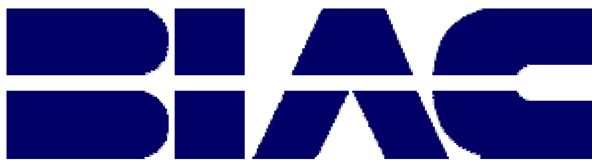

Business and Industry Advisory Committee to the OECD

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Tax Issues and Ramifications of Electronic Commerce

Prepared by the ICC Commission on Taxation jointly with the Business and Industry Advisory Committee to the OECD (BIAC)

Introduction

The Business and Industry Advisory Committee ("BIAC") and the International Chamber of Commerce ("ICC") have worked together to explore issues arising out of electronic commerce, which is radically changing business practices and processes. In this joint paper, we identify potential tax issues that are expected to emerge as more business is conducted electronically, rather than through traditional methods.

Electronic commerce raises compliance and administrative issues. A technical understanding of the Internet is required to fully appreciate the tax issues that electronic commerce presents, as was highlighted in the OECD discussion paper for its 1997 Turku Conference "Electronic Commerce: the Challenges to Tax Authorities and Tax Payers".

In addition, an international perspective is required when addressing this subject, since electronic commerce potentially cuts across national boundaries to a greater degree than traditional forms of business. Accordingly, no nation should create a new regime or alter its existing regime with respect to electronic business without serious consideration as to the impact on its trading partners. In order to avert the potential for double taxation, an internationally accepted consensus to the taxation of electronic commerce must be developed. We believe that the OECD is the appropriate forum to sponsor the required international dialogue, and its coordination of such an effort will help to achieve the dual goals of avoiding international double taxation and creating a climate of greater certainty.

We also believe that input from the business community is essential for governments attempting to cope with the issues presented by this new medium: The OECD's ongoing study of these issues is making an invaluable contribution in this field. This statement therefore makes reference primarily to the work of OECD (of which BIAC is the natural dialogue partner) but the points discussed are of equal relevance to non-OECD countries, in which many ICC members are based.

The development of electronic business is an extension of existing business models to take advantage of advances in technology, and results in changes in the way in which international business is conducted. Traditional tax policy and tax concepts have, over the years, accommodated changing facts and circumstances. BIAC and ICC ("BIAC/ICC") see no reason why this evolution cannot continue. Therefore, we believe that a new tax regime to deal with electronic commerce is premature.

As a starting principle, we believe that techniques for applying existing taxation principles in the electronic commerce *must be built upon tools that businesses already use to meet their market needs* – it is only in this way that tax compliance can be encouraged and sustained with the least burden, and the fewest economic distortions.

As a secondary principle, we believe that simplicity and clarity must be promoted in national tax regimes, in order to allow for the global trading potential of the new communications media. Tax rules everywhere should be understandable and user-friendly to allow for the potential increase in foreign sales by small companies. Rules that are difficult to understand and administer will neither encourage compliance nor facilitate the growth of electronic business.

Significant issues and questions

The following is a list of the most significant issues:

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Currently, these issues are under study by five technical advisory groups ("TAGs"), which report to OECD working groups and are composed of representatives from the business community together with delegates from tax authorities of OECD countries (and non-OECD countries). The aim of these groups is to thoroughly examine specific subjects and, where possible, to develop solutions to issues that the authorities will face.

General comments

Reliance on Existing Principles

BIAC/ICC strongly endorse the principle of neutrality (*i.e.*, that the tax system should treat economically similar income similarly, whether earned electronically or through non-electronic means). We believe that the best way to achieve neutrality is through the adaptation, to the extent possible, of existing tax principles and rules rather than the introduction of a new tax regime. We understand, however, that some minor changes to existing tax law may be necessary to achieve the goal of neutrality. BIAC/ICC are concerned over the possible adoption of new, Internet-specific taxes. We strongly urge that such efforts be discouraged.

Bases for Taxation

OECD member countries, and a significant number of non-OECD countries, have bifurcated income tax systems. Generally, residents are subject to taxation on a global basis, while nonresidents are taxed on a source basis. Although the details of the source rules may vary somewhat from country to country, the thrust is generally consistent among such OECD and non-OECD member countries. This is a long-standing international tax regime that is recognized by international taxpayers.

BIAC/ICC do not agree with the opinions of some commentators that tax policy in the electronic commerce environment should be shifted away from any reliance on source-based income taxation, thereby increasing the importance of residence-based taxation. While we concede that certain aspects of the use of the electronic medium to conduct commerce may lead gradually in the direction of residence based taxation, we counsel against adopting this approach prematurely.

The international tax regime practised by OECD member countries for taxing foreign persons, although not perfect, has continually accommodated changing fact patterns. This is an ongoing process that we believe has been accomplished with a minimum of difficulties in most countries. The advent and growth of electronic commerce is, in our view, merely another factual change.

Businesses use new technologies to extend and improve upon current business models to reach new markets and customers. The use of the Internet will permit nonresidents to conduct certain types of transactions from a foreign location (*e.g.*, sales of products and services) without the physical presence in the host country that was previously required. As a result, the host country may lose the income tax revenue formerly associated with these types of transactions, ceding sole taxing jurisdiction to the residence country. This trend makes it seem that residence-based taxation is becoming more predominant, but this is a natural evolution that does not require changes in tax policy.

Accelerating a move toward residence-base income taxation through statutory amendments is likely to meet with disapproval in many countries, particularly industrializing countries. These nations tend to favor rules that better protect their revenue base which translates into a heavy reliance on source based taxation. Such a situation highlights the need for the development of an international consensus on this issue.

We believe that existing tax rules in OECD member countries and a large number of non-OECD member countries have achieved a reasonable balance between residence-based and source-based taxation and we advocate their retention. Further, we would like to underscore the importance of reaching an internationally endorsed and accepted solution that eliminates the incidence of double taxation.

Role of Tax Treaties

Generally, tax treaties impact source basis taxpayers by narrowing the scope of taxability in the source country. Tax treaties should continue to serve the purpose of reducing double taxation by minimizing the income tax burdens of nonresident taxpayers in the host country. This is a crucial consideration in the removal of tax obstacles from cross-border commerce (both in its traditional and electronic form). Although, we believe that the existing tax treaty network can accommodate the changes in the way that international commerce is conducted, minor modification to the definitions in those treaties may be required to clarify their application to electronic commerce.

Permanent establishment

Permanent establishment for income tax purposes is a treaty principle that establishes a threshold for taxable nexus in a jurisdiction. Under this standard, merely engaging in business activities in a host country will not necessarily establish a taxable presence. Rather, the business activities in question must be carried out by, or through, a permanent establishment that the foreign taxpayer maintains in the host country. A permanent establishment is best described as a substantial presence of some degree of permanence, physically situated in the host country, which actively carries on business there (*e.g.*, an office, a branch, a manufacturing facility, etc.). In addition, certain types of agency arrangements can create a permanent establishment of a foreign principal.

Electronic commerce enables foreign enterprises to engage in business transactions with host country customers from any jurisdiction (without creating a traditional permanent establishment in the host country). That fact provides the stimulus to the reexamination of the permanent establishment concept. For example, a transaction for the sale of goods by a foreign supplier can be completed on the Internet (including offer, acceptance, arrangement of the terms and conditions of the sale, and payment). These transactions can occur without the use of a host country employee or agent. The server (*i.e.*, a computer storing the data that the customer would require to enter into the transaction) used by a foreign supplier to transact this type of business can be located anywhere. Such transactions formerly required the foreign enterprise to set up an office in the host country to exploit the market to any substantial degree. That requirement is no longer necessary, reducing the incidence of permanent establishment.

We recognize that the enhanced capacity to carry on international business activities from the country of residence is not a new phenomenon, but the continuation of an ongoing trend. Sophisticated technological innovations have made it far easier to conduct a business remotely. The advent of electronic commerce has merely accelerated this trend. Moreover, whether or not a business can exploit the market in another country to the maximum extent possible via the Internet without establishing a local business presence depends upon the facts and circumstances. It is our view, that many businesses that will continue to utilize a physical presence in the host country in order to maximize market penetration and to provide local service and support to customers, which may not otherwise be accomplished by relying solely on the electronic medium.

BIAC/ICC see no compelling need for a wholesale adoption of new permanent establishment rules for purposes of electronic commerce. Some foreign taxpayers may be able to operate remotely, thereby avoiding the host country tax under the current rules. They will be taxed, however,on that income in their country of residence at income tax rates comparable to the that of the host country.

Characterization of income

Many types of information can be digitized and transferred electronically including computer programs, books, music and other types of images (*e.g.*, motion pictures, videotapes, etc.). A purchaser of such information could be restricted to using the purchased information, could be granted the right to make a limited number of reproductions (for internal distribution to its affiliates), or could be granted the right to reproduce the information for resale to a mass market. These types of transactions have occurred for many years in more traditional formats and will continue to be consummated in electronic and non-electronic form. If changes to income tax rules are ultimately necessary, any changes to be effected in the income tax rules involving these data transfers must be applied to non-electronic transactions as well as to their electronic counterparts in order to ensure neutrality of treatment.

Facts and circumstances have always played a major role in determining the tax consequences of business activities. Although technology makes it easier to reproduce and disseminate digitized information, we do not believe new rules to govern the classification of income are necessary. The ability to handle data transfers electronically is just a change in facts and circumstances which can be accommodated under existing income tax rules.

An illustration of a "facts and circumstances" approach is provided in the following example. A customer desires to purchase ten copies of a particular book by receiving one copy electronically with the right to reproduce nine additional copies. The statement speculates that the transaction might generate royalty income because the right of the purchaser to reproduce the additional nine copies is usually a right reserved to a copyright holder or a licensee. Nonetheless, the substance of the transaction clearly indicates that it constitutes a sale of ten books, and it should be so treated for income tax purposes. We do not see a need for formulating new income classification rules to avoid abuses in this area.

Software can be readily transmitted electronically, and may warrant special attention because of complications that currently exist that can result in double taxation. Countries may feel the need to develop internal rules on the characterization of software transactions for income tax purposes. BIAC/ICC believe that these rules should be created utilizing a facts and circumstances approach to determine the economic substance of the transaction and to distinguish software transactions that constitute licensing transactions from those that constitute transfers of property. It is crucial that countries strive to adopt uniform principles in the software area to promote internationally conforming income characterization. International tax policy makers should encourage such consistency since differences in characterization will result in double taxation. It would be of great significance for OECD, having started this discussion, to set an example in this respect.

Consistency in characterizing cross-border software transactions is also extremely important in the proper application of bilateral income tax treaties. When a transaction constitutes a sale, the taxability in the source country will depend upon the existence of a permanent establishment there. Without a permanent establishment there is no source country taxation. Conversely, the existence of a permanent establishment will attract source country taxation. Under traditional international tax rules, relief from double taxation should be available in the home country. Both fact patterns generally provide double taxation relief.

If the source country applies a royalty characterization, a withholding tax at the rate specified in the relevant treaty will be assessed on the gross proceeds. Double taxation relief is also generally available in this fact pattern. These are fairly straightforward situations. Complications arise where the source country characterizes the income as a royalty and subjects it to the nonresident tax while the home country asserts a sales characterization for the same transaction, and vice versa. BIAC/ICC suggests that the software issue

be given full and adequate attention during the process of reviewing the application of the existing tax rules to electronic commerce.

In addition to the potential confusion between sales income and royalty income, digitized information could present difficulties in defining services income and distinguishing it from sales income and/or royalties. Again, we recommend that any issues arising in this context be resolved through the application of a facts and circumstances approach. A careful analysis of the facts and circumstances of transactions involving digitized information flow in a service environment should provide the appropriate income tax treatment without the need to prescribe a new set of rules.

Source of services income

Generally, in OECD member countries, the source of services income is the geographic location in which the services are physically performed. Under existing international tax rules, service income is only subject to host country income tax if the services are physically performed in the host country through a permanent establishment (e.g. by employees who work in the country), or a fixed base (e.g. other representatives of the foreign service provider in the country). When the services can be performed from the country of residence, the foreign service provider generally will not be taxed, either on the basis of net income attributable to a permanent establishment or on a withholding/gross income basis in the host country.

As the use of technology has increased, the connection between the location of the service provider and the location of the consumer has become less significant. Even before the advent of the Internet, services were provided from outside the country of the consumer. Although the trend of providing more and more services from remote locations will continue, it will still be necessary to render certain types of services in the host country.

The use of the Internet only represents a change in the facts and circumstances under which service businesses are conducted. Residence-based income taxation will become more prominent in accordance with this fact pattern, but this will occur as a result of the changing environment. It should not be forced by way of statutory amendments.

The critical issue is not whether the predominant source rule of the OECD countries is the appropriate standard, but whether international harmony (*i.e.*, consistency) can be achieved so as to avoid the potential for double taxation. As noted, most OECD countries use the place of performance test as a basis for sourcing services income. Developing countries, however, sometimes use a place of use test, which conflicts with the place of performance test. Under the place of use test, a foreign service provider rendering services from its resident country to a consumer in a developing country will frequently be taxed on a withholding/gross income basis in the host country. For resident country tax purposes, the income will presumably constitute domestic source income. The conflicting tax treatment results in double taxation without double tax relief, an outcome which represents an extra cost for companies doing business in developing countries.

BIAC/ICC do not recommend changing the relevant source rules to the place of use test. However, we would like to focus the attention of policy makers on this area. Inconsistency of tax treatment between countries is already creating the potential for double taxation. This situation will be exacerbated as the Internet makes the rendition of cross-border services from the resident country more effective and efficient. We urge that this issue be put on the agenda of international tax policy fora for further study. OECD's Project Outreach would be an appropriate additional forum for taking the discussion further.

Residency

Technological advances may affect the continued viability of the "mind and management" test (as contrasted to the place of incorporation test) to establish corporate residence. Tiebreaker tests in various tax treaties also contain place of management standards to settle on the country of residency for a dual resident taxpayer. Board meetings by video conferencing could destroy the efficacy of the "mind and management" concept by mitigating the weight generally placed on the location of board of directors meetings in determining the place of management.

Most countries that use the "mind and management" test for corporate residency understandably put more weight on where the key management functions of the corporation are performed than on where the board of directors meets. This trend would suggest that the teleconferencing of board meetings is an insignificant criterion. An important reason for the lack of importance placed on the location of the board meetings is the flexibility, as a result of high technology communication, to conduct board meetings in any location. This is an example of how tax rules have adjusted to the changing facts and circumstances in the business environment without the need for wholesale legislative amendments. BIAC/ICC believe that the tax rules in most countries can easily adjust to the changes attributable to these technological advances, with only minor modification.

Transfer pricing: global trading

Global trading has increased over the last decade from an almost insignificant level to the significant role it now plays in the global economy. This is a result of the trend away from regional and national economies to a global economy, coupled with enhanced communication capabilities. Global trading could not exist without this sophisticated technology.

Transfer pricing is the primary tax issue that arises in this subject area. This issue, however, should not be considered in a discussion of the tax consequences of electronic commerce. Global trading has been the topic of a statement issued as a chapter of the OECD transfer pricing guidelines. Ascertaining the appropriate allocation and apportionment of income and expenses arising from the cross-border trading of financial products is a matter of properly applying existing transfer pricing rules. It is not related to the reliance of this industry on enhanced technology. Accordingly, we do not think the subject should be included in the consideration of the taxation of electronic commerce.

Administrative and compliance matters

BIAC/ICC do not believe that the Internet will be used to escape taxation. Although the Internet has created different means for the dishonest and criminally oriented, this opportunity alone will not turn honest taxpayers into criminals. The overwhelming majority of business taxpayers, including those in the multinational corporate community are honest taxpayers interested in enhancing their profitability worldwide through the use of legitimate means.

BIAC/ICC believe that it is a worthy objective for governments to use their various powers to reduce criminal activity. However, we do not favor attempts to over-regulate and burden the business community with far-reaching information gathering and reporting requirements beyond those already in force. The recent trend in many countries is to require more information reporting from businesses with international operations. These increased reporting demands already impose a significant burden on the resources of corporate taxpayers. For this reason we urge that governments **and the OECD** seriously consider the

impact of any recommendations that would impose additional levels of information reporting on the business community.

It is important to reiterate that all techniques for applying existing income taxation principles to electronic commerce must be constructed around the tools that businesses already use to meet their market needs. For example, tax authorities should develop policies and procedures for the acceptance of electronic records that companies are developing for business reasons (e.g. improved speed and accuracy). By addressing application issues in this way, high tax compliance can be sustained with the least burden, and the fewest economic distortions.

Consumption taxes

BIAC/ICC are of the opinion that consumption tax rules (including collection procedures) should not be applied so as to impede electronic commerce. The global nature of electronic commerce makes the development of a framework for taxation on consumption a particularly significant issue, which should be considered a top priority for international tax policy makers (noting that progress in income tax issues cannot lag behind). Accordingly, we take this opportunity to provide our views on this important matter.

Fiscal authorities are understandably concerned that electronic commerce provides business with the opportunity to avoid the application of consumption taxes by locating in a jurisdiction that does not impose a consumption tax, thereby causing consumers to favor foreign over domestic suppliers for like products (and giving an incentive for other domestic electronic sales companies to move to the low or no tax jurisdictions). We agree that consumption tax rules should be trade neutral and should not discriminate between foreign and domestic suppliers.

The minimization of double taxation is also important in considering a consumption tax framework for electronic commerce. To reduce the occurrence of double taxation, attention should be given to the consistent application of consumption taxes, like VAT, particularly in the place of supply rules. Consideration should also be given to the development of a mechanism to address relief of double taxation on consumption.

It is important to design rules that are readily understood and administered by foreign and domestic business. The incidence of non-compliance, particularly for foreign businesses, increases significantly, as rules become unreasonably complex and burdensome to administer. In keeping with the spirit of electronic commerce, governments should utilize technological advances to reduce the compliance costs associated with consumption tax. Business input could be of considerable assistance in this area.

BIAC/ICC believe that consumption tax rules, such as VAT tax rules, should not be applied so as to impede electronic commerce. Electronic commerce transactions should not be treated less favorably than non-electronic forms of commerce, and complex compliance regimes requiring service providers to act as collection agents should be avoided. To provide consistency with non-electronic commerce, the responsibility for compliance should remain with the vendor/supplier or a trusted third party until a satisfactory internationally agreed arrangement is established..

It is important for fiscal authorities to work with business before developing consumption tax rules applicable to electronic commerce.. We believe that OECD is uniquely positioned to foster discussion of this important issue. As more business is conducted using these new technologies, the importance of an international consensus regarding consumption tax compliance and enforceability becomes more crucial.

Summary

BIAC/ICC strongly endorse the continued application of the current tax systems of the OECD member countries to address the issues that arise from electronic commerce. This is the surest way to avoid trade distortion and to achieve neutrality. We reject the need for new income and/or consumption tax regimes to deal with electronically consummated transactions which, we believe, merely reflect a change in the way that business is conducted. We are not opposed to changes where necessary to modernize tax rules to clarify their application to this new way of conducting business. We believe, however, that those changes should be carefully thought out through consultation with the business community before they are implemented.

BIAC/ICC urge governments from both OECD and non-OECD countries to build a broad international consensus in an effort to minimize the incidence of international double taxation on income or consumption, and to reduce compliance obstacles. As a result, businesses will benefit, particularly small businesses, which stand to gain the most from their ability to use the Internet and operate internationally.