial meeting. The scope of this work, prepared by countries that presently have national consumption taxes, is explained more fully below. In addition to the conclusion reached by the CFA on the principle of taxation at the place of consumption (explained below), the CFA has also reached conclusions on the treatment of digitised products, and that countries should examine the possible use of certain existing collection arrangements for taxation of imported products. These arrangements will enable Revenue authorities to maintain revenue yields from the two largest segments of electronic trade. Member

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countries recognise and address the need to encourage compliance with tax requirements in the proposals for future work.

Taxation at the place of consumption

Implementation Option 17

Revenue authorities have concluded that rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and that an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction

- a) This conclusion reaffirms the principle of territoriality concerning consumption taxes that tax should accrue to the Revenue authority where supplies or products are deemed to be consumed. It also raises a number of issues for the effective administration of these taxes.
- b) Place of taxation rules are used to determine where a supply should be taxed. The risk of double or unintentional non-taxation arises from differences in the rules in use by Member countries and elsewhere. Double taxation may distort competition against overseas suppliers. Unintentional non-taxation may distort competition against local suppliers and threaten the tax base of the country where the consumer belongs. The lack of symmetry in existing consumption tax systems in respect of cross border trade is highlighted by electronic commerce. Suppliers in one tax jurisdiction can relatively easily supply digitised products to private consumers in another jurisdiction. Risks to the proper taxation of such transactions could be reduced if consensus were to be reached on the rules that determine the place where supplies should be taxed, namely the place of consumption.
- c) Moreover, differences in the definitions of services and intangible property applied in Member countries lead to uncertainty about the tax treatment of such supplies provided by overseas businesses. These differences may also open up opportunities for tax avoidance and evasion. Convergence of the definitions of relevant supplies would make it easier for taxpayers to comply with tax requirements generally and would help the development of electronic commerce.
- d) There is an inherent difficulty involved in the identification of the customer in electronic transactions, in particular to private consumers. The supplier is normally responsible for collecting and accounting for consumption taxes and may have limited means to prove the location of the customer. The supplier may also be beyond the fiscal jurisdiction of the Revenue authority where consumption takes place. Existing rules that are used to determine where tax is due, such as “effective use and enjoyment”, may no longer suffice. This problem raises the question of whether the rules to determine where a supply is deemed to be consumed need amending.
- e) Implementation of this principle will require consensus on the circumstances under which different types of supplies of services and intangible property are considered to be consumed in a given jurisdiction. It is also recognised that agreement on pragmatic approaches may be required where the theoretical application of the principle would lead to an overly complex or unworkable approach. Finally, the CFA recognises that, given the significant differences

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in the design of OECD consumption tax systems, different mechanisms in particular countries may be appropriate to achieve consistent results.

- f) Member countries therefore intend to work together, in consultation with business, to reach a consensus on the approaches to implementing this principle.

Classification of digitised products

43. The treatment of digitised products as something other than goods provides certainty about treatment for consumption tax purposes, for example the basis of value for tax.

Implementation Option 18

Revenue authorities have concluded that for the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods

- a) Services and intangible property can be received on-line in digitised form. They are received by customers directly from the supplier. They are not subject to customs control nor handled in the traditional sense by an intermediary. They are not tangible products when received initially by customers. The consumer/customer may create a tangible product thereafter but that is a matter of choice.
- b) The CFA has therefore concluded that in order to provide certainty about the treatment for consumption tax purposes of digital products delivered on-line across international borders these products should not to be treated as goods for consumption tax purposes.
- c) This approach is intended to provide certainty in the application of taxes, and to prevent the tax base erosion that could occur under some systems if these types of products were to be considered goods for the purpose of application of tax on importation and for the purpose of applying place of supply rules.

Consumption Tax Collection

44. In addition to retaining the existing arrangements for taxation of imported products Revenue authorities will examine more efficient mechanisms, to enable revenue yield from electronic commerce activities to be maintained.

45. Electronic commerce is already a feature of business-to-business activity. Many Member countries have mechanisms to account for consumption tax on services and intangible property imported by business and domestically exempt organisations such as public bodies and charities.

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Services and intangible property

Implementation Option 19

Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers

- a) The reverse charge/ self assessment is an effective revenue collection mechanism but it has disadvantages and advantages.
- b) It provides for the customer to account for output VAT on imported services but it also gives the right to input tax deduction in respect of purchases related to taxable outputs. The disadvantages are:
 - i) there is no tax invoice from the supplier as a means to check the integrity of the customers business records; and
 - ii) it may offer a cash flow advantage in that the customer does not pay out VAT to the supplier and this distorts competition against local suppliers who must add VAT to the value of their supplies.
- c) The advantages of use of reverse charge are:
 - i) it allows Member countries to continue to collect VAT on services and intangible property imported by businesses and other organisations; and
 - ii) the liability to account for tax rests with a person located within the jurisdiction of the revenue authority in the place of consumption; and
 - iii) it can minimise costs for business where overseas suppliers are not required to register or otherwise notify a liability to account for tax in respect of supplies to customers in a different tax jurisdiction.
- d) While the reverse charge is an effective device for the taxation of business to business transactions there are grave doubts that it is an efficient mechanism for the taxation of on-line cross-border supplies to private consumers. It is recognised therefore that in developing a system of taxation for cross-border on-line electronic commerce generally, thought must be given to the application of the reverse charge mechanisms for business transactions in the longer term.

Physical goods

46. Member countries also have systems in place to ensure the taxation of imported tangible goods. Electronic commerce provides increased opportunity for cross-border trade and in particular between business and private consumers. The expected upsurge in the volume of commercial consignments to private consumers could add significantly to the workload of customs authorities creating the need for

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additional resources to ensure effective collection of taxes due on these packages. Delays in delivery could hinder the growth of electronic commerce as a consequence.

47. Many Member countries also have at present a *de minimis* relief for low value packages. This relief from customs duty and taxes allows many packages to escape taxation legitimately. The *de minimis* is set generally at a level which finds the balance between the cost of collection and the amount of tax which would otherwise be due. However, the *de minimis* may in a global market give an advantage to distant suppliers as consumers exercise choice in a wider commercial environment. Member countries may therefore wish to review the *de minimis* in the context of the global market place and the possible distortion of competition against local suppliers. The need therefore is to ensure:

- a) the efficient collection of taxes;
- b) minimal distortion of competition; and
- c) speedy handling of consignments at customs control points to help minimise transit times.

Implementation Option 20

Countries should ensure that appropriate systems are developed in co-operation with the WCO and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers

- a) The adoption of simplified customs clearance procedures utilising electronic data interchange technology may provide a solution.
- b) The WCO recommends the development of simplified customs clearance procedures in consultation with carriers and other business users as one of its proposals for the revision of the Kyoto Convention. This presents the opportunity for suppliers to calculate and account for taxes to the Revenue authority in the place of consumption and for the electronic filing of customs documentation. The CFA encourages Member countries to develop simplified customs clearance procedures at the earliest opportunity. The Canadian Low Value Shipment programme is an example of the options available.
- c) In addition, it may be appropriate to review of the *de minimis* level relief from customs duty and taxes for low value commercial consignments in conjunction with the implementation of efficient and simplified customs clearance procedures in order to avoid distortion of competition against local suppliers.

International Taxation Norms and Co-operation

48. The CFA believes that the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing (through the Model Tax Convention and the Transfer Pricing Guidelines) are capable of being applied to electronic commerce, there should be a clarification of how the Model Tax Convention applies with respect to some aspects of electronic commerce.

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Tax Treaty Issues

49. The CFA has been at the forefront of developing international taxation arrangements with its seminal work in the area of tax treaties. The CFA believes that the principles which underlie the OECD Model Tax Convention are capable of being applied to electronic commerce.

50. Revenue authorities recognise that the application of tax conventions will require careful attention to three sets of issues:

- a) the definition of when a permanent establishment exists and what profits should be attributed to it;
- b) the characterisation of income, particularly as regards digitised information and the definition of royalties; and
- c) the application of special rules, found in some tax treaties, dealing with income from services.

51. The CFA has already initiated a discussion on tax treaty issues that includes these three issues. Since any changes in this area could have far reaching implications for governments and business in the application of the extensive treaty network, the CFA has decided to proceed carefully. Nevertheless, the discussion has already allowed the CFA to decide on ways to deal with some of these issues concerning the application of treaties to electronic commerce. The following sets out these decisions. Most of these decisions will result in further work to be carried out after the Ottawa meeting.

Implementation Option 21

The CFA has agreed to provide clarification, in the Commentary on the Model Tax Convention, as to how the current definition of permanent establishment applies where electronic commerce transactions are concluded through a web site on a server located in a country

- a) Tax conventions generally provide that business profits of non-resident enterprises may only be taxed in a country to the extent that they are attributable to a permanent establishment that the enterprise has in that country. Article 5 of the OECD Model Tax Convention defines the term “permanent establishment”. Paragraph 1 of that Article states that a permanent establishment is a “fixed place of business through which the business of an enterprise is wholly or partly carried on”. Examples of what constitutes a permanent establishment are provided in paragraph 2. Paragraph 4 indicates that where a place of business is used exclusively for the performance of certain types of activities, which are generally of a preparatory or auxiliary nature, that place will not constitute a permanent establishment. For instance, a permanent establishment does not include “the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise” (sub-paragraph 4 a)). Paragraphs 5 and 6 indicate in which circumstances an agent will constitute a permanent establishment of the enterprise for which he is acting. The application of the definition of permanent establishment in the context of electronic commerce raises a number of issues.

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- b) The first question is whether the general condition for the existence of a permanent establishment found in paragraph 1 of Article 5, namely that it constitute a “fixed place of business through which the business of an enterprise is wholly or partly carried on” may be satisfied by a web site on a server owned or used by a foreign enterprise, taking into account that there would not necessarily be any employees of the enterprise present in the country.
- c) Another question is whether the activities carried on through a web site go beyond the types of preparatory and auxiliary activities which, under paragraph 4 of Article 5, would not result in a permanent establishment. If the functions performed through a given web site and server were such that it did not constitute a permanent establishment, there would nevertheless be a need to examine whether other activities were carried on through that server, e.g. where the enterprise would lease excess capacity in its server to allow another business to operate a web site.
- d) Other questions arise with respect to an enterprise that owns a web site and its relationship to an Internet service provider, the question being whether and to what extent the latter may be considered to be an agent of the former for purposes of paragraph 5 of Article 5.
- e) Ultimately, it may well be that the issue of whether a web site on a server can constitute a permanent establishment will have little practical impact on tax revenues. This is because technological developments in data transmission allow (or will very soon allow) most taxpayers to structure their electronic commerce operations so as to avoid the need to store their data or software on servers located in countries where these taxpayers do not want to risk having a permanent establishment. The issue will nevertheless have practical consequences in the application of tax conventions and domestic tax legislation.
- f) Representatives of the business community have stressed the need for the OECD to provide clarification in this respect, noting that this was a current issue which carried significant consequences in terms of compliance. The CFA has therefore decided to provide clarification, in the Commentary on the Model Tax Convention, as to how the current definition of permanent establishment applies where electronic commerce transactions are conducted through a web site on a server located in a country.

Implementation Option 22

Revenue authorities have agreed to closely monitor the application of existing norms for the taxation of business profits and to examine proposals for alternative rules so as to be ready to make recommendations (for or against) if and when necessary

- a) It has been suggested that the concept of permanent establishment is ill-adapted to electronic commerce. Those who take that position have argued that a rule based on physical presence is meaningless in the electronic commerce environment. Particular concerns have been expressed with respect to the allocation of tax revenues between source and residence countries and with respect to the use of tax havens.
- b) Since electronic commerce may allow substantial business to be carried on with residents of a jurisdiction without the need to maintain a physical presence therein, it has been argued that the threshold below which source taxation of business profits is precluded under the rules of Articles 5 and 7 may be inappropriate in the context of electronic commerce. These

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rules could also be exploited by some countries that would offer a low or no tax environment for base companies involved in electronic commerce.

- c) Some commentators have already suggested proposals for special tax rules restricted to electronic commerce, sometimes on the basis that special rules already exist for some types of business such as artistes and athletes, international transport and, to a lesser extent, insurance companies. An obvious problem with that approach is that electronic commerce is not a particular type of business, as are international transport and insurance, but rather a new mode of production, marketing, distribution, payment, etc. Thus the different treatment of the means of carrying out these functions that would result from special rules for electronic commerce could affect almost all businesses.
- d) The most important difficulty with this approach, however, is that electronic commerce is still in its infancy. Anecdotal evidence suggests that there are transactions that have been carried out on the Internet that have resulted in business profits that were not taxable in the country of the purchaser of goods or services in circumstances where a transaction carried out in a more traditional way would have generated income taxable in that country. However, since electronic commerce transactions as a whole represent only a small fraction of business operations, these incidences cannot currently be significant. It would be difficult, at this point, to determine whether and which countries would experience an erosion of their tax base because of the resulting overall shift from source to residence taxation that may arguably result from electronic commerce.
- e) It could be wrong to assume that the present international allocation of Internet businesses and consumers would be mirrored in a mature system. As Internet technology becomes more stable and widespread, it should be expected that Internet businesses will develop everywhere. The process of disintermediation that is often associated with electronic commerce could well mean that the taxation of business profits will, through the current permanent establishment concept, shift towards locations where physical production (e.g. where the enterprise maintains facilities through which its employees exercise their activities) takes place. For these reasons, the CFA has concluded that it would be premature to reach any conclusion as to the effect of electronic commerce on the sharing of tax revenues between source and residence countries or to put forward alternatives to the present rules of tax conventions concerning the taxation of business profits.
- f) While it is important to maintain the international consensus that exists concerning the rules for taxing business profits of non-resident enterprises and, therefore, to avoid unilateral measures departing from that consensus, it is recognised that countries that are concerned that electronic commerce will erode their tax base are unlikely to refrain from adopting unilateral measures if they feel that nothing is being done at the international level to prevent such erosion.
- g) The CFA has therefore decided to closely monitor how the existing international norms for taxing business profits will apply to electronic commerce. At the same time, it will examine proposals for alternative rules so as to be ready to make recommendations (for or against these proposals) if and when necessary. It will also discourage unilateral initiatives having the effect of taxing electronic commerce in ways that are contrary to international norms.

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- h) Since the international consensus in this area cannot be maintained without the active participation of the business community and non-Member countries, the CFA will ensure that both representatives of the business community and tax officials from non-Member countries are closely associated to that work.

Implementation Option 23

Revenue authorities are encouraged to consider whether specific guidance is needed on the attribution of profit to permanent establishments in the electronic commerce environment

- a) The CFA is currently discussing the general issue of how to attribute profits to a permanent establishment. The discussion is focusing, in particular, on how the principles underlying the application of the arm's length principle contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations can be of assistance in making the attribution of profit under Article 7 of the OECD Model Convention. The special factual nature of businesses engaged in electronic commerce will be considered as part of these deliberations.

Implementation Option 24

Revenue authorities should examine the characterisation of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarification in the Commentary to the OECD Model Tax Convention

- a) It is sometimes difficult to distinguish whether a particular electronic commerce payment, e.g. a payment made for electronically searching a computer database and downloading a document from it, is made for the sale or lease of property, for the provision of a service or as a royalty. These categories of payments may, however, carry different tax consequences under tax conventions.
- b) A first distinction needs to be made between payments for services and income from sales or leasing of property. While the OECD Model Tax Convention generally provides similar treatment for income from independent services and income from other business activities, some conventions have special rules that make it necessary to determine whether particular payments are for the provision of services or the transfer of property. That distinction may also be relevant for the purposes of the application of domestic tax laws, e.g. where withholding obligations are imposed on residents who make payments for services provided by non-residents.
- c) Another distinction needs to be made between these two types of payments and payments that qualify as royalties. While the OECD Model Tax Convention does not allow source taxation of royalties, a number of tax conventions provide otherwise. The tax treatment of royalties is therefore often different from that of business profits.
- d) Paragraph 2 of Article 12 of the OECD Model Tax Convention defines "royalties" as "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

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- e) It is not always clear how this definition applies in the digital world, especially with respect to payments for digitised information. This, in turn, raises the policy issue of which payments should be covered by that definition. Some transactions, such as the electronic acquisition of a book in digital form, may be seen as merely substitutes for conventional transactions involving physical objects and, under that approach, it may seem inappropriate, in policy terms, to treat them as creating royalty income. Other transactions may involve payments for the availability and/or actual use of an on-line service in circumstances where it could be argued that the payment is for services rather than for the use of a copyright. It could be argued, however, that transactions involving digitised information could involve considerable differences in substance that could justify a different tax treatment, for example, a consumer purchasing a physical copy of a book is usually unable to manipulate the data in the book, while a consumer downloading a digital version of the book may be able to alter its format, manipulate the data, etc.
- f) Finally, while the OECD Model Tax Convention no longer distinguishes leasing income from other types of business profits, many conventions have rules that include payments for the use of industrial, commercial or scientific equipment within the definition of royalties. Arguably, various types of payments related to electronic commerce (e.g. payments made to Internet access providers) entitle the payer to the use of electronic facilities of the recipient.
- g) Representatives from the business community have stressed the importance of clarifying the criteria on the basis of which these various distinctions should be made. The CFA has agreed to examine how various types of electronic commerce payments should be characterised for the purpose of the application of the provisions of tax conventions with a view to providing the necessary clarification in the Commentary to the OECD Model Tax Convention.
- h) As concerns the definition of royalties, the CFA has decided to publish immediately the changes to the part of the Commentary on Article 12 which deals with software payments that its Working Party No. 1 has recently approved (and which the CFA will be invited to approve, at a later time, as part of the next update to the Model Tax Convention). Given the fact that these changes discuss the application of the definition of “royalties” in relation to one type of digitised product (i.e. software), the principles that underlie these changes may be relevant in considering how that definition applies in the case of electronic commerce transactions involving digitised contents (e.g. not only software but also movies, music, pictures, text, etc.) and comments from interested parties on this issue will assist the CFA in clarifying the application of tax conventions in this area.

52. In addition, the CFA has agreed that there is no need to pursue the issue of whether the communication revolution could make it difficult, if not impossible, to determine the place of effective management of a company. After discussing this issue with business representatives, the CFA concluded that this was not a significant practical problem. On the one hand, the ability of a company to establish its place of residence or effective management will not, except in unusual circumstances, depend on the mere issue of where virtual meetings have taken place. On the other hand, while the new technologies may make it easier to establish the place of effective management of a company in a given country, it is doubtful that this will significantly increase the potential for tax avoidance since there has always been some room for manipulating the residence of a company, either through incorporation or change of the place of effective management.

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Transfer Pricing Issues

53. To date electronic commerce has presented neither fundamentally new nor categorically different problems for transfer pricing. However, it has the potential to make some of the more difficult transfer pricing problems more common. In particular, as a result of the nearly instantaneous transmission of information and the effective removal of physical boundaries, it may become significantly more difficult for tax administrations to identify, trace, quantify and verify cross-border transactions.

54. More specifically, electronic commerce and the development of internal private networks (Intranets) within Multinational Enterprise (MNE) Groups (including Small to Medium sized Enterprises - SME's) may be seen as putting significant pressure on the traditional approach taken to deal with non-arm's length transfer pricing even though the basic nature of the problem has not changed. The difficulty lies in the application of the internationally accepted transfer pricing methods to the special factual circumstances created by electronic commerce activities, in particular the greater possibilities for specialisation, integration of common functions and co-operation between different locations and legal entities within the MNE group. The more significant of these are potential difficulties in:

- a) applying the transactional approach ;
- b) establishing comparability and carrying out a functional analysis; for example in
 - i) identifying, valuing and determining the location of intangibles,
 - ii) evaluating the contribution of individual parts of an integrated business, and
 - iii) allocating the benefits of greater integration and co-operation ;
- c) applying traditional transaction methods ;
- d) the taxation treatment of integrated businesses;
- e) determining and complying with appropriate documentation and information reporting requirements.

55. Experience of dealing with transfer pricing matters in the field of electronic commerce is so far fairly limited and it is not easy to come to firm conclusions without a close examination and factual description of the elements of electronic commerce. It may also be difficult to perform a detailed examination of the factual background at such an early stage in the development of the business of electronic commerce. However, some of the difficult issues listed above have arisen in the context of the global trading of financial instruments and have already been the subject of detailed analysis by the OECD.²

56. The preliminary conclusion of the CFA is that the existing guidance of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the Guidelines") is capable of being applied to the special factual circumstances of enterprises conducting their businesses through electronic commerce. Accordingly, traditional transaction methods are to be preferred as a means of establishing arm's length prices. However, where such methods cannot be applied reliably, because there is insufficient data on uncontrolled transactions or such data is considered unreliable or because of the

² See the OECD Document ; "The Taxation of Global Trading of Financial Instruments".

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nature of the business situation (for example some integrated businesses), transactional profit methods could be used in accordance with the guidance given in Chapter III of the Guidelines. Some of the difficulties in applying transaction based methods to individual transactions may be alleviated by applying the existing guidance on evaluating combined, rather than separate, transactions.³ In addition, in order to be able to identify, trace, quantify and verify transactions undertaken in the course of electronic commerce, it will still be necessary to follow the existing guidance concerning appropriate documentation. Other parts of this paper discuss, more generally, the impact of electronic commerce on documentation requirements, audit trails and other related issues.

Implementation Option 25

Revenue authorities are encouraged to monitor developments in electronic commerce to see whether additional guidance on the application of the OECD Transfer Pricing Guidelines is necessary

- a) The CFA is aware of the need to continue to monitor developments in the fast moving area of transfer pricing and electronic commerce to see whether additional guidance on the application of the Guidelines is necessary. For example, whether the existing guidance on documentation requirements needs to be revised for businesses engaged in electronic commerce in order to ensure the necessary availability of verifiable documentation on transactional data. The CFA intends to do so in the context of carrying out its existing instruction from the OECD Council: “to monitor the implementation of the 1995 Report as amended, in co-operation with the tax authorities of Member countries and with the participation of the business community and to recommend to the Council to amend and update, if necessary, the 1995 report as amended, in the light of this monitoring”. Consequently, the CFA looks forward to an ongoing dialogue with the business community on how to ensure an effective and practical implementation of the existing guidance given by the Guidelines to businesses engaging in electronic commerce.

International Co-operation

57. In order to respond fully to the global reach of electronic commerce, Revenue authorities will need to work co-operatively.

Implementation Option 26

The CFA may consider developing an Article for inclusion in the OECD Model Tax Convention to allow for assistance by one State in the collection of tax for another State

- a) It is not sufficient that Revenue authorities are able to assess tax liabilities correctly in this new environment, they must be able to collect the tax due. Where the taxpayer is in another jurisdiction this may prove difficult, even where there are effective exchange of information arrangements between the two States. The need to address this issue is not new. Taxpayers have operated out of reach of Revenue authorities in the past. However the expected increase in the number of taxpayers in one jurisdiction operating in, but not present in, another jurisdiction, is expected to increase due to electronic commerce. In this context Revenue

³ 1.42 of the Guidelines

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authorities could develop an Article for inclusion in the OECD Model Tax Convention, or could develop a revised Commentary, to allow for assistance by one State in the collection of tax for another State.

Implementation Option 27

Revenue authorities may examine ways to improve the use of existing bilateral and multilateral agreements for administrative assistance

- a) Where Revenue authorities are not currently parties to appropriate existing international agreements for mutual assistance in tax administration matters, such as the OECD/Council of Europe Multilateral Convention, they may be encouraged to review their decision. Revenue authorities could also explore new options for bilateral and multilateral arrangements which facilitate administrative assistance between tax administrations in the assessment and collection of tax.

Implementation Option 28

Revenue authorities may consider how harmful tax competition for electronic commerce is to be avoided, in the context of the Recommendations on geographically mobile activities accompanying the OECD Report *Harmful Tax Competition*⁴

The post-Ottawa Agenda and Process

58. As noted earlier, the above areas do not comprehensively address all of the issues and the discussion within the areas may not necessarily be complete. As part of the future work proposals Revenue authorities will work through the OECD and in consultation with business to identify concrete substantive steps that can help implement and extend the taxation framework conditions, and to consider the feasibility and practicality of those steps, including consideration of the following:

- a) *Improving Taxpayer Service* - Developing an international consensus on ways to simplify taxation systems to minimise the cost of tax compliance, particularly for small-to-medium sized enterprises;
- b) *Tax Administration* - Adapting conventional identification practices for businesses engaged in electronic commerce. Developing internationally acceptable guidelines on the levels of identification sufficient to allow digital signatures to be considered acceptable evidence of identity in tax matters. Developing internationally compatible information requirements (such as acceptance of electronic records, format of records, access to third party information and other access arrangements and periods of retention and tax collection arrangements) and designing appropriate strategies and measures to improve tax compliance with regard to electronic commerce transactions, including measures to improve voluntary compliance.

⁴ Luxembourg and Switzerland abstained from the Council recommendations which accompanied that report.

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- c) *Consumption Taxes* - Reaching agreement on, *inter alia*, defining place of consumption, on place of taxation rules and on internationally compatible definitions of services and intangible property and developing options for ensuring the continued effective administration and collection of consumption taxes as electronic commerce develops; and
- d) *International Taxation Norms and Co-operation* - With regard to the OECD Model Tax Convention, clarifying how the concepts used in the Convention apply to electronic commerce (in particular to determine taxing rights, such as the concepts of “permanent establishment” and the attribution of income and to classify income for purposes of taxation, such as the concepts of intangible property, royalties, and services, and in particular as regards digitised information). Monitoring of developments in, and tax administration challenges presented by, electronic commerce, in the application of the OECD Transfer Pricing Guidelines. Improving the use of existing bilateral and multilateral agreements for administrative assistance and considering how harmful tax competition for electronic commerce is to be avoided, in the context of the Recommendations on geographically mobile activities accompanying the OECD Report *Harmful Tax Competition*⁵.

Possible Future Work Process

59. The Turku conference initiated work on developing framework conditions for the taxation of electronic commerce. The Ottawa Ministerial meeting takes this process further. However, much remains to be done. This Paper has identified the broad taxation principles which should apply to electronic commerce and identified some implementation options, including how these new technologies offer Revenue authorities the opportunity to improve the service they provide to taxpayers.

60. However, the work is not complete. The Ottawa Ministerial meeting should be seen as a new focal point for taking the work forward rather than, in any sense, a culmination of work. Some of the tasks which Revenue authorities believe require future work have been identified in this Paper.

61. As part of the process of taking the work forward, Revenue authorities would like to work with business in a number of areas using small technical advisory groups consisting of business and government delegates to develop responses to a number of the key issues.

62. The views of business will be welcomed on topics that might be most usefully discussed and the timeframe for that discussion.

63. In addition to this consultation with business, Revenue authorities would welcome input from groups representing non-business taxpayers.

⁵ As noted previously, Luxembourg and Switzerland abstained from the Council recommendations which accompanied that report.

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Conclusion

64. Revenue authorities intend to engage in a close working dialogue with business to ensure that government is fully informed when they reach decisions on the development of tax policy in relation to electronic commerce. Some of this work will involve monitoring the application of existing domestic and international taxation arrangements. Other work may involve re-defining or clarifying existing taxation concepts.

65. The CFA will continue to use its existing subsidiary bodies to carry out this work and looks forward to continuing its close and productive relationship with the European Union and the WCO, as appropriate. The CFA hopes to intensify its dialogue with business by creating a number of technical task groups. Non-Member countries will be invited to participate, over time, in this follow-up work.