Unclassified **DAFFE/CFA(97)35/REV2**

Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

OLIS : 14-Oct-1997
Dist. : 15-Oct-1997

Or. Eng.

DAFFE/CFA(97)35/REV2
Unclassified

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

THE COMMUNICATIONS REVOLUTION AND GLOBAL COMMERCE: IMPLICATIONS FOR TAX POLICY AND ADMINISTRATION.

19-21 November 1997 in Turku, Finland

A Policy Statement by the Committee on Fiscal Affairs of the OECD to be presented at the International Conference "Dismantling Barriers to Global Electronic Commerce".

For further information, contact Mr. Michael Hardy (tel: 01 45 24 85 23, Fax: 01 45 24 78 52)

57157

Document complet disponible sur OLIS dans son format d'origine
Complete document available on OLIS in its original format

Or. Eng.

Executive Summary

The challenges posed to tax systems by the Internet and Global Electronic Commerce are real and Governments will need to develop a common approach on how to respond to these challenges. This paper identifies the features of the Internet which are relevant for tax policy and tax administration, examines how these features impact on consumption taxes, income taxes and international taxation arrangements (particularly in the areas of tax treaties and transfer pricing) and sets out the options open to Governments to deal with these issues.

TABLE OF CONTENTS

I. INTRODUCTION 4

II. THE INTERNET: AN OVERVIEW FROM A TAX PERSPECTIVE 5

A. Aspects of Internet Electronic Commerce relevant for Tax Policy Makers........ 5
B. The types of economic activities that can be carried out on the Internet. 8

III. IMPLICATIONS FOR TAX POLICY AND TAX ADMINISTRATION 9

A. Introduction 9
B. The Challenge to Tax Administrations 9
(a) The opportunities offered by new communication technologies to tax administrations. 14
C. The Challenge to Consumption Taxes........15
(a) An overview of VAT 15
(b) The concept of “place of supply” under VAT........17
(c) Distinguishing between Goods and Services 19
(d) Distinctions between types of services 20
(e) Impact of VAT and Customs Procedures on Electronic Commerce 21
(f) Customs: Mail order goods 21
(g) Proposals for a Duty Free Zone........22
D. Income Taxation: The Challenges to Existing International Taxation Arrangements 22
(a) The current International Tax Consensus........22
(b) Tax Treaties........23
(c) Electronic commerce and the permanent establishment concept 24
(d) Digitised Information: Characterisation of Income........26
(e) Residency 27
(f) Source rules 29
(g) Global collaboration 29
E. The challenge to Transfer Pricing........29
(a) Traditional transfer pricing rules may be inadequate........29
(b) Evaluating contributions is difficult in integrated businesses........30
(c) Differing tax treatment for permanent establishments and subsidiaries can arise........30
(d) Other issues........31
(e) Preliminary conclusions........31

IV. THE RESPONSE OF GOVERNMENTS........32

(a) Criteria by which to evaluate any reform proposals........32
(b) Options being examined by the Committee on Fiscal Affairs........33

ANNEX........36

I. Work of the Committee on Fiscal Affairs on the Tax Policy and Administrative Implications of the Communication Revolution. 36

I. INTRODUCTION

1. The American writer and urbanist Lewis Mumford when presented with a series of challenges said "I am very optimistic about the possibilities but pessimistic about the probabilities". Many tax authorities feel the same way about Internet Electronic Commerce. The communication revolution has opened up new possibilities for tax administrations to improve the efficiency of their operations. But these new technologies also open-up new "probabilities" for tax evasion and avoidance. The challenge for tax administrations in the 21st Century will be how to maximise the potential efficiency gains of the Internet and at the same time protect their revenue bases without hindering the development of these new technologies.

2. The challenges posed to tax systems by Internet Electronic Commerce are real and governments will need to focus on how to address them in a spirit of collective co-operation. The allocation of taxing rights must be based upon mutually agreed principles and a common understanding of how these principles should be applied. Even if such a consensus is achieved, governments may find that their ability to enforce taxation may be diminished. Without such a consensus, the Internet and other new communication technologies may pose a serious challenge to governments in maintaining their revenue bases.

3. In addition to the need for consensus between governments, there is also a need for co-operation between governments and business. There will need to be an integrated review of how the Internet will impact on tax systems: on legislation and administrative regulations; on implementation and audit practices; and on international taxation arrangements. All the major sources of revenue must be included in this review, including taxes on income and consumption. This is the approach of the work being undertaken by the Committee on Fiscal Affairs (CFA), the main tax policy body of the OECD.

4. At the outset the CFA emphasises that it is ready to work with other regulatory and administrative bodies and the business community to identify and to remove unreasonable tax barriers to the development of electronic commerce and to improve the delivery of service in tax administration by the use of new technologies. Such barriers may derive from the actual operation of legislation; including tax treaties from administrative practices or procedures or from uncertainty about the operation of these laws and rules in relation to Internet Electronic Commerce. However the business community must stand ready to work with tax authorities to ensure that these new ways of doing business do not place unacceptable administrative burdens on tax authorities and do not result in an inappropriate allocation of revenues between countries, taking into account each country's role in creating the underlying income.

5. The CFA believes that a first approach should be to examine how the existing tax provisions and the existing international tax arrangements can be applied to Internet Electronic Commerce. If the existing rules can be successfully applied, this would avoid the need for governments to examine new taxes to be applied to these activities.

6. The CFA may need to examine arrangements outside of purely tax considerations as so much tax policy and administration relies on other aspects of commercial law, practice and regulation. This is one

of the most compelling reasons for the CFA to work with other bodies and the business community to develop an integrated and comprehensive position.

7. This report focuses on the implications of the Internet, private intranet networks and emerging payment technologies such as electronic money for tax policy and tax administration. Whilst the Internet is only one part of the global information superhighway, it is by far the most widely used which is why this paper discusses 'Internet Electronic Commerce' (herafter, electronic commerce), to distinguish the issue from other forms, such as those associated with electronic data interchange (EDI). This report has been prepared by the CFA as input into the Turku Conference. It reflects the views of the CFA at this point in time. However the Committee recognises that in this rapidly changing environment, it will need to review continually the issues addressed herein. The CFA also intends to review the text in the light of the Turku discussions and to provide a revised text for the proposed Canadian conference.

8. The report begins by identifying those features of the Internet which are likely to have the greatest impact on the operation of tax systems. Section III examines the implications of these features for tax policy and administration. Section IV looks at the options open to governments to deal with the challenge posed by electronic commerce and which are currently being considered by the CFA.

9. The theme throughout the note is that if governments are to meet successfully the challenges posed by the electronic commerce for tax systems, a co-ordinated approach is required. The Internet is a truly global phenomenon. Tax authorities must respond by reaching globally consistent approaches to taxing these new activities. The Committee on Fiscal Affairs is well placed to achieve this response.

II. THE INTERNET: AN OVERVIEW FROM A TAX PERSPECTIVE

10. What are the main characteristics of the Internet that are likely to influence the operation of tax systems? And what types of taxable economic activities will develop through the use of Internet? These are the two questions addressed in this section. No attempt is made to provide a comprehensive description of the operation of the Internet since this will be available in other papers prepared for the conference.

A. Aspects of Internet Electronic Commerce relevant for Tax Policy Makers

11. There are at least two types of business opportunities created by the Internet that will influence the operation of tax systems:

(i) new ways for businesses to advertise, sell and deliver products and services to customers.

Start-up capital requirements on the Internet are typically low and the Internet gives enterprises the ability to access an inexpensive global communication system, through which goods and services can be advertised, sold, and possibly delivered. Small and medium size enterprises will find it easier to engage in international commerce. This, in turn, will lead to a rapid expansion in cross-border activities. Access for small and medium size enterprises is easier because the

Internet reduces the need for intermediaries in the sale and delivery of goods and services. For example, over the Internet, a producer of software can sell and deliver its products directly to the final consumer, an airline company can sell and deliver tickets directly to passengers, and financial information may become available without the involvement of banks and other financial institutions.

(ii) new ways for businesses to communicate and organise their activities.

The Internet gives enterprises the ability to establish private global communications systems or use the public system for business communication. In this way, the Internet opens up opportunities for new and more efficient forms of commercial activities (such as global collaboration) in the development, marketing and delivery of products. For example, the Internet is facilitating an increase in global collaboration, whereby businesses utilise the Internet to work around the world and around the clock (e.g. global dealing). It is also allowing the decentralisation of product development, whereby developers from a number of physical locations can use the Internet to interact in the development of a single product or project. Private Intranet networks, which are now widespread in Multinational Enterprises (MNEs), are also giving an increased scope to the integration of business functions, e.g. design and production.

These opportunities are enhanced by the proliferation of encryption technology, which protects the confidentiality of the data transmitted on the Internet. Even if it were possible to detect a message sent by one person to another over the Internet, encryption generally precludes understanding the content of the message.

12. Aspects of commerce over the Internet that have implications for the operation of tax systems:

(i) Lack of any user control as to the location of activity

The nature of the system is such that it has no physical location. Users of the Internet have no control and in general no idea of the path travelled by the information they seek or publish. Many participants in the system are administrators or go-betweens who have no control over what type of information travels over their computer. In practice, it makes no difference whether the data or digital tokens sought to be transmitted are within one jurisdiction or between several, as the Internet pays little or no regard to national boundaries. As the physical location of an activity, whether in terms of the supplier, service provider or buyer of the goods or user of the service, becomes less important, it becomes more difficult to determine where an activity is carried out.

(ii) No means of identification of users

In general, proof of identity requirements for Internet use are very weak. The pieces of an Internet address (or “domain-name”) only indicate who is responsible for maintaining that name. It has no relationship to the computer or user corresponding to that address or even where the machine is located. In addition, it is not difficult to introduce a new computer to the Internet which has the ability to be recognised anywhere else on the Internet. Registration requirements are not difficult to satisfy and there is little to prevent transfer of the site to new controllers.

(iii) Reduced use of information reporting and withholding institutions.

In general, tax compliance is facilitated by identifying key “taxing points”: for example, reporting and withholding requirements can be imposed on financial institutions which are easy to identify. In contrast, one of the great commercial advantages of electronic commerce is that it often eliminates the need for intermediating institutions. Although from a purely economic

perspective such “friction-free” capitalism may be an advantage of the new technologies, the potential loss of these intermediating functions poses a problem for tax administration.

13. Developments in electronic payment systems also pose issues for tax administration. Electronic payment systems may partially displace cash, checques and credit cards, which currently constitute about 90 percent, by volume, of financial transactions. Electronic payment systems have the potential to create new forms of money in which value is represented in digital form. The digital form of electronic money allows it to be processed inexpensively and instantaneously transferred around the world. “Electronic money” encompasses a wide range of products, which are all still under development. However, electronic payment systems share certain similar features and an understanding of these general features is a necessary step in developing means to integrate these new payment systems into our system of tax administration and compliance. The following Figure compares attributes of current conventional payment systems and electronic payment systems.

Figure I. Contrasts with conventional payment systems.

Current payment Systems	Electronic Payment System
High degree of central bank control	Various national views about control
Highly structured supervision/regulation	Highly technical, yet to be designed
Large legal and policy literature	Little current literature
Body of examining and Customs mechanisms	Monitoring technology unavailable
Physical means of payment-cheques, currency	Intangible electronic analogs
Huge infrastructure established world-wide	Downsized, computer-based
Relatively labour intensive	Relatively capital intensive
High value infrastructure - brick and mortar	Low cost decentralised facilities
Bank-dominated wire transfers	Personal computer transfers
Clearing mechanism required	Clearing requirement reduced
Transportation - courier, land, sea, air	Telecommunications
World-wide use of US currency	Easy currency exchange/one currency
Serial numbers and banks records	Enciphered messages
Significant statistical data collection	No methodology for Ms statistics
Economic national borders	No borders, effectively
Defined jurisdictions	Overlapping, unknown jurisdictions
Generally non-refutable, standard methods of validation	Evolving methods of transaction verification
Authentication, established structure to verify authenticity	Undetermined, system specific may involve third party

14. Some commentators may argue that few of these characteristics are new and that many of the problems they pose for tax administrations are similar to those posed by mail-order businesses or by developments in the communication sector in the 1970s. But few would dispute that the speed, global access and automation of functions provided by communications on the Internet, the mobility it offers, and the potential for new payment systems, may change the way business is being undertaken. The use of electronic media creates a qualitative difference in the way existing activities can be carried out and taxed. But at the same time these techniques will open up new ways in which tax administrations can assess and collect taxes.

B. The types of economic activities that can be carried out on the Internet.

15. To tax an economic activity, the tax authority must be able to identify a taxable event. In the case of income taxes, this requires identifying and measuring the income generated by an activity; consumption taxes rely upon identifying a transaction; taxes on capital require identifying the ownership or transfer of ownership of an asset. It is therefore necessary to identify the types of economic activities that are carried out on the Internet, where they are carried out, and by whom.

16. A number of broad categories of economic activities may be carried out on the Internet:

(i) The sale-lease of goods

There are numerous web sites enabling buyers to select, pay and order physical goods which are then delivered by traditional mail-order methods. Some digital "goods" can already be downloaded (e.g. computer software, magazines and newspapers) and it is expected that most "goods" capable of being digitised (e.g. compact disks, videos) will be able to be delivered by downloading within the next few years.

(ii) The provision of services

Many traditional services are available via the Internet. Web sites offer offshore banking services, ticketing arrangements, stock-brokerage services the provision of health care advice and other professional services.

(iii) The provision of on-line information

Services such as Lexis and Nexis have created large computerised databases which can be accessed by customers, with the information either being read on screen or printed.

(iv) Advertising.

Commercial enterprises are increasingly using the Internet to advertise their goods and services.

(v) Gambling

The Internet opens up new possibilities for 24 hour global gambling: the ultimate Las Vegas.

(vi) Global Dealing

This refers to the capacity of financial institutions and MNE's to engage in 24 hour trading, with the "book" moving between time zones.

17. The issues posed above will be more pressing as a result of increased international trade, especially in services, and increased capital mobility. It is now much easier for services (e.g. banking and financial services, insurance, engineering, accounting, consultancy, advertising, public relations, legal services, research and development, management, market research and architectural services) to be produced in one place and consumed simultaneously in another. The production of such services need no longer take place where the services are to be consumed and, as a result, the concepts of specialisation and comparative advantage have become more applicable to the production of services. This process has been most evident in the way MNEs have set up specialised service centres to provide financial management, marketing, accounting and other services to different arms of the enterprise. These service centres can easily be separated from the rest of the enterprise and located, for example, where skilled (or low cost) labour is readily available. The recently concluded agreements in WTO and APEC will give further impetus to trade in these services. Capital mobility is also likely to increase substantially as a result of the communications revolution. Given the difficulties countries face in trying to enforce residence taxation,

the increased risk of capital flight will place further pressure on their ability to impose taxes on capital income.

18. These changes will also have implications for the ways in which tax authorities go about their business.

III. IMPLICATIONS FOR TAX POLICY AND TAX ADMINISTRATION

A. Introduction

19. The on-going work of the CFA has already shown that the implications of electronic commerce for tax systems are wide-ranging. From the perspective of the tax administrator, these new communication technologies open up possibilities to improve the administration of tax systems but also open up new avenues for tax evasion and avoidance. From the perspective of the tax policymaker, legislator and tax treaty negotiator, these developments may challenge many of the traditional concepts embedded in tax laws and tax treaties. This section provides a brief overview of each of these issues.

B. The Challenge to Tax Administrations

20. Effective enforcement of tax laws, as with other laws, requires accurate identification of a party and evidence that can be linked to the party. In fiscal matters this equates to identifying a taxpayer, obtaining evidence of income and linking the income to the taxpayer.

21. There are two major ways tax authorities seek to verify disclosed income tax liabilities. The first, the "specifics" method, examines transactions which have been disclosed (or partially disclosed) to the revenue authorities and seeks to establish by an examination of the relevant facts and law whether or not a particular item is taxable or is a legitimate tax deduction. This method is unlikely to change under the new environment but the techniques used to apply this method must be adapted to take into account technological developments.

22. The second method is not a single method as such; it is a collection of "non-specific" methods relating to measurement of assets or spending and funds over time, frequently supplemented by inspection of particular matters such as trading stock. As discussed below, the growth of unaccounted electronic payment systems and electronic commerce will create problems in the application of this method.

23. Even at present non-specific methods have obvious weaknesses. If, for example, a taxpayer earns cash income and puts it under the bed instead of a bank account, then it may not be detected by an approach which measures the difference in value of assets at two points in time (the inference being that asset accretion occurred through undisclosed income). Similarly, if someone is paid $100 for a cash job and spends it untraceably on a night's entertainment it is likely to go undetected as income. The ability to make untraceable investments offshore poses similar problems. Non-specific methods depend critically on the tax authorities' ability, under powers conferred by law, to obtain information and evidence compulsorily, both from taxpayers and third parties.

24. There are two important and related properties of current payment systems which impose constraints on the nature and extent of tax evasion. The first is the nature of cash. Cash in relatively small amounts is easily hidden. In larger amounts it is bulky and becomes a major security risk. There are acceptance and trust issues in using cash for payment of other than small to moderate transactions. Cash can be used in other than face to face dealings, but the levels of trust between payer, recipient and carriers would in many cases be insufficient.

25. Electronic money poses a tax evasion potential similar to that created by paper money which depends in part on the technological features of the particular electronic payment system at issue. Electronic payment systems can be distinguished in part based on whether they are accounted or unaccounted systems. In accounted systems, the issuer maintains a central record of the flow of its electronic money through the economy. In unaccounted systems no such central record exists.

26. Accounted systems are unlikely to present substantial tax administration concerns because the central record of transactions, if it is available for examination on audit, will permit tax administrators to match payments and receipts to specific taxpayers. In contrast to accounted systems, problems may arise with unaccounted systems, which maintain no such central record and are therefore analogous to cash. Transactions using unaccounted electronic money create the opportunity for both not reporting or under reporting the resulting income because detection of these transactions is difficult. The extent of this problem will be measured by the extent to which unaccounted systems are used instead of accounted systems and other payment systems.

27. Unaccounted electronic payment systems therefore create the same tax evasion potential as is created by cash, but without the limitation of paper money, discussed above. Tax administrators have developed techniques to reduce tax evasion through cash transactions and the CFA will be studying how these techniques can be adapted to electronic money.

28. The second and related issue is the nature of banking systems in developed countries. Typically there is a central regulatory bank and a relatively small number of trading banks acting as vehicles for cash issue and deposits. These intermediaries provide a paper trail independent of the taxpayers who use them. Reporting mechanisms can be introduced in relation to larger cash transactions (as they have been in Australia and the United States) which can be helpful for tax authorities in the light of well-established correlations between tax evasion and cash transactions.

29. Electronic money can also facilitate the use of offshore banking centres. It is now very easy to open a bank account, in another jurisdiction. Once an individual depositor can open accounts, transfer funds, make bill payments, and arrange personal loans without visiting a local branch, there may be little reason for a customer to prefer a local to a foreign institution, other things (such as security, deposit insurance, etc) being equal. Transactions, including the actual opening of an account and funds transfer, can be done directly and instantaneously over the Internet, and the anonymity and ease of doing this are both likely to increase as electronic payment system technology matures. From the standpoint of the would-be tax evader, the optimal bank is one that is at least as accessible and well-run as any local institution, but that remains beyond the reach of the domestic tax authority. Not only the bank's holdings should be impervious to tax investigation, but also its dealings with its depositors and debtors, regardless of their location. While it has always been possible to open bank accounts in other countries, practical drawbacks limited their appeal, in particular:

(i) funds went through the conventional banking system so anonymity was limited or non-existent; and

(ii) transaction costs associated with opening an account and the deposit and withdrawal of funds tended to be high.

30. Thus while the *principles* of offshore bank accounts and other investments may be similar, the *practicalities* in relation to ease, anonymity, immediacy of funds transfer pose crucial differences in making international tax evasion easily accessible to a much wider audience.

31. In addition to facilitating tax evasion in the form of hidden cash deposits, the availability to consumers and businesses of secure offshore electronic financial intermediaries may have an impact on corporate tax revenues from the domestic banking sector. Some of these issues are being considered by the CFA in the Special Sessions on Tax Competition.

32. Electronic Commerce poses a number of practical evidentiary problems for both taxpayers and tax administrators in the area of identity and transaction verification. The identities of parties to an electronic business transaction may be difficult to determine. For example, it may be impossible to identify the owner of a Web site conducting Internet business. This is particularly relevant as it could preclude enforcing tax in respect of business activities by residents and even between residents. Identification and registration requirements will have limited success with the growing ease with which Web sites can be located offshore.

33. While revenue authorities typically have extensive powers to compel disclosure of information and production of documents, their writ usually runs only within their own jurisdiction and they must rely on co-operation under applicable treaty provisions with other jurisdictions. Even where such co-operation is forthcoming, the difficulties of attempting to obtain information and evidence in respect of documents or payments in encrypted digital form are likely to be great. In some cases, however, a jurisdiction's lack of appropriate tax and regulatory structures makes it an unsuitable tax treaty partner.

34. The need to verify the identity of a counterparty is also an issue for electronic commerce. For example, a seller of electronic information may claim to be a resident of a treaty country and thereby entitled to a reduced or zero rate of withholding tax on royalties. At present, in some countries, a payer might be able to rely on the postal address of the payee. In In electronic commerce, there is no necessary relationship between an Internet address and a physical location. A person could easily establish an Internet address in a treaty jurisdiction without any other connection to that jurisdiction. If withholding taxes are to be imposed on electronic commerce, it will be necessary to establish standards and procedures for verifying the identity of electronic counter parties. For example, a taxpayer who downloads a digitised photograph from one of the electronic stock photograph agencies could obtain the right to reproduce the image in a book or magazine. The payment for this right would presumably be a royalty. How would the customer verify the payee's claim that it was entitled to a reduced rate of withholding, and if withholding were necessary, how would it be administered?

35. The elimination of 'middlemen', disintermediation, that results from electronic commerce may cause problems in the collection and administration of cross-border withholding taxes resulting in revenue losses. As discussed above, it is now possible for individual and relatively unsophisticated taxpayers to engage in cross-border transactions. The parties to these transactions may be unfamiliar with their withholding obligations and the current technology does not provide a mechanism for computing and paying such taxes, although such a mechanism seems technically feasible. The small amounts involved will also complicate tax administration.

36. Even where the ownership of a web site or Internet address is established, tax administrations will encounter greater difficulties identifying and tracing electronic transactions because of factors such as

encryption, the fragmentation of transmissions, and the use of remote control and diverting mechanisms. Taxpayers may conduct their business in cyberspace for increasingly long periods of time. Electronic trails may be inadequate, especially where several taxing jurisdictions are involved in a transaction.

37. Audit trails depend on accurate records and electronic commerce also raises issues under the recordkeeping requirements that are central to tax administration. Taxpayers are required to keep accurate books and records, which are subject to examination by the revenue authorities in order to verify the income and expenses reported on the taxpayer's return. Traditionally, these records were kept in hard copy format. However, taxpayers engaged in the sale of electronic goods or services may never create paper records because customer orders are placed and fulfilled electronically and therefore the only record that exists of these transactions could be an electronic one. Such electronic records can be easily altered. Even taxpayers engaged in the sale of physical, as opposed to electronic, goods may soon receive orders and issue invoices electronically. Consequently, electronic records and business documents must be verifiable in order to minimise the potential for tax evasion.

38. However, new technologies may create solutions to some of these problems. For example, technologies such as "digital certificates" can make it possible to verify the identity of an online counterparty and "digital notarisation" can make it possible to verify that electronic records have not been altered. The CFA intends to study these and other developing technologies, in conjunction with other segments of the OECD, in order to determine the extent to which they can alleviate some of the tax administration issues posed by global commerce.

BOX I

Summary of Tax Administration and Compliance Issues in Cyberspace

39. The Internet will change the environment within which tax administrations operate.

(i) Establishing identity. The identities of parties to a business transaction may be difficult to determine. For example, it may be impossible to identify the owner of a web site conducting Internet business. This is particularly relevant as it could preclude enforcing tax in respect to business activities by residents and even between residents. Identification and registration requirements will have limited success with the growing ease with which web sites can be located offshore.

(ii) Establishing location. Individuals and entities engaging in electronic commerce will be able to establish an Internet address in almost any taxing jurisdiction irrespective of the location of his residence or the source of his activities. For example, an individual may establish an Internet address in the United Kingdom to claim the benefits of a reduced rate of withholding specified in the UK-US treaty. How does the payer verify that the payee is entitled to this treaty benefit.

(iii) Obtaining acceptable documentation of proof will become more difficult. Tax authorities have extensive powers to obtain information from taxpayers (see OECD 1990: "Taxpayers' Rights and Obligations"). These powers are relatively easy to enforce within their own jurisdiction. Obtaining information on activities carried out in other taxing jurisdictions, however, requires the use of exchange of information provisions found in tax treaties. Where books and records are maintained in a tax haven, it is unlikely that the tax authorities will be able to obtain access to them since few countries have treaties with tax havens. Thus domestic disclosure requirements may become difficult to enforce. It is also unclear whether the evidence that tax administration would be able to produce on transactions in cyberspace would meet the documentation and evidence standards set by Tax Codes and Courts.

(iv) Disintermediation will remove convenient "taxing points". The elimination of "middle-men" will force tax administrations to collect smaller amounts of revenue from a larger number of taxpayers. Withholding taxes, particularly on financial transactions, and certain consumption taxes will become less viable sources of revenue. This will increase the administrative and compliance cost of the tax system. Traditional banking systems which today are characterised by a small number of very large banks, may be transformed by the availability of a large number of banking facilities on the Internet operating in an off-shore environment. This may make it more difficult for tax authorities to "piggy-back" on the reporting requirements that Central Bank traditional place on their domestic banking sectors.

(v) Tax havens and off-shore banking facilities will become more accessible. It will be increasingly easy for the "average" tax payer to use offshore financial centres. Already a number of traditional tax havens are offering numbered and coded bank accounts combined with such services as international wire transfers on-line and other on-line payment options. Whilst the principles which govern off-shore banking are similar to those which govern traditional banking, the ways in which banking over the Internet may operate in the future will make a crucial difference to the ability of tax authorities to counteract international tax evasion and avoidance. Internet banking will offer an ease of access, low transaction costs, a degree of anonymity and an immediacy of transferability of funds which is not available today. If these attributes can be combined with well run off-shore institutions in an environment which provides security, we can expect that a much wider clientele will be attracted to this medium.

40. Although these features do not pose any really new problems, they do give rise to greater complications due to increased volumes and a change in the character in the way transactions are handled. It may be, however, that many of the problems created by these new technologies can also be solved by new technologies.

(a) The opportunities offered by new communication technologies to tax administrations.

41. Whilst the challenges are here today, the opportunities offered by these new technologies are only just emerging. Tax administrations will be able to improve their operations by using new communication facilities. Already a number of tax authorities have electronic data interchange (EDI) programs that are making their operations more efficient, improving the quality and timeliness of service to taxpayers. Electronic data interchange means that businesses need less time to comply 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. In the area of income taxes, a number of countries (eg Australia, Canada, Denmark, The Netherlands and the US) have implemented:

(i) Direct deposit program

Direct deposit can replace cheques as standard method of issuing payments. Direct deposit has a number of advantages over the traditional method of payment. It offers clients a safe, convenient, dependable, and time-saving way of receiving payments, and saves the government money through reduced fees and postage. Business clients can also have their income tax refund and VAT refunds and rebates deposited directly.

(ii) Electronic filing

Tax returns can be filed by using electronic media. The advantages of using electronic filing include accuracy of tax data, reduced cost to the public and to the tax authorities, reduced paper use and fast processing of returns. Electronic filing can be used by individuals who complete their own returns, or by individuals who use the services of a tax professional. An encryption device can be used to ensure that tax information remains confidential.

(iii) Automated deductions of social security and other payroll taxes

The authorities can accept payroll deductions electronically from any employer who wants to send them that way. This process eliminates the need for employers to file tapes or paper.

(iv) Customs Process

EDI systems may be used to streamline the customs commercial process (e.g. the recent Canada-United States Accord on the shared border arrangements).

(v) Improved Exchange of Information

Intranet type networks may open up new possibilities for tax authorities to exchange information in a more timely and secure way. Already the OECD has developed an OECD Standard Management Format for automatic exchange of information (OECD Council Resolution of 1992) and work is advancing on developing an EDIFACT standard for Electronic Exchange of Tax Information. In the field of Consumption Taxes work is in hand to develop international co-operation and to introduce the means for exchanges of information.

42. The members of the CFA are committed to exploiting these new opportunities to improve the service available to taxpayers and to explore ways in which administrative and compliance costs can be reduced by using these new technologies. Work has already commenced on a project to record the best administrative practices of member nations and to make this research available for the consideration of all members.

C. The Challenge to Consumption Taxes

43. Taxes on consumption now account on average for 30 per cent of the tax revenues in the OECD area and 27 of the 29 Member countries use a Value Added Taxes (VAT) (the two exceptions are Australia and the US). This section of the paper focuses primarily on VAT, although many of the issues raised would apply also to other forms of sales taxes. Readers will also note that many of the issues referred to below are quite similar to those described under direct taxes.

44. The communications revolution poses challenges for the traditional concepts underlying VAT systems. Tax administrations and others are concerned with the ways in which supplies of telecommunication services, Internet fees, satellite broadcasting and supplies of computer software and related computer services will be dealt with under the VAT. There is also the issue of how these new technologies will interact with mail order businesses.

45. Apart from services related to the financial sector (which presents a whole new set of problems), the vast majority of the services in question are normally taxable at a positive rate of VAT when supplied for domestic consumption and at a zero rate when qualifying as exported services. Consequently, it is the VAT rules governing the accountability of international services that have always posed problems for tax administrations. These problems are amplified manyfold when services dependent upon the new communication technologies are considered, particularly in respect of the time, place and value of the supplies.

46. The following discussion makes numerous references to services provided by the Internet. These include on-line activities (e.g. digitalised information including text, sounds, pictures, software etc) where supplies of “goods” and services are ordered and delivered electronically; and off-line activities (such as consulting, advertising, financial and telephone services provided over the Internet) where goods and services are ordered electronically but delivered by other means.

(a) An overview of VAT

47. All of the 27 OECD countries which use a VAT apply the <u>credit invoice VAT method.</u> Although Canada and New Zealand have introduced their particular versions of VAT under the title of Goods and Services Tax (GST), these tax systems to all intent and purposes fall into the category of a credit invoice VAT method (all references hereafter to VAT apply equally to GST).

48. The <u>credit invoice method</u> requires taxable persons to calculate VAT at the appropriate rate on all taxable supplies made (outputs) throughout the chain of supply. Taxable persons are entitled to deduct a credit on amounts of VAT charged by suppliers (inputs) in the way of business. Such supplies are supported by the issue of a tax invoice conforming to certain requirements.

49. VAT is a tax on consumer expenditure and is charged on the supply of goods and services effected for a consideration within the territory of a country by a taxable person, where such supplies are not specifically exempted or liable to a zero rate of VAT (e.g. exports). In addition to taxable supplies,

VAT is also charged on imports. Supplies are deemed to be outside the scope of the VAT where they are made by someone who is not a taxable person, or made outside the jurisdiction of a specific tax authority, or not made by way of business.

50. A taxable person is any person who independently carries out in any place any economic activity. The status of such persons can take the form of a private individual, a partnership, a private or public incorporated body, government bodies and non-profit making organisations. In most countries, persons who make supplies over a certain value threshold are required to notify and to register for VAT purposes. Every taxable person is allocated a unique identification number by the tax administration which is usually distinguishable solely for VAT purposes.

51. Thus, for most businesses, VAT is not a real cost but a flow-through item. It is the final customer (e.g. the consumer, financial sector, government, etc.) that ultimately bears the economic burden of VAT. Besides the final customer, however, there is a significant group of business entities for which VAT is a real cost: *businesses that are exempt from the VAT.* The most prominent *exempt* industry which very often is unable to recover VAT is the financial sector. For these industries as well as for the final customer the Internet may offer planning opportunities with a potential for real cost savings.

52. The value of the consideration is normally the actual or open market value of the supply. The consideration can be any form of payment in money or in kind, including anything which itself is a supply. If the consideration is not in money (e.g. barter), the tax value of the supply is the monetary equivalent of the consideration.

53. Separate place of supply rules apply to goods and services. The basic rule in the case of goods is the place where the goods are when dispatch or transport begins. The place of supply rules for services is much more complicated and can be either the place where the supplier is situated or the place where the customer is situated depending on the category of the services in question (see section (ii) below).

54. The time of supply or the chargeable event (also known as the tax point) is taken as when the goods are delivered or services performed, or the date of issue of the invoice, or the date of payment - whichever occurs first.

55. The issuance of a tax invoice is fundamental to the credit invoice VAT system. In OECD countries this is usually a commercial document prepared in line with normal commercial practices and conforming to certain requirements laid down by the tax authority. It indicates, inter alia, the name, address and VAT identification number of the supplier who issues the invoice, the name and address of the customer, description of the goods/services, the date and tax point, the value of the supply and the VAT rate and amount of VAT. It identifies the output tax liability of the supplier and is mandatory evidence of recoverable input tax by the customer.

56. The necessary administrative regulations determine obligations for taxable persons in relation to the issue of tax invoices, maintenance of records and accounts, and declaration and remittance the tax. Total output tax charged by suppliers to their customers is due to be paid to the tax administration. If the customers are registered for VAT and the supplies are wholly for business use, the VAT will under normal circumstances be recoverable as input tax. VAT registered persons can reclaim input tax on purchases and imports which relate to both positive and zero rate supplies. In principle, input tax relating to exempt supplies or non-business activities is not recoverable. Therefore the tax sticks with the final consumer whether this is a private individual or a taxable person.

57. Declarations are made at fixed intervals. In most OECD administrations the frequency of VAT declarations is monthly for large traders and varying frequency (usually quarterly) for other traders, with annual returns for small and medium sized enterprises. The net tax due will be the excess of amount of output tax over the amount of recoverable input tax. Where the input tax exceeds the output tax (e.g. exporters) a repayment will be claimed from the tax authority (a more detailed description of VAT can be found in Consumption Taxes Trends OECD February 1997).

(b) The concept of "place of supply" under VAT.

58. All VAT systems include a set of rules which determine the country where tax on a transaction is chargeable. In the European context, the EU 6th Directive aims to provide a standard set of rules to ensure parity of treatment within the European community and to avoid economic distortions by ensuring that appropriate goods or services are subject to taxation, but only once. Under the EU rules, which were developed in the mid-1970s, there is a basic 'place of supply' rule for services, providing for certain services to be taxed according to where the supplier has established his business, or has some other fixed establishment from which the service is supplied. However, there are several exceptions to this rule: Services related to land are generally taxed where the land is situated; transport is in principle taxed where it takes place; some services such as cultural, entertainment and artistic services are taxed where they are performed. Intangible or intellectual services - such as copyrights, licences, advertising, professional and consultancy services and financial transactions - are taxed where the customer is established or has a fixed establishment which received the service.

59. In broad terms, the place of supply rules therefore fall into two categories: those which depend upon the identification of a relevant establishment (belonging to the supplier in some cases, and to the customer in others) and those which are based on the place of performance or enjoyment irrespective of where the supplier or customer belong.

60. The Internet and deregulation of services have meant that many services now can be supplied to customers without the supplier having to set up a recognisable establishment in the country where the supplies are consumed. Cross-country service suppliers over the Internet have no need for staff, premises or even equipment in the consumers' country and maintenance as well as service obligations can be discharged by contracting companies.

61. In Europe, telecommunications are probably the largest area of consumption to be taxed under the basic 'place of supply' rule - i.e. where the supplier has established his business or has a fixed establishment. When that rule was originally implemented, telecommunications services were generally provided by national institutions. The supplier was therefore established in the same country as the consumer. However, the last decade has seen very rapid developments in the communications industry both in terms of technology and commercial practices. The main effects of these developments may be summarised as follows:

(i) in an increasing number of countries, consumers are presented with more choice as to the range of available services and the number of service providers. Increasing international competition also means that it can no longer be assumed that the provider of such services will necessarily be established (for VAT purposes) in the country of consumption;

(ii) through the use of modern technology, e.g. satellites, it is now possible for suppliers to provide telecommunication services without having any tangible place of business in, or even close to, the country of consumption; and

(iii) with developments such as increased usage of phone cards, credit facilities and mobile telephones, telephone usage may occur in countries other than the country where the customer belongs or where the customer is invoiced.

62. These developments offer business consumers new opportunities to evade or avoid VAT by turning to non-resident suppliers with no business or other fixed establishment within a Member country or the EU area. Such business can establish contractual arrangements with the sole purpose of avoiding VAT by creating an artificial source of supply outside the taxing jurisdiction. This clearly undermines the current 'place of supply' rules. This may be particularly attractive for those customers, such as banking institutions, which cannot recover fully the VAT normally charged to them on their business expenditure.

63. One current example is the development of telephone services provided over the Internet. Software now exists that will allow Internet users to make long-distance telephone calls by using the computer networks that make up their Internet connection. This allows consumers to avoid using the telecommunications network provided by telecommunications carriers and to avoid paying long-distance charges. Instead of talking into a telephone, consumers can use Internet telephones by speaking into a PC equipped with a microphone, speakers and a sound card.

64. The sound quality of the Internet telephone is inferior to that of the traditional telephone because of limited bandwidth. However, the technology and sound have been improving rapidly. Because the software providers sell only software products, and do not provide any transmission services, they are not viewed as providing "telecommunications" by regulators. As a result, unlike telecommunications carriers, the Internet telephone software makers may not be subject to the regulations which currently govern long-distance carriers. However, in so far as there is a link from the users computer to the Internet via a provider for transmission purposes, the service of the provider may be classified as telecommunications services.

65. Users do not have to pay any fee on a per call basis for these long-distance calls. The costs are included in the flat-rate charged by internet providers. The Internet system is not established in a way to monitor who opens a channel and how long that connection stays open. If the Internet phone gains in popularity, this will result in an erosion of both the tax base and the telecommunication carriers' customer base.

66. One possible option to deal with these developments is to maintain the current "place of supply" rule and to focus on the definition of fixed (or permanent) establishment. If cabling, switching and other technical resources required to deliver such services do not give rise to a permanent establishment under the current definition, a widening of such definition (by a legislative amendment) could be contemplated. This would bring into question whether the permanent establishment definition for purposes of VAT for Internet related transactions should depart from the general definition applicable to other economic activities. The CFA sees some complications arising from this approach.

67. Another option would be to take the opposite view, namely that cabling and switching is not sufficient by itself to create a fixed establishment, and to change the 'place of supply' rule to where the customer is established. This has the immediate attraction of putting an end to the current avoidance schemes by placing the onus on the financial institutions themselves to account for VAT on the services they receive. However, it raises the fundamental question of how tax would be levied on non-business consumption. It could also still be susceptible to avoidance of tax by the financial institutions, who could arrange their affairs so that the "customer" is an associate who is not established in the taxing jurisdiction. In other words, there can be no guarantee that the customer is also the person who has the effective use and enjoyment of the services, and both may not be situated in the same country. Moreover, although in

this situation, the customer may wish to recover all or some of the costs of the services from the user, this could be effected through a management service charge, which would not be liable to VAT when the supplier is, for example, outside the EU since management services are taxed where the supplier is established. Neither of these solutions deal with the issue of how to treat Internet fees under the VAT.

68. In principle with effect from 1 July 1997 all EU tax administrations introduced changes to the place of supply rules for telecommunications services. The main affect of these changes is to move the place of supply rules for such services from where the supplier is established to where the customer is established. In cases where the customer is a VAT registered person the reverse charge/self-supply tax mechanism may be applied (whereby the tax is declared and paid usually by using the normal VAT declaration form); supplies to non-VAT registered customers require that the overseas supplier be registered for VAT in the country of consumption (taking due account of national VAT Registration procedures).

(c) Distinguishing between Goods and Services

69. The European and most other countries' VAT systems require that a distinction be made between goods and services. Yet newspapers, standard software packages and CD's traditionally supplied in shops or by mail order can now be delivered in digitised form. Since classification as a "good" for VAT purposes is generally linked to the existence of a physical object and the physical "means of transport" is no longer required, the dividing line between goods and services becomes increasingly blurred. It is clear that the classification as a good or a service should not depend on the means of distribution (e.g. sale of standard software through a retail outlet versus sale of standard software via direct download). However, it is yet less clear how consistent treatment can be achieved. It may well be that the growth of electronic commerce may lead to a reevaluation of the way certain transactions are traditionally classified.

70. Goods imported from outside the EU are liable to VAT at importation; goods delivered from one Member State to another are taxed in the country where the transport of the goods begins, unless supplied to VAT registered customers, in which case they are taxed as an acquisition in the Member State of receipt. Supplies of goods to non-taxable persons may be taxed in the supplier's Member State, subject to the total value of his supplies in any single Member State remaining below a threshold. Once that threshold is reached, registration for VAT in the Member State concerned is compulsory.

71. Services are subject to different place of supply rules depending upon the type of service and whether the customer is in business. Most services (which are relevant here) are generally deemed to be supplied in the country of the supplier when supplied to non-taxable persons. However, there is no distance selling threshold for services. Supplies of such services - whether they are classified as the provision of information or the granting of copyrights - are taxed in the customer's country under Article 9(2)e of the Sixth VAT Directive when made to taxable persons. Moreover, the customer is required to account for VAT under the so-called reverse charge or self-assessment procedure (i.e. to declare the transaction and pay the tax voluntarily).

72. Any inconsistencies in the classification of goods and services may allow businesses to minimise their VAT liability by selling products as services and vice versa. In particular, non-EU suppliers can supply such services VAT-free (and presumably free of import duty or Customs controls) and are not subject to any distance selling threshold.

(d) Distinctions between types of services

73. Under current EU place of supply rules, it is critically important to determine the type of service being supplied. Whereas telecommunications and broadcasting services are deemed to be supplied in the country of the supplier, the services of consultants and engineers, data processing and the provision of information supplied to businesses are taxed according to the country of the customer. Live entertainment services are deemed to be supplied in the country of performance.

74. The internet and new communication technologies blur the borderline between transmission and data processing and similar services. For example, multi-messaging services are more than a basic service of transmission which may represent only a relatively minor cost component of the total package. The services vary in type but typically, the customer provides a telecommunication company with the basic data or message to be conveyed. The telecommunication company is responsible for formatting the message, editing, adding headers and footers and sometimes even translating it into foreign languages as well as the dispatch of the message to the addressees.

75. New combinations of services will be offered to customers. Access to the Internet may be supplied with “free-banking” or other services offered for no additional consideration. Alternatively, free Internet access could be provided to those using it to order goods or services. This calls into question whether there are one or more supplies for VAT purposes (potentially with different place of supply consequences for each). Also, if it is a single composite supply, whether it should be classified as a banking or as a transmission service.

76. More generally, these new communication technologies will increasingly mean that the country of consumption need not necessarily correspond to the country where either the supplier or the customer is established. For example, an MNE may lease a private intranet network linking two or more offices world-wide (a common phenomenon in global trading). The MNE may contract with a single supplier (who will have acquired the necessary capacity by trading in wholesale markets with other telecommunication providers). Should EU VAT be applied to the lease or use of that part of the circuit which lies outside the territory of the EU? The territoriality principle implies that the answer is “no”. But the implementation of that principle could involve some awkward and complex apportionments between charges relating to EU and non-EU use.

77. A further potential difficulty is the non-taxation of services which are deemed to be supplied in the business customer’s country, where these are supplied to companies with establishments both within and outside the EU. The Sixth Directive refers to the place of supply as “where the customer has established his business or has a fixed establishment to which the service is supplied”. Taxable persons who cannot fully recover VAT charged to them (notably banks, insurance companies and other partly exempt bodies) may be inclined to arrange for services to be supplied to an overseas establishment. The onus is then on tax authorities to identify any supply or transfer of those services for consumption within the EU, and to identify a chargeable event in relation to that supply or transfer. This may prove very difficult where the services are re-labelled, e.g., as management charges, or where there is no clear evidence of a consideration in return for the services.

(e) Impact of VAT and Customs Procedures on Electronic Commerce

78. To assess the impact of VAT and Customs procedures it is necessary in the first instance to categorise transactions into on-line supplies and off-line supplies. Secondly, it is important to consider whether transactions are defined as supplies of goods or supplies of services (particularly in respect of products such as CDs, videos, and computer software where previous consignments of goods will be able to be transferred in a digitalised form). Finally, the issue concerning mixed supplies of telecommunications/internet services which are difficult to disentangle as between the carrier and the content has to be addressed.

79. Off-line activities involving international mail order transactions of goods will, in principle, continue to be dealt with by the Customs authorities at the point of importation with regard to the collection of both Customs duties and VAT as appropriate. The major difference will be the anticipated increase in the volumes of such transactions if this area of electronic commerce is to be allowed to fulfil its full potential, with the resulting demand placed on Customs authorities. Similarily, the majority of off-line services supplied via the Internet present no new problems to VAT authorities, but the anticipated volumes raise a large question mark over the ability of the VAT authorities to be able to exercise any effective control with their shrinking resources. Solutions for simplified or streamlined procedures will have to be found which nevertheless do not pose a significant threat to revenue and other cross-frontier controls. It is also important to note that there are no customs duties on such services.

80. Supplies of on-line activities in the form of digitalised information are a serious challenge to the current place of supply rules for most VAT/GST systems, as explained in the foregoing paragraphs (Section (ii), paragraphs 64-74), creating a real possibility of either double or no taxation. If treated as supplies of services, then hitherto the place of supply is deemed to be where the supplier is established or has a fixed place of establishment from where the services are supplied (usually in the form of equipment or human resources). But new technologies and deregulation means that many of these types of supplies can be made without the supplier having any form of physical presence. This situation has recently been highlighted in the EU where measures have been introduced to change the place of supply rule for certain telecommunications services of the so-called “call back” variety made by non-EU suppliers (see also paragraph 74).

(f) Customs: Mail order goods

81. In September 1997 the OECD Committee on Consumer Policy in close co-operation with the Committee for Fiscal Affairs and the World Customs Organisation (WCO) organised a roundtable to examine the possibilities of developing simplified customs procedures to facilitate international movements of mail order goods in an effort to reduce costs and create time-saving benefits. The meeting brought together customs officials, public and private carriers, distance sellers and consumer advocates.

82. The participants at the meeting agreed that, whilst taking due account of the need to continue to combat the illicit importation of prohibitive and restrictive goods (e.g. dangerous drugs), there is a genuine desire by all to streamline Customs procedures in a common effort towards achieving the full potential of a global market place for consumers.

83. The general consensus of the meeting was that the ongoing review of the Kyoto Convention (International Convention on Simplification and Harmonisation of Customs Procedures) by the WCO presented an ideal opportunity and the appropriate instrument to accommodate implementation of the

required procedures identified in the conclusions at an international level. The review of the Kyoto Convention is due to be presented to the WCO Council in June 1999. The OECD Secretariat will continue to work closely with the WCO throughout the period of the review.

(g) Proposals for a Duty Free Zone

84. The United States *Framework for Global Electronic Commerce* states that "The Internet [should] be declared a tariff-free environment whenever it is used to deliver products or services". In this context it is necessary to distinguish between goods which are ordered over the Internet and delivered to a household or business by traditional means (like a mail order transaction) and "goods" or services which are actually delivered to the consumer electronically.

85. The United States believes that the concept of the Internet as a duty-free zone should be limited to goods or services delivered electronically. Therefore, if a customer downloads computer software from the Internet or obtains professional services over the Internet, the transaction should be free from customs duties. This is consistent with current law. For example, in the case of computer software tariffs are only imposed on the value of the media (e.g. the computer disk or tape) and not the value of the software itself. If the media is eliminated through an electronic transaction, then there is no longer a transaction to which tariffs should be applied. However, when physical goods are ordered over the Internet and delivered through conventional means, such as a mail-order sale of clothing, then the transaction should be subject to any generally applicable duties, as if the goods had been ordered through the telephone or by mail. There is nothing in the US proposals which are intended to limit the application of VAT/GST as appropriate by any national tax administration in respect of importations of all relevant goods and services.

D. Income Taxation: The Challenges to Existing International Taxation Arrangements

86. This section begins with a brief review of the existing international taxation arrangements, then examines the role of tax treaties and concludes with a review of the challenges posed by the Internet to the concepts of permanent establishment and related issues.

(a) The current International Tax Consensus

87. Any country's income tax system must specify to whom (individuals, corporations and other entities) the tax applies and, for those it does apply to, what income is subject to tax. The two basic concepts used to answer this question in an international context are residence and source. Apart from matters of general tax policy that are taken up below, there are good administrative reasons for adopting these twin standards. Under rules of private international law as applied in most countries, no assistance is given to enforce the tax claims of another country. Hence a country will be most successful in the collection of revenue in the international context if it focuses its enforcement activities on persons or economic transactions connected with the country. As a matter of principle, the country of residence is best thought of as the place with which a taxpayer has the closest personal links. The country of source is the country with which income has its closest economic connection.

88. As the importance of the international dimension of income taxation has grown, an international consensus has emerged about the structure of the international income tax rules (partly reflected in and partly created by tax treaties). The income tax is typically levied by a country on (1) the domestic and foreign (world-wide) income of its residents (on at least some categories of income) and (2) on the

domestic source income of non-residents. These are referred to respectively as the residence and source principles of taxation.

89. Where a resident of one country earns income from a source in another country, the potential for double taxation arises because one country may tax that income on the source principle and the other country on the residence principle. In this case the internationally accepted regime varies depending on the nature of the income. Where the source country is given the right to tax, this right takes precedence over that of the residence country which is responsible for relieving any double taxation that results. Such relief is generally achieved by one of two systems, the exemption system whereby the foreign income is exempted from tax in the residence country (often subject to conditions such as tax being levied in the country of source) and the foreign tax credit system whereby the tax of the residence country on the foreign income is reduced by the source country tax on the income. Most countries employ some combination of the two systems.

(b) Tax Treaties

90. Typically tax treaties are bilateral and cover income and capital taxes, though there are some examples of multilateral tax treaties and treaties concerning other taxes such as estate and gift taxes. There are well in excess of 1,500 tax treaties and the number is growing rapidly. The discussion here is confined to bilateral tax treaties in relation to taxes on income and capital which are largely based on the OECD Model Tax Convention on Income and Capital, with a number of countries following variants found in the UN Model Double Taxation Convention between Developed and Developing Countries.

91. The purpose of bilateral tax treaties is typically expressed in their preamble to be “the avoidance of double taxation and the prevention of fiscal evasion”. As most countries nowadays have within their domestic law provisions to prevent double taxation of their residents in the most common cases (where another country taxes the same income on a source basis), the main operation of tax treaties in this respect is for other types of double taxation. The prevention of tax evasion primarily refers to cases where taxpayers fraudulently conceal income in an international setting and rely on the inability of tax administrations to obtain information about income from foreign sources. The exchange of information article in tax treaties is the major provision dealing with this problem. In a general sense these two purposes summarise the domain of international taxation: substantive rules designed to allocate taxing rights and administrative rules designed to give effect to the single taxation objective, the two objectives which are closely linked.

92. There are a number of other purposes of tax treaties that are usually unstated, but in many cases are equally important. First, there is the division of tax revenues to be derived from income involving the two countries which are parties to the treaty. Where flows of income from business, investment etc. are balanced between two countries, it often does not make a large difference to the direction of revenue collections if each country agrees to significantly curtail its source jurisdiction to tax on a reciprocal basis as its residence taxation of income sourced in the other country is correspondingly increased. Curtailing of source jurisdiction rather than residence jurisdiction in this context makes sense because of the distorting effects of gross basis taxes at source (e.g. withholding taxes) and the greater ease of enforcing net taxation by assessment in residence countries. This process must also take into account each country’s role in creating the underlying income. Typically larger developed countries will be in this position as a group even if there are some disparities in flows as regards specific countries in the group. Second, there is an agreed basis for determining whether the income returned or expenses claimed on related party dealings by taxpayers forming part of an multinational group operating in the two countries which are parties to the treaty can be regarded as acceptable.

(c) Electronic commerce and the permanent establishment concept

93. In assigning taxing rights over business operations, the OECD Model Tax Convention's concept of permanent establishment is used to determine whether the enterprise has brought itself within any particular taxing jurisdiction. Under Article 7 of the OECD Model Treaty, a country may tax an enterprise's business profits attributable to a permanent establishment located in that country, regardless of the enterprise's country of residence for tax purposes.

94. Article 5 of the OECD Model Tax Convention gives a definition of the concept of a 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 provide rules according to which an agent may constitute a permanent establishment of the enterprise for which he is acting.

95. While there are many cases in which the application of these rules is difficult and contentious, the application of the concept of permanent establishment in the context of electronic commerce raises a number of new and difficult questions.

96. The first question is whether the general conditions for the existence of a permanent establishment found in paragraph 1 of Article 5 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 source country. This requires a determination of whether such a site constitutes a "place of business", whether the server can then be said to be "fixed" and whether the undertaking of periodical automated business functions (such as advertising, ordering, or payment) may be said to constitute the carrying on of a business through such a fixed place of business.

97. The determination of whether the site constitutes a "fixed place of business" must take account of various possible scenarios. For instance, a server may be located in a building situated in a country where the enterprise has no other presence. Alternatively, it could be located on a portable computer used in different places within that building or moved from city to city by an itinerant employee. Further difficulties would arise where a number of mirror web sites on different servers located in different countries would be used so that a customer could be directed to any site for any function depending on electronic traffic. Another possibility would be to have only one web site which is electronically transferred in total every three months to a new server in a different building, city or country. The ownership of the web contents and of the server would also be relevant: for instance, the enterprise could own the web site but lease the server from a service provider, lease both the web site and server from the service provider or lease the web site and server and share various functions with the service provider.

98. 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. This question has to be addressed with respect to the various functions that can be automated, such as advertising, ordering, payment, storage and digital delivery as well as with respect to various combinations of these functions. It also requires a determination of the extent to which a database of digital contents may be said to constitute a stock of goods and, if that is the case, whether the database may be said to be maintained solely for the purposes of storage, display or delivery if it also has a search

and reporting facility (e.g., if a customer can select the contents of the database merely for viewing). Particular issues arise in respect of the exception, included in sub-paragraph 4(d), concerning the collection of information as it is not clear at what point mere collection of information substantially becomes processing of raw information collected, which may render the exception inapplicable.

99. If the functions performed through a given web site and server were such that it did not constitute a permanent establishment, there would also 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.

100. Other questions arise with respect to the relationship between an enterprise that owns a web site and a 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.

101. A further complication is anticipated once the hurdle of bandwith limitations is surmounted given the expected progress of cable and satellite technology. Once these limitations are overcome, it will be possible to locate most, if not all, of the functions of an Internet business in any country, either the country of residence or a low tax jurisdiction. This will pose a challenge to domestic tax laws which often rely on concepts similar to that of the permanent establishment in order to determine whether business profits of non-residents are taxable. In that case, the use of tax havens as locations for web sites and servers may have implications for domestic rules (e.g. residence, source of income and controlled foreign corporation legislation).

102. If it is determined that an enterprise carrying on electronic commerce operations has a permanent establishment in a given country, it is necessary to determine the income attributable to that permanent establishment. Particular difficulties could arise in these cases because there are no branches in the traditional sense and therefore branch account operations between the branch and the head office which could be used as the starting point for the determination of the income attributable to such a permanent establishment. In addition, it might be difficult to determine the functions and transactions that should be attributed to the operations of the permanent establishment (e.g. the use of server arrays, i.e. linked servers located across many jurisdictions that switch signals from one server to the other depending on traffic volumes, would provide practical difficulties with identifying which servers are used at any particular time and for which activities). These issues should be considered by the transfer pricing Steering Group of the Working Party No. 6 in connection with its study of transfer pricing issues arising from electronic commerce.

103. This development is an occasion to step back and evaluate the rules of Articles 5 and 7 (on the definition of, and allocation of income to, permanent establishments) and consider whether they are appropriate for purposes of taxing electronic commerce or whether refinements or changes may be in order. Electronic commerce constitutes an environment where automated functions, by their very nature, can undertake a significant amount of business activity in a source jurisdiction with little or no physical activity in that jurisdiction. These are questions that the Working Group on Permanent Establishment is exploring. In the context of its work, the Working Group intends to examine:

(i) whether there is need for changes to the tax treaty rules for the taxation of business profits and, if so, the pros and cons of any such changes, particularly in relation to compliance issues;

(ii) whether approaches used for other taxes, such as VAT, provide any assistance; and

(iii) what are the potential implications of electronic commerce for domestic tax rules (e.g. residence, source of income, and controlled foreign corporation legislation).

(d) Digitised Information: Characterisation of Income

104. The ability to digitise data and sell digitised data over the Internet presents issues under the income characterisation rules of tax treaties. Any type of information that can be digitised, such as computer programs, books, music, or images, can be transferred electronically. For example, a person in State B could connect with a computer in State A and download a computer program or digitised image in exchange for a fee. The purchaser's rights in the information transferred could vary depending on the contract between the parties. For example, the purchaser of a digitised image could obtain the right to use a single copy of the image, the right to reproduce ten copies of the image for use in a corporate report, the right to reproduce the image for use in an academic work that is expected to have a limited press run, or the right to reproduce the image in a mass-circulation magazine. It may be argued, some of these transactions are equivalent to the purchase of a physical copy of the photograph, which would result in business profits, while other of these transactions would result in royalty income, which would be taxable in the source country. Consequently, existing income characterisation principles may require modification in light of the ease of perfectly reproducing and disseminating digitised information.

105. Article 12, paragraph 2 of the Model Convention defines "royalties" as "payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films...." It is not always clear how this definition applies to the sale of digitised information. On the one hand it may be arguable that some of these transactions, such as the electronic purchase of a digital book, are merely substitutes for conventional transactions involving physical objects and that it would be inappropriate to treat them as creating royalty income. On the other hand, it is arguable that the transactions could involve considerable differences in substance, 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 copy of the book will be able to alter its format, manipulate the date, etc. Whether, and to what extent, the definition of royalties needs to be adapted needs further consideration.

106. Digitised information also poses problems for the definition of services income, as distinguished from sales of goods income or royalties: problems similar to those described above under the section on VAT. Previously a reference work, such as an encyclopedia, would have been sold as a set of bound volumes and the sale of the bound volumes would have resulted in sale of goods income, notwithstanding

the fact that the cost of printing and binding represented only a small fraction of the encyclopedia's value. Now, instead of purchasing a bound volume, a potential purchaser might be able to choose between a set of CD-ROMs and a computer on-line service through which the encyclopedia's content can be accessed. If the customer has a sufficiently fast modem connection, there may be little practical difference between accessing the on-line service and the CD-ROMs on the customer's personal computer. Yet the sale of the CD-ROMs still results in sale of goods income while the character of the income arising from the on-line service is not clear. It may be necessary to reconsider existing principles in this area in relation to income, and sales and consumption taxes.

107. The ability of taxpayers to electronically sell digitised information and services may have an effect on existing regimes that seek to limit the use of tax deferral through foreign corporations. Many countries have regimes whereby income earned by controlled foreign corporations may be currently taxed to the corporation's shareholders[1]. If controlled foreign corporations can engage in extensive commerce in information and services through Web sites or computer network located in a tax-haven, it may become increasingly difficult for tax administrators to enforce these anti-deferral regimes. It may also be necessary to broaden the scope of the income subject to these regimes.

108. Given the unique characteristics of digitised information and the difficulties of characterisation that could arise in this context, the Committee is examining how to further clarify the definition of royalties in the Model Convention.

(e) Residency

109. Communications technology has the potential to affect residence tests for countries that rely on the location of management functions. This is relevant for the operation of the "place of effective management" tie-breaker test contained in the OECD Model Tax Convention and many double tax agreements, and many domestic residence tests such as "seat of management", "place of management", or "central management and control".

110. The CFA is currently considering an amendment to the definition of "royalty" in the Commentary to the OECD Model Tax Convention that would take into account the unique characteristics of computer software and digitised information. This new analysis recognises that software can be distributed either on a physical media, such as a diskette or CD-Rom or by electronic transfer, such as downloading the software from the Internet. This analysis also takes into account the ease of perfectly reproducing computer software and the fact that the acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.

111. Under this proposed analysis, the character of payments as either business profits or royalties would depend on the nature and extent of rights that the transferee acquires under the arrangement regarding the use and exploitation of the program. Copyright law principles would be used to determine the extent of the rights transferred. Copyright law generally distinguishes between rights in the underlying copyright and rights in a copy of the computer program, whether or not such copy is embodied in a material medium or provided electronically. Payments made for the acquisition of partial rights in the copyright will generally represent a royalty. Such arrangements will include licenses to reproduce and distribute the copyrighted program to the public.

---

1. See Controlled Foreign Company Legislation OECD 1996.

112. In other types of transactions, the transferee only acquires the rights necessary to operate the program and essentially only acquires rights equivalent to those in a program copy, even though the transaction may be considered a license for copyright law purposes. Although the transferee generally acquires the right to copy the program onto a computer hard drive or make an archival copy of the program, these rights are essential to the utilisation fo the program. Therefore, it has been proposed that rights in relation to these acts of copying, where they do no more than enable the effective operation of the program, should be disregarded in analysing the character of the transaction for tax purposes. Payments for these types of transactions would be dealt with as business profits. In addition, "site licenses", arrangements in which the transferee obtains rights to make multiple copies of the program only for use within its own businesses, will also generally be considered to be business profits.

113. The CFA also intends to study whether the principles used to characterise computer software transactions can be extended to all other types of digitised information. Software is simply one form of digitised information and there may not be any relevant distinction between transactions concerning computer software and those concerning digitised text, images, music or motion pictures.

114. The development of videoconferencing facilities and the relaxing in many countries of corporations law requirements for board meetings already facilitates board meeting being undertaken simultaneously in more than one jurisdiction. The Internet may soon be able to allow simultaneous (and relatively inexpensive) audio, video, and online communications between a number of users. This may make it easier, for example, for a company's place of effective management either existing in more than one location or not capable of being pinpointed to a specific location.

115. As well as presenting difficulties with determining the legal status of a company, there would be compliance and enforcement problems. For example, the Internet could allow a company operating offshore to be significantly managed from onshore without the tax authorities being able to establish an evidentiary connection to determine the company as being a resident.

116. The ability of residents to establish offshore non-resident companies, when combined with the highly mobile nature of electronic commerce, could lead to a tax driven migration of businesses to the Internet and Internet businesses (web sites and individuals providing services) to low tax jurisdictions. This will place even greater importance on the role of controlled foreign corporations measures and their current effectiveness in addressing Internet operations.

117. Even if residence rules and controlled foreign corporation measures prove to be capable of applying adequately to electronic commerce, potential for complete anonymity for Internet users could facilitate widespread offshore activity which derives low or no taxed income that cannot be traced back to users. This would be of particular concern given the ease with which individuals and small businesses will be able to access arrangements previously the domain of multinational enterprise. Of even greater concern is the potential for possible complete anonymity for Internet users to facilitate widespread domestic activity that would result in taxable income that cannot be traced back to users.

118. Further consideration needs to be given to the extent to which the migration of Internet businesses to tax havens will be a concern, and if any measures will need to be taken to address any such concerns.

(f) Source rules

119. The Internet is expected to pose challenges to the operation of the domestic source rules of all member countries. The ability of members to apply domestic source rules to Internet businesses could become crucial if most Internet businesses eventually migrate to low tax jurisdictions, which are generally expected to fall outside tax treaty networks. Potential jurisdictional and enforcement issues for source rules will be common to all OECD members and are likely to benefit from a co-ordinated approach. Further work needs to be undertaken in this area.

(g) Global collaboration

120. The Internet is expected to facilitate global collaboration, for example global trading whereby businesses can operate around the world around the clock[2]. Global collaboration could also apply to manufacturing and services activities. This raises significant issues for the allocation of income and expenses. Further work needs to be undertaken in this area.

E. The challenge to Transfer Pricing

121. To date the communications revolution presents neither fundamentally new nor categorically different problems for transfer pricing. However, the emergence and growth of electronic commerce has the potential to make some of the more difficult transfer pricing problems more common. As a result of the nearly instantaneous transmission of information and the effective removal of physical boundaries, it may become more difficult for tax administrations to identify, trace, and quantify cross-border transactions.

122. More specifically, electronic commerce and the development of internal private networks within MNEs (Intranets) may be seen as putting 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 transfer pricing methods to the special factual circumstances created by electronic commerce activities.

(a) Traditional transfer pricing rules may be inadequate

123. The traditional transfer pricing approach has two fundamental characteristics elaborated by the OECD’s 1995 consensus on transfer pricing: to require a transactional approach and to establish comparability (taking into account functions performed, assets used and risks assumed) between the controlled and the uncontrolled transactions.

124. The speed, frequency, anonymity and integration of exchanges over the Internet and the development of intranets within MNEs may well make it harder to apply a separate transaction analysis. The greater integration of business activities may mean there is a greater need to consider sets of related party transactions rather than to consider each transaction separately.

---

2. The issue of Global Trading in Financial Products has recently been extensively analysed in a discussion draft issued by the Committee on Fiscal Affairs, see The Taxation and Global Trading of Financial Instruments OECD February 1997.

125. The aggregation rules in Chapter I of the 1995 OECD Transfer Pricing Guidelines ('the Guidelines') permit aggregation of controlled transactions where the transactions are "so closely linked or continuous that they cannot be evaluated adequately on a separate basis." Such continuity, as well as close linkage among transactions, is already common in the area of innovative financial transactions, e.g. global trading. In the context of electronic commerce, it seems arguable that a case could often be made for the aggregation of controlled transactions, particularly in relation to highly integrated businesses. There is also a related question to consider of which transactions should be aggregated.

126. Establishing comparability is also central to the application of the arm's length principle. It is the link between the arm's length principle and the operation of arm's length transfer pricing methodologies. The objective of comparability analysis is always to seek the highest practicable degree of comparability, recognising that there will be unique situations (which could be a result of business complexity) and cases involving valuable intangibles where traditional methods cannot reliably be applied alone or exceptionally cannot be applied at all. The standard of comparability that is practicable will be determined by the availability and extent of reliable data on which to make comparisons with uncontrolled situations and dealings for the particular case.

127. The availability or absence of reliable data affecting comparability influences the selection of the most appropriate transfer pricing methodology. As indicated in the Guidelines, the various methods use data in different ways and use different criteria for assessing the comparability of transactions. So, in some situations it may be possible to apply one of the transfer pricing methodologies in circumstances where the data are not complete or reliable enough to apply another method that conceptually would provide a more direct or reliable reflection of comparability.

(b) Evaluating contributions is difficult in integrated businesses

128. Through the information-sharing system and co-operative-work system of the Internet and intranets, it is possible for many of the corporations within an MNE group to act more like a division or segment of a single corporation. That is, private communications systems may help each corporation become even more specialised in its area of expertise without having to carry out other functions necessary for its maintenance as an independent corporation. This in turn would promote the streamlining of similar functions performed by related corporations, and more specifically, the co-operative-work systems of an intranet can organically link specialised and professional service functions (e.g., design, engineering, research and development) of each of the corporations in an MNE. Under such a system, the MNE would be much more integrated in its functions than it would otherwise.

129. These ways of sharing workloads among related corporations in the form of collaborative projects can make it difficult to evaluate the contribution of each related corporation to the overall project. They also raise the issue of how to allocate any synergistic benefits amongst the participants in any such project. Problems may also emerge of how to properly reward the functions of gathering, updating and delivering common information as well as providing the computer servers and infrastructure.

(c) Differing tax treatment for permanent establishments and subsidiaries can arise

130. Where a permanent establishment is found to exist, the amount of income attributed to the permanent establishment is normally determined under rules corresponding to those governing transfer pricing between related companies. Article 9 of the OECD Model Treaty, applicable to associated enterprises, requires the application of the arm's length principle to determine transfer pricing. Article 7 of

the OECD Model Treaty, addressing the allocation of business profits to a permanent establishment, endeavours to follow the same principle (see Commentary on Article 7, paragraph 11) although exceptions are made for intragroup remittances under the name of interest or royalties (see Commentary on Article 7, paragraphs 18 and 17.4 respectively). In some special cases, i.e. where customary in a country, the permanent establishment's profits can be determined on the basis of apportionment, but even then the result must accord with the arm's length principle.

131. The tax treatment of permanent establishments, where they can be identified in the context of electronic commerce, may be different from that of subsidiaries carrying on similar activities. This raises the issue as to whether it is appropriate to treat permanent establishments and subsidiaries differently for tax purposes if they are undertaking economically similar activities. Such an issue often arises in the context of global trading of financial instruments, as such trading can be carried on by a particular MNE group entirely through branches, entirely through subsidiaries or in a mixture of both forms.

(d) Other issues

132. With the development of communication technologies, MNEs can more readily use intangibles (such as production technologies and marketing databases) which may have had only limited uses in the past due to the distance between a potential user and the location of the intangible. New intangibles may be developed to specially fit the Internet market place and there will be a further blurring of the distinction between transactions involving intangibles and those involving tangibles or services. Accordingly, in the future, tax administrations will have to evaluate the effects of intangibles more often (as well as their effect on the characterisation of payments - see Part D(e)). But it is often difficult to quantify the effect that intangibles have, especially where more than one type of intangible is involved.

(e) Preliminary conclusions

133. Although the transfer pricing problems raised so far are not unique to electronic commerce, the increased speed and mobility of business activities and cross-border transactions may raise further difficulties in the application of transfer pricing methods. As a result of the nearly instantaneous transmission of information and the effective removal of physical boundaries, it may become more difficult for tax administrations to identify, trace, and quantify cross-border transactions. The rapidly changing factual circumstances of electronic commerce may also put pressure on traditional ways of auditing transfer pricing issues because of the delay between the time a transaction is undertaken and the time it is examined for audit purposes.

134. Some of the issues that arise in the context of global trading of financial instruments may provide examples of the challenges that are likely to be presented to traditional approaches for resolving transfer pricing issues by electronic commerce. Suggestions made in the OECD Discussion Draft "The Taxation of Global Trading of Financial Instruments" in relation to the determination of profits and the application of the profit split method may have wider application to transfer pricing issues in the context of electronic commerce.

135. At this point in time it is difficult to solve specific transfer pricing issues without a close examination and factual description of the elements of electronic commerce that may give rise to new or particularly difficult transfer pricing issues. It may be difficult to perform such a detailed examination of the factual background at such an early stage in the development of the business of electronic commerce.

However there may also be dangers in waiting too long, given the rapid growth in certain aspects of electronic commerce and the potential implications for preservation of existing tax bases.

IV. THE RESPONSE OF GOVERNMENTS

136. The response of governments to the developments described in this paper has been one of caution. No government to-date has issued new laws or regulations or instructions on how to apply existing concepts to activities carried out on the Internet. The position of governments has generally been one of "lets learn more about how the net functions" and lets discuss the issues in such international fora as the OECD before taking any action. More than twelve OECD countries now have Commissions, Committees or Ad hoc Groups looking at the tax implications of the Net. The US and Australia have issued discussion papers. The CFA has initiated a series of study projects The International Fiscal Association has launched an international research project.

137. This cautious approach may dismay the private sector which is looking for greater certainty in this area, but the Committee feels that this is the right approach at the moment. Because of the global nature of the Internet, and the rapid pace of technological change, it is essential that globally accepted principles of taxation are agreed upon on how to tax the transactions and income from activities carried out over the Internet. Such an agreement will only be reached once tax policymakers and administrators have: (1) come to a common understanding of how the net functions; (2) agreed upon which existing tax arrangements need to be reviewed; (3) agreed upon the process by which any of existing arrangements will be changed and (4) agreed upon the nature of these changes. Throughout this process the dialogue must include all parts of the government and those parts of the private sector which have an interest in the Internet and electronic commerce. Only then will a stable tax environment be achieved which will enable the Internet to develop its full potential but at the same time protect the revenue base. The work being carried out by the CFA is intended to provide such a stable environment and to encourage a closer cooperation between tax authorities and other agencies in government.

(a) Criteria by which to evaluate any reform proposals

138. In setting out proposals on how to deal with the issues discussed in this Report, the Committee found it useful to identify a number of criteria that governments can use in their search for the appropriate ways to tax activities on the Internet and global electronic commerce:

(i) The system should be equitable. Taxpayers in similar situations which carry out similar transactions should be taxed in the same way;

(ii) The system should be simple. Administrative costs for the tax authorities and compliance costs for taxpayers should be minimised as far as possible;

(iii) The rules should provide certainty for the taxpayer so that he or she knows in advance of a transaction what will be the tax consequences. Taxpayers should know what is to be taxed and when and where the tax is to be accounted for;

(iv) Any system adopted should be effective. It should produce the right amount of tax at the right time. The potential for evasion and avoidance should be minimised;

(v) Economic distortions should be avoided. Corporate decision-makers should be motivated by commercial rather than tax considerations. This applies to both domestic and international transactions;

(vi) The systems need to be sufficiently flexible and dynamic to ensure that the tax rules keep pace with technological and commercial developments;

(vii) Any tax arrangements adopted domestically and any changes to existing international taxation principles should be structured to ensure a fair sharing of the Internet tax base between countries; and

(viii) Initially the focus should be on adapting existing tax arrangements to the Internet rather than examining the introduction of new forms of taxation.

139. The CFA recognises that these criteria will conflict. A simple system may not be equitable and may not be sufficiently robust to be effective in protecting the revenue base. All involve an element of judgement. Views on what is a fair distribution of the revenue base, for example. Governments and businesses are likely to take different views on what the trade-offs should be where conflicts do arise. But most would agree on the criteria listed above. The Committee emphasises, in particular, that maintaining an <u>international consensus</u> is the key to enable the internet to develop to its full capacity and at the same time enabling tax authorities to protect their revenue base. This consensus could, in practice, be more important than decisions on the actual rules.

(b) Options being examined by the Committee on Fiscal Affairs

140. Whilst it is too early to put forward solutions to many of the issues identified in this Report, the work carried out by the CFA's subsidiary bodies has identified a number of options that governments can consider, individually and collectively. The following paragraphs set these options. The CFA looks forward to having a lively discussion of these proposals with the business community.

(i) Dealing with the consequences for VAT

141. As with other taxes, audit trail difficulties and related control issues pose a serious threat to compliance for VAT administrations; and developing effective and efficient mutual assistance arrangements through a programme of international co-operation will be an essential element to combat tax avoidance and evasion. Work is in hand to introduce a system of international co-operation between OECD Member countries in the field of indirect taxes.

142. An informal working group on Electronic Commerce set up to investigate the implications for consumption taxes has identified one of the main conceptual problems to be the application of the current place of supply rules to certain on-line supplies of digitalised information and the disappearing difference between goods and services as a consequence of on-line supplies. Linked to this is the implementation of a suitable tax mechanism to complement any changes to the place of supply rules.

143. In putting forward proposals it is important to learn any lessons from the action taken by the EU Member countries concerning the closely related problems involving the so-called "call back"

telecommunications services. As with these types of supplies the highest area of revenue risk would appear to be supplies of on-line material to private consumers or other customers who do not have full entitlement to input tax credits for VAT.

144. The Special Sessions on Consumption Taxes is currently examining these issues in close co-operation with the European Commission and the informal working group will where necessary submit proposals for changes to the place of supply rules to avoid the possibility of distortion of competition caused by double or non taxation (whilst recognising the relevant legislative situation currently in place throughout the OECD countries). Such proposals will seek consistency and uniformity in the place of supply rules and related definitions of services, consider the use of appropriate tax mechanisms, address the problem of audit trail difficulties and look at ways to develop improved mutual assistance arrangements.

(ii) Dealing with the consequences for tax treaties

145. First results of this work are expected in 1998. A Working Group of WP1 on Tax Treaties is currently examining the permanent establishment issues attached to the Internet and Electronic Commerce. The Group is working at two levels. First to see how the existing concepts used in the OECD Model can be applied to these new ways of doing business. Secondly, to examine the longer-run implications of these developments for the Permanent Establishment concept and the concept of Royalties. A report on the first part of the work is expected early in 1998.

(iii) Dealing with the consequences for transfer pricing

146. The Electronic Commerce Working Group of WP6 has identified a number of areas in which additional work could be undertaken. The most significant of these being:

(i) the difficulty in applying the transactional approach;

(ii) the difficulty in establishing comparability;

(iii) the difficulty in applying traditional transaction methods; and

(iv) the taxation treatment of integrated business.

147. The Working Group noted that the basic issues of income attribution and allocation of expenses that arise in relation to permanent establishments and global trading are about to be discussed by the Steering Group of WP6 in the course of the review of the OECD Transfer Pricing Guidelines. While too early to predict the results of that work, the Steering Group could be asked to consider examples of electronic commerce identified by the Working Group in the course of its deliberations.

148. The Committee’s work in this area will continue by attempting to describe factual examples, carefully distinguishing between relatively clear-cut cases and more complex cases. As part of the monitoring process for the OECD Transfer Pricing Guidelines, the Working Party could invite descriptions of situations that raise new or difficult transfer pricing issues for which the existing guidance in the Guidelines may be inadequate, so that it can take account of such developments in its ongoing work programme.

(iv) Dealing with the compliance issues

149. A special group is examining the threats and opportunities electronic commerce may have on tax compliance (basic compliance issues as well as avoidance/evasion issues). The work is focusing on:

(i) the review of the steps businesses and monetary authorities are taking to minimise the risks of fraud they face and an analysis of how far these can be adapted to meet tax administration's needs (e.g. concerning security, encryption, e-money, registration of domain names);

(ii) the identification of additional requirements to ensure compliance with tax laws where the tools being developed for business purposes do not meet, or conflict, with the needs of tax administrators;

(iii) the design of Internet business models to help develop understanding the risks challenges that tax administrations face from electronic commerce, and how far these can be mitigated through domestic and/or internationally co-ordinated responses;

(iv) developing a set of best practices which harness the opportunities presented by new technologies to improve customer service and administrative practice;

(v) examining the implications of electronic payment systems within the mandate of WP8; and

(vi) developing a menu of practical approaches to support effective tax administration in relation to cyberspace for discussion within the OECD and appropriate elements of the public and private sector.

ANNEX

I. Work of the Committee on Fiscal Affairs on the Tax Policy and Administrative Implications of the Communication Revolution.

In June 1996, the Committee on Fiscal Affairs (CFA) considered a note on the implications of the Communications Revolution for tax policy and tax administration and decided to intensify its work in this area by inviting its subsidiary bodies to examine the impact of the communications revolution in their respective areas of competence.

Four separate sub groups have been formed respectively by Working party N°1 on Double Taxation , Working party N°6 on Taxation of MNEs, Working Party N°8 on Tax Avoidance and Evasion and the Special Session on Consumption Taxes which are working closely together and benefiting from other work carried out in other parts of the OECD on the Communications Revolution (see Figure IV). This work in the tax area is carried out in a co-ordinated manner in close contact with the business and tax community.

Figure II

The Committee on Fiscal Affairs and its Working Parties