

by R. A. Davis

# TAX ISSUES IN A VIRTUAL WORLD

*Il est difficile d'appliquer au commerce électronique les principes du droit fiscal international tels qu'ils existent actuellement, car ils supposent généralement qu'une transaction prend éventuellement la forme d'un échange physique. Dans le contexte du commerce électronique, le fournisseur et le client peuvent conclure une transaction sans se préoccuper des barrières physiques ou des frontières nationales. Aussi faut-il s'attendre à ce que les transactions internationales soient assujetties à des règles fiscales inégales d'un pays à l'autre. Les autorités canadiennes et autres devront se pencher sur les conséquences de cette transformation de leurs régimes de taxation et mettre au point des règles qui assurent un traitement cohérent et évitent la double imposition. L'auteur décrit divers aspects du régime fiscal reliés au commerce électronique international, notamment les impôts directs (impôt sur les bénéfices, retenues fiscales) et indirects (taxe à la valeur ajoutée, droits de douane).*

If you are having trouble keeping up with new developments in international communications technology and electronic commerce, you can imagine the plight of international tax policy makers. Technology, especially intangible property such as software, can be created, marketed, shipped and paid for over the Internet without any of the standard, auditable traces of the transaction that tax authorities generally use to determine its taxability.

The nature of these transactions renders them virtually "invisible" to tax authorities. And understandably, tax authorities are wary of relying on taxpayers to self-report all of their taxable transactions. For tax authorities around the world, the loss of tax revenue on Internet transactions is seen as an issue of major concern.

## **The Internet is international**

The Internet knows no international boundaries and allows unrestricted access to a plethora of goods and services. Therefore the invisibility of Internet sales holds for both national and international transactions.

Internet technology has also spawned a number of other similar media with equally unimpeded global reach. For example, many multinational enterprises are developing extensive internal networks (or "intranets") that span the globe, and over which they can conduct intra-company transactions. A number of new technologies are also being developed, among them encryption technologies and "extranets," which will allow company-to-company transactions. In fact, many people in the know predict that this facet of electronic commerce will see the most growth over the next few years. Electronic shopping for the general public will become more common once they gain confidence in secure payment mechanisms. As a result of technological improvements and expanded markets, many companies will see the bulk of their future revenue growth arise from international transactions conducted electronically.

As technical issues are resolved, the Internet as a marketplace will grow strongly, spurred on by manufacturers and software developers anxious to expand their markets, to cut out the middleman and deal directly with consumers over electronic networks.

## **Electronic commerce and taxation**

Once payment systems can be made more secure, products may no longer need to be distributed to foreign markets through an agent or through the manufacturer's sales office or subsidiary. Sales may no longer require the physical presence of a sales organization, or storage and distribution facilities. Existing principles of international tax law are difficult to apply in this "virtual" domain since they generally assume that an international transaction will involve a physical exchange at some point in the transaction. In the new electronic business environment, suppliers and customers can conclude agreements without regard to physical or national frontiers.

As a result of confusion and the lack of coordination between tax authorities, cross-border transactions may even run the risk of being taxed twice in the same country or by two different countries, and taxpayers may be subject to inconsistent taxation. Tax authorities in Canada and around the world will need to consider the impact of this shift on their own taxation systems and develop rules that provide certainty and prevent double taxation. This can only be accomplished by working together.

### Corporate concerns — critical legal concepts challenged

“Permanent establishment” is the standard, international legal criteria used to determine residence and hence a company’s tax status in a given jurisdiction. Residency however is a concept that does not appear to encompass the diffuse nature of the Internet and electronic commerce. International transactions are usually taxed on the basis of a business’ residency status (as defined for tax purposes) in the jurisdiction in which profits from the transaction arise. Traditional residence concepts are based on criteria such as physical presence, personal and economic relationships, incorporation and place of central mind and management. Rapid technological change will dilute the importance of such location-specific concepts.

Since the original “permanent establishment” concept was entirely based on geographical location, its application to the virtual world of the Internet is uncertain. For example, a company that offers an online research database can do so through a computer physically located in the consumers jurisdiction. Alternatively, computer space can simply be rented from a third party in another jurisdiction. In either case, does the computer server constitute the use of storage, display or delivery facilities that would therefore not be considered a permanent establishment under most of Canada’s treaties? Or is the computer server a permanent establishment because it constitutes a fixed place through which business is carried on? Tax policy makers need to tackle these and similar questions in determining how to interpret tax treaties in such situations.

International organizations are contributing to the debate and bringing electronic commerce to the attention of tax authorities. The latest versions of the Organization for Economic Cooperation and Development (OECD) Model Tax Treaty and the US Model Income Tax Convention broaden the concept of a taxable entity to include those that perform “any other activity of a preparatory or auxiliary character.” Under the new terminology, an Internet site that simply advertises a company’s wares clearly should not constitute a permanent establishment. However, once the Web site has the abil-

ity to solicit and consummate orders, its status becomes less clear.

The taxation of profits attributable to a permanent establishment is generally based on source of income principles that were also developed in the context of physical transactions. In today’s electronic world, the source of income derived from the electronic sale of digital products such as software may be ambiguous.

### Concerns for consumers — withholding taxes

Many individual consumers will also be caught in the web of uncertainty that surrounds the Internet. They may become unwittingly liable to taxation for certain Internet transactions to which they are party.

For instance the explosion of commercial activities over the Internet could cause large numbers of unwary taxpayers to become subject to withholding and other taxes. The application of withholding taxes generally relies on the ability to identify transactions of a particular type. Canada imposes a withholding tax on certain amounts paid or credited to persons not resident in Canada. If a Canadian resident remits rents, royalties and similar payments to non-residents, a certain percentage of the payment must generally be withheld and remitted to Revenue Canada.

Of particular concern, to both tax authorities and taxpayers alike, is the ability to electronically transfer digitized information such as software, books, movies and images with relative ease. The taxation

of these products in hard copy is sometimes considered to be subject to withholding tax and electronic trading in these products creates ambiguities in Canada’s existing withholding tax system.

### Concerns for consumers — commodity (sales) taxes

Electronic transfers generally give rise to the goods and services or harmonized sales tax (GST/HST) and/or provincial retail sales taxes (PST). Non-resident vendors who do business with Canadians over the Internet need to consider their obligation to register with the federal and provincial tax authorities. While federal and provincial sales tax rules may require a non-resident to register and collect the tax, enforcing such rules on a non-resident is difficult, particularly if the non-resident does not have assets in Canada and provides its services or information electronically.

Where sales tax is not collected by the seller, most provinces require the purchaser to remit PST to the provincial tax authorities, that is, to “self-assess” where the good or service is subject to tax. Compliance in this area has been problematic for provincial tax authorities even before the advent of electronic commerce so this added reality will not bode well for government.

Transactions within Canada over the Internet attract

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GST/HST where the supply is subject to tax. For the purchaser, provincial self-assessment may be required if the Canadian vendor resides in another province and does not collect the applicable PST.

### **The underground economy may be difficult to uproot**

The above analysis highlights some of the important issues surrounding this trend in commercial activity. Although the issues may appear complex, further analysis may lead to the conclusion that the existing rules are flexible enough to accommodate these new trends. However, the tax authorities should be shaken by the virtual anonymity of undertaking transactions on the Internet since the potential for tax revenue loss is enormous. It appears that a virtual global underground economy is emerging that may be difficult to uproot. A number of solutions to these issues and others have recently been put forward by a number of tax authorities and other interested organizations.

The OECD was one of the first to issue a report on the implications of electronic commerce. In June 1997, it released *Electronic Commerce: Opportunities and Challenges for Government* in which it sets out the views of 19 senior executives of companies that are leading international users of electronic commerce.

The report opposes proposals for taxing data exchange based on the volume of data transmitted. Although such a "bit tax" would theoretically eliminate the advantage of using tax havens to conduct electronic commerce, the report rejects this approach as unworkable and potentially discriminatory to electronic commerce activities and to normal business communications.

Late in 1997, the OECD released a paper that focusses on international tax issues for income taxes, consumption taxes and transfer pricing. It identified and defined many of the issues raised by electronic commerce that current tax systems are unprepared to confront. Income taxation rules are stretched by electronic commerce and draw into question many provisions of existing international tax treaties. The OECD is continuing the review of the Model Tax Convention and the application of the permanent establishment concept.

In the US, the Clinton administration published the results of its two-year study into electronic commerce in July, 1997. The Clinton report resigns itself to allowing the *status quo* to continue in order allow the Internet medium to grow. It opposes new taxes and regulations, and it calls on the private sector to determine how it will operate and regulate itself in the electronic business environment.

The report also makes recommendations on areas where international efforts are needed to preserve the Internet as an unregulated market shaped by competition and consumer choice. Echoing comments made in a 1996 report by the US Treasury, the Clinton report advocates declaring the Internet a tariff-free zone whenever it is used to deliver products and services. Since the US is a net exporter of digitized products sold over the Internet, the US Treasury could reap substantial revenues from this plan. However, other major trading nations that are net importers of intellectual capital *via* the Internet may see a weakening of their tax base should such policies be adopted globally. Individual states in the US are troubled by this decree since it may mean a significant decrease in their revenues.

Consumers of electronic products and services purchased over the Internet must be encouraged by the implied movement away from regressive consumption taxes. However vendors of consumer services may face an increased tax burden.

### **Revenue Canada's E-Commerce Committee reports**

Revenue Canada established an Advisory Committee on Electronic Commerce in the spring of 1997 and released its report on April 30, 1998. The Committee was composed of representatives of government, business, Internet service providers and computer experts. KPMG Calgary partner Wayne Chodzicki, leader of KPMG's International Tax Technology Group, and Chuck Ormrod, Tax Partner in KPMG's Information, Communications and Entertainment practice, represented the views of Canadian tax practitioners.

The Advisory Committee on Electronic Commerce concluded that governments should avoid unduly regulating and restricting electronic commerce and let the private sector take the lead. Where government involvement is needed, the Committee members felt that its aim should be to support and enforce a predictable, consistent and simple legal environment. Further, governments should impose no new

taxes on electronic transactions and should avoid placing additional compliance burdens on taxpayers, suppliers or supporters. The Committee agreed that equivalent transactions should be treated the same whether they are concluded electronically or otherwise.

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