E-commerce guides:
Tax and e-commerce

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What is e-commerce?

Electronic commerce (or E-commerce) can be defined as business transactions taking place through the electronic transmission of data over communications networks such as the Internet. Electronic commerce is not new in itself; - the electronic transfer of funds has been possible for some time. However, its full exploitation has been dependent on a number of factors as follows:

- The lifting of restrictions on the commercial exploitation of the Internet;
- Technical developments such as the emergence of the world-wide web in the 1980s and the use of interface technology such as browser programmes to make it widely and cheaply accessible in the 1990s.

The potential for electronic commerce is generally accepted to be enormous with the prospect of at least a ten-fold volume growth by the year 2000 and continued rapid expansion thereafter. An OECD discussion paper on electronic taxation issues states that electronic commerce has the potential to be one of the great economic developments of the 21st Century and contemplates that the technologies that underlie this new way of doing business will provide opportunities to improve the global quality of life, economic well being, spur growth and employment and industrialise emerging and developing countries.

However, electronic commerce also poses one of the greatest threats to the tax bases of countries throughout the world. The challenge of electronic commerce for tax administrations arises from the important tax planning opportunities available to businesses that are of such a nature that their trade can be conducted with little or no physical presence in a jurisdiction, the obvious difficulty of establishing audit trails and ensuring compliance with national tax laws.

Why should electronic commerce impact on the taxation of income?

From the perspective of a taxing authority, there are four major issues that must be resolved in order to tax electronic commerce:

- How is the income generated by a transaction to be characterised - sales income or royalties?
- In what jurisdiction does the income arise?
- Transfer Pricing - How should income and expenditure from multi-nationals engaged in electronic commerce be allocated amongst their various subsidiaries?
- How can compliance be ensured and enforced?

Characterisation of income

A simple example of the problems in characterisation is presented by a transaction whereby a United Kingdom resident person pays to view a picture on the Internet. The first issue is whether that person makes a royalty payment or whether the payment is made simply in respect of a purchase of goods or services. If the payment were to be characterised as a royalty payment, the United Kingdom, like many other countries, would require tax at the basic rate to be withheld from that payment. The current rules which distinguish between royalty payments and payment for purchases of goods or services (from which tax does not usually have to be withheld) were developed in relation to physical products and do not always work properly in relation to intangible products such as a digital image acquired over the Internet.

Images of certain products can now be transmitted electronically rather than in physical form and it is increasingly common for customers to have to pay a fee before being allowed to view such images or being allowed to download a copy of the product. The operation of computer software can be viewed in a similar way where customers can only download a copy after the payment of a fee. Music can also be downloaded. Customers may be permitted to modify downloaded products or to incorporate them in products which they develop themselves, either for their own use or to sell to others. It is not always clear whether payments to view and download such products for those various purposes are, in whole or in part, payments for the use of, or the right to use, a copyright on the one hand or are payments for a supply

of services. If they are the former, practical issues arise whether, under United Kingdom law, the customer should deduct and account for tax when making the payment.

Jurisdiction where income arises

The key issue here is which taxing authority has the right to tax a transaction. In the United Kingdom, as in most countries, direct taxes are levied on the world-wide income of a resident taxpayer, and on the national source income of non-residents. A system of double tax conventions reduces double taxation, generally providing relief in the country of residence for tax imposed in the source country. However, if the taxpayer has a permanent establishment (ie a branch) in the source country, the relief may not be available. The problem raised by electronic commerce lies in the concept of permanent establishment. Article 4 of the OECD model double tax convention defines a permanent establishment as a fixed place of business through which the business of an enterprise is carried on. In general, to have a permanent establishment in a country requires some physical presence there, although that principle has been eroded by recent foreign cases.

Electronic commerce may erode the requirement for physical presence further, as "intelligent" software develops. This is software which is placed on a business's website and can conclude simple contracts. This action is similar to that of an agent and an agent may be sufficient to give a business a permanent establishment in the jurisdiction in which the agent is present. The OECD model double tax convention still requires an agent to be a person but some countries, such as Italy, have indicated that such software should be treated as forming a permanent establishment. The United Kingdom's Inland Revenue has indicated that it continues to support the concept of a permanent establishment, but acknowledges that it needs some clarification as technology opens up new opportunities for business.

A further issue in relation to determining the jurisdiction in which the income arises is the treatment of VAT. For VAT purposes, electronic commerce can generally lead to three kinds of supply, (i) supplies of physical goods to both business and private customers, for example where the internet acts as a huge market place akin to millions of mail order catalogues presented by commercial web sites for the placing and fulfilment of orders, (ii) supplies from business to business of services and intangible property - such as downloadable software, music or pictures and (iii) supplies from business to private consumers of services and intangible property.

Most electronic commerce based supplies fall into the first two categories and the supply of physical goods ordered via electronic means still predominates. Where physical goods are supplied, the main issue is whether they are despatched into the European Union or their supply from within the European Union can be adequately controlled through the usual mechanisms of customs duty and VAT clearance.

Transfer pricing

International transactions between associated companies need to be undertaken on an arm's length basis for the purposes of tax computations. The growth of electronic communications increases not only the potential for such transactions to take place but also for those transactions to become more complex. Furthermore, it could also become more difficult to identify where relevant functions have been performed, to quantify the value added in relation to business conducted over the Internet, and to establish where any such value has been added. This point can be illustrated by taking the example of an American multinational company that writes computer software. There may well be a transfer pricing issue if the basic code is written in America, but the software is made application specific by that American company's French subsidiary and it is eventually sold to a United Kingdom resident customer. The issue will be how much of the payment from the United Kingdom should be attributed to the French subsidiary and the American parent?

At present, there is no reason to suppose that the arm's length principle and, in

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particular the methods to apply that principle recognised by the OECD's 1995 Transfer Pricing guidelines should not continue to work. However, Revenue authorities will clearly be keeping these issues under review.

Compliance

The first compliance issue is that of anonymity. The task of identifying parties and detecting particular transactions is virtually impossible where data transfers are encrypted. Tracing transactions would be an immense time and cost burden upon tax administrations. Taxpayer compliance is also more complicated in the electronic commerce context. If one takes the example of VAT, a supply must be identified before the tax can be applied. This can be costly. For example, many supplies of services either outside the European Union or to another European Union country do not attract VAT, whilst VAT must be charged on supplies within the United Kingdom. However the United Kingdom supplier will need to satisfy itself which is the case; monitoring the nature and location of a customer in the electronic commerce context is particularly difficult because it is often difficult to know where the customer is.

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Tax planning possibilities

The advent of electronic commerce offers a range of tax mitigation possibilities. These possibilities are the recharacterisation of income and the use of low tax jurisdictions as a base for operations.

Recharacterisation of income

As set out above, there are potential issues as to whether the making of a payment to purchase a picture on the internet is a royalty payment or simply a purchase of services. If the payment is a royalty payment, then it is likely there will be a withholding on account of tax in relation to that payment. On the other hand, if it is simply a payment of services, it is unlikely that a withholding will apply. Thus, in order to mitigate tax it is important to seek to characterise the income as being the purchase of services.

The OECD has been reviewing the guidance it has already given on the nature of payments for computer software in its model double tax convention on income and capital. It recently announced that its commentary on article 12 of the model double tax convention, dealing with royalties, is to be amended to cover payments for computer software. The new commentary suggests that the income from computer software sales will be treated as trading income, not royalties, unless the sale is (broadly) one under which the software can be altered or re-sold. As trading income, no tax would then need to be withheld by the purchaser. The United Kingdom's Inland Revenue has accepted this and anticipates that this principle will be confirmed to extend to other intangible supplies.

It seems likely that there will now be an increasing trend towards treating income from computer software or the right to do pitches across the internet and related matters will be treated as being simply a supply of services rather than a royalty payment. Accordingly, withholding taxes are likely to become less of a problem over time. In the meantime, however, the possibility of recharacterising income to avoid a withholding should be considered as part of any tax planning strategy.

Basing operations in low tax jurisdictions

As ordering goods through the global marketplace represented by the internet becomes more common, it is likely that suppliers will take orders in their local web sites, but arrange for them to be fulfilled centrally, for example from a central distribution point inside the European Union. If the supplier of the goods where the order is taken is located in a tax haven outside the European Union, no VAT would generally be payable (there will be no VAT charge on the import of goods, since the goods are already in the European Union). In this way tax can potentially be avoided by suppliers.

The conventional method of tackling the sort of avoidance set out above is the reverse charge mechanism. In the case of business to business on line services, it is generally accepted that the most effective revenue collection mechanism is represented by the reverse charge, which places the liability to account for tax on the business

customer within the jurisdiction of the revenue authority in the place of consumption.

The reverse charge has successfully been applied to a growing number of services in the European Union, originally the intellectual and consultancy services enacted in the United Kingdom in the Value Added Tax Act 1994 and contained at Schedule 5 of that Act, to which over the years the hire of goods (other than a means of transport) and telecommunications were added. Provided businesses are generally VAT compliant, they are used to meeting their reverse charge obligations, which only lead to irrecoverable VAT when the businesses concerned are partly exempt.

The main drawback of the reverse charge mechanism for tax authorities is the severe difficulty of applying it to the taxation of cross border supplies of services to private consumers. This has been tried in some countries, such as Canada and Switzerland, but there is little evidence that widespread compliance has been secured. It is therefore unlikely that the reverse charge mechanism will work properly outside the business to business sphere. Accordingly, the sale of goods and services to individuals where contracts are made outside the EU but supplies are made within the EU may avoid VAT altogether.

One of the disadvantages of using the reverse charge to secure tax on business to business supplies is that it weakens the message to the on line service provider in a third country that he must register and account for VAT in the European Union, particularly if the bulk of his supplies are to business customers and only a few are to final consumers. For a third country supplier, differentiating between business and non-business customers will not always be an easy task, particularly if the mere possession of a VAT registration number is deemed to be insufficient evidence of receiving the service in a business capacity.

New proposals and policies

In view of difficulties posed in relation to the taxation of electronic commerce and the risk of erosion of the tax base, the United Kingdom, European Union and OECD have all set out policies and proposals in relation to the taxation of electronic commerce. These policies and proposals were discussed at the OECD's Ottawa conference on electronic commerce with the result that various proposals were made for the future.

On 17th June 1998, the European Union's Commission issued a "Communication" to the Council, European Parliament and the European Union's Economic and Social Committee on the subject of electronic commerce and indirect taxation. The Communication was intended to set out the European Union's position on the taxation of electronic commerce for discussion within the European Union and at the international level. The Commission outlined six points as a basis for discussion as follows:

- No new tax should be levied.
- All electronic transmissions and intangible property supplied via the Internet should be regarded as the provision of services, subject to VAT.
- Services used in the European Union should be taxed by the member states of the Union, whatever their origin. Similarly, services supplied by the community operators to parties in countries not belonging in the European Union should not be subject to VAT (ie a tax neutrality principle).
- The levy of tax on electronic commerce should be adapted to trade practices and should not complicate the task of operators. Proper co-ordination between operators and tax administrations will be essential to ensure an efficient levy of taxes.
- Mechanisms for verification should be introduced to guarantee taxation of services provided within the European Union via the Internet by companies and private individuals.
- Services provided on the Internet should mostly be invoiced electronically. Operators should be able to meet their obligations through electronic and VAT accounting and tax declarations based on community rules to be drawn up. By establishing an international framework for co-operation, it should be possible to apply this principle to all international electronic invoicing.

On 6th October 1998, the United Kingdom set out its policy on the taxation of electronic commerce. The United Kingdom set out four broad principles that it considers should apply to the taxation of electronic commerce as follows:

- Neutrality - the taxation of electronic commerce should seek to be technology neutral so that no particular form of commerce is advantaged or disadvantaged.
- Certainty and transparency - the rules for the taxation of electronic commerce should be clear and simple so that businesses can anticipate, so far as possible, the tax consequences of the transactions they enter into.
- Effectiveness - the tax rules should not result in either double or unintentional non-taxation, and risks from increased evasion and avoidance should be kept to a minimum. The overriding aim should be that the right amount of tax would be paid at the right time and in the right country. The rules would need to be sufficiently flexible to continue to achieve this policy objective as technology develops.
- Efficiency - the tax rules should be efficient, keeping the compliance costs of business and the administration costs of government to the minimum compatible with effective tax administration. Measures to counter evasion or avoidance should be proportionate to the risks which they seek to address.

The United Kingdom government went on to state that it did not believe it was necessary to make any major changes to existing tax legislation and regulations, or introduce new taxation. However, the government considered that it was possible that some changes might become necessary to existing domestic rules to ensure that they continue to work effectively - the scope of controlled foreign companies legislation is already due to be reviewed in this context.

The OECD's committee on fiscal affairs published a report entitled "Electronic Commerce: Taxation framework conditions" on 8th October 1998 which stated that the broader taxation principles which should apply to electronic commerce were as follows:

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 and taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency
Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

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 for.

Effectiveness and fairness
Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

Flexibility
The systems of taxation should be flexible and dynamic to ensure that they keep pace with the technological and commercial developments.

The committee went on to sketch out a taxation framework for consumption taxes and international tax arrangements and co-operation. In relation to consumption taxes, the committee set out four principles as follows:

- 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.
- For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.
- Where business and other organisations within a country acquire services and intangible property from supplies 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 the competitiveness of domestic supplies.
- Countries should ensure that appropriate systems are developed in co-operation with 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.

In relation to international tax agreements and co-operation, the committee stated that while it believed that the principles which underlie the international tax rules that had been developed in the area of tax treaties and transfer pricing were capable of being applied to electronic commerce, there should be clarification on how the model double tax convention applied with respect to some aspects of electronic commerce.

It will be obvious from the above that there has been a co-ordinated approach between the United Kingdom, European Union and OECD. Accordingly, it is likely that the various taxing authorities will adopt a co-ordinated approach in relation to electronic commerce. This view is reinforced by the conference conclusions agreed by the OECD ministers on 9th October 1998 which, "welcomed the report 'Electronic Commerce: Taxation Framework Conditions' which sets out the taxation principles that should apply to electronic commerce and outlines the agreed conditions for a taxation framework."

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The post-Ottawa Agenda

The OECD ministers also endorsed the proposals set out in the report "Electronic Commerce: Taxation Framework Conditions" on how to take forward the work contained within that report - ie the post-Ottawa Agenda.

The OECD's committee on fiscal affairs noted that their report had identified the broad taxation principles that should apply to electronic commerce and that it had identified implementation issues. The committee proposed the following post-Ottawa Agenda:

- Tax administration, identification and information needs - the committee suggested that conventional identification practices for businesses engaged in electronic commerce should be adopted. It went on to suggest that internationally acceptable guidelines on the levels of identification sufficient to allow digital signatures to be considered acceptable evidence of identity in tax matters should be drawn up. In addition, 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 taxable election arrangements should be developed.
- Tax collection and control - appropriate strategies and measures to improve tax compliance with regard to electronic commerce and transactions should be designed, including measures to improve voluntary compliance.
- Consumption taxes - agreement should be reached on defining the place of consumption, the place of taxation rules and on internationally compatible definitions of services and intangible property. Furthermore, options for ensuring the continued effective administration and collection of consumption taxes as electronic commerce develops should be considered.
- International tax arrangements and co-operation - with regard to the OECD model double tax convention, steps should be taken to clarify how the concepts used in the convention applied to electronic commerce, in particular (i) to determine taxing rights, such as the concepts of "permanent establishment" and the attribution of income and (ii) to classify income for purposes of taxation, such as the concepts of intangible property, royalties, and services, and in particular as regards digitised information. The application of the OECD transfer pricing guidelines should be monitored for developments in and tax administration challenges presented by electronic commerce.

  Improvements should be made in the use of existing bilateral and multilateral agreements for administrative assistance. Consideration should be given as to how harmful tax competition for electronic commerce should be avoided.

Conclusion

Traditional concepts of taxation based upon a physical presence within a jurisdiction are quickly being overtaken by technological developments. The rapid growth of the Internet means that there is no requirement to establish a branch within a jurisdiction. The difficulties with the taxation of electronic commerce should be looked at on the same basis as its opportunities - on a global and international basis. This is what has happened, with the OECD co-ordinating an international response and the clear electronic commerce taxation agenda that has arisen from the Ottawa summit.

The proposed international response is evolutionary rather than revolutionary in nature. The proposals are, in effect, that the dividing line between royalty and sales income should be clarified, that the rules relating to permanent establishments should be retained, but updated as necessary, that VAT should be adapted as necessary and that the principle of transfer pricing be retained, but updated. Furthermore, there should be more co-operation on an international level to ensure taxpayer compliance.

The greatest threat proposed by electronic commerce to national tax revenues is not in relation to the taxation rules that should be applied to it, but rather in ensuring that electronic commerce participants comply with tax law. One of the many problems with Internet technology is that it is essentially anonymous. There is no way in which tax administrations will be able to check the identity of Internet traders operating computer systems. The world has also become significantly smaller with the advent of modern technology and an increasing number of people are able to gain access to offshore financial centres, which offer the use of numbered bank accounts. The ability to identify transactions through such accounts will, inevitably, be limited.

Many Internet traders will have little incentive to establish themselves within low tax jurisdictions (such as the United Kingdom) when they can trade without any tax risk whatsoever from offshore centres (such as the Cayman Islands) and pay no tax whatsoever. The ability to tax non-resident traders is capable of being achieved by the application of an income tax charge. However, in practice, the Inland Revenue faces two fundamental problems: how will it be possible to identify when a non-resident is exercising a trade in the United Kingdom and how will it be possible to enforce a tax charge on a non-resident with no physical presence in the United Kingdom whatsoever? In Clarke v Oceanic Contractors Inc Lord Scarman said of the direct tax legislation "... the Income Tax Acts imposed their own territorial limits. Parliament recognises the almost universally accepted principle that fiscal legislation is not enforceable outside the limits of territorial sovereignty of the kingdom. Fiscal legislation is, no doubt, drafted in the knowledge that it is the practice of nations not to enforce the fiscal legislation of other nations". This tax vacuum for offshore traders is likely to continue for the foreseeable future. The European Union has taken the stance that no new tax should be applied to electronic commerce, such as the "bit tax" and no one is precisely sure how existing tax concepts can be adapted to meet the danger that offshore centres pose to national tax revenues.