

## IMPLEMENTATION ISSUES FOR TAXATION OF ELECTRONIC COMMERCE

### Background

1. The OECD's "Taxation and Electronic Commerce—Implementing the Ottawa Taxation Framework Conditions," (the "2001 Report") defined the application of the *Guidelines on the Definition of the Place of Consumption* (the Guidelines) as follows:

*In the context of value-added or other general consumption tax systems, these Guidelines are intended to define the place of consumption (and so the place of taxation) for the international cross-border supply of services and intangible property by non-resident vendors/suppliers that are not otherwise registered and are not required to register in the destination jurisdiction under existing mechanisms.*

*These Guidelines apply to the cross-border supply of services and intangible property, particularly in the context of international cross-border electronic commerce that are capable of delivery from a remote location.*

*The Guidelines do not, therefore, apply to services which are not capable of direct delivery from a remote location (for example, hotel accommodation, transportation or vehicle rental). Nor are they applicable in circumstances where the place of consumption may be readily ascertained, as is the case where a service is performed in the physical presence of both the service provider and the customer (for example, hairdressing), or when the place of consumption can more appropriately be determined by reference to a particular criterion (for example, services related to particular immovable property or goods). Finally, it is recognized that specific types of services, for example, some telecommunications services, may require more specific approaches to determine their place of consumption.*

2. The Consumption Tax TAG ("CT TAG") established Project Team D ("Team D") in 2001 to consider implementation issues raised by the Guidelines not yet addressed by other Project Teams in the TAG. In particular it addressed the issues described by Project Team A regarding challenges businesses face in developing their systems to account for multiple country consumption taxes. The purpose of the Project Team was to identify practical issues, and suggest holistic, rather than fragmented, approaches for resolving them.

### Issues

3. Continually developing technologies are causing governments and suppliers to face many challenges in the collection of consumption taxes with respect to:

- 1) Determining the jurisdiction in which tax should apply;

- 2) Verifying the place of consumption;
- 3) Determining the correct tax treatment of bundled products, bad debts, and tax credits;
- 4) Retaining data; and
- 5) Complying with audit requirements.

4. While the evolution of electronic commerce raises issues in the application of traditional consumption tax rules in each of these areas, all of these issues are compounded by the potential for different implementing legislation in individual countries. In some instances, the potential for multiple laws addressing identical issues in different ways may be as challenging as finding any single way to address the underlying issue. In addition to creating high compliance costs for governments and suppliers, the implementation of inconsistent laws and definitions could result in double taxation or unintentional non-taxation of e-commerce transactions.

5. Some of these challenges may arise as a result of the blurring of the distinctions between traditional commerce and commerce involving digitized products. The crux of the problem is that the Internet and new communication technologies have introduced a new channel through which sales may occur. It is a matter of debate, however, as to whether these new channels create new products. Some believe that delivery through these channels alters the character of a product to such a degree that it must be considered a wholly new product, distinguishable from that delivered through traditional channels, and therefore treated as unique for tax purposes. Others believe that digitizing a product does not alter the purpose of the product and therefore the digitized version should be treated the same for tax purposes as that delivered in physical form. This issue is discussed further in paragraphs 37 and 38. It is clear, however, that, under the Ottawa Framework Conditions, taxation should be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation. Accordingly, it is important not to lose sight of the basic principle of neutrality. The reality is, however, that in some instances existing tax legislation is not consistent with this principle and there is an historic overhang that may warrant further review.

6. The information and communication technologies (ICTs) that underlie e-commerce as well as the trend to deregulation have greatly facilitated the growth of cross-border transactions in services and intangibles at a time when these represent a growing share of economic activity. Ultimately, the evolution of global markets will make it necessary to address these e-commerce issues in the broader context of the treatment of services and intangibles in the global economy.

### **Double (and Non) Taxation**

7. This section focuses on how and when inconsistent policies might result in double taxation or unintentional non-taxation. Possible approaches to achieving greater consistency and minimising, as far as possible, the incidence of double taxation and unintentional non-taxation are suggested.

8. There are two primary areas that create the potential for double or unintentional non-taxation:

- Conflicts Between Place of Taxation and the Ottawa Taxation Framework Conditions (Ottawa Framework)

- Bundling Issues

### ***Conflicts Between Place of Taxation and the Ottawa Framework***

9. A key principle outlined in the Ottawa Framework is that e-commerce should be taxed in the place of consumption. Until all countries apply this principle using consistent rules, different approaches to taxing international services give rise to the potential for double taxation or unintentional non-taxation. In the main, this problem should be resolved as countries adopt this principle from the Ottawa Framework, but even where taxation is to be in the place of consumption, other issues also need to be considered if the overall aim of avoiding double or non taxation is to be achieved.

10. In broad terms countries take one of two general approaches to determine the jurisdiction of taxation for international services and intangibles. For the purposes of this paper, we will refer to these as:

*the European approach and the New World approach. This is a simplification for the purposes of this section and does not purport to characterise tax systems in a divisive way, nor does the paper seek to exercise judgement on preferred approaches.*

11. Under the European approach, legislators have, in order to fix taxation in the country of consumption, traditionally defined services by their nature and determined the "place of supply" (*i.e.* the place of taxation) accordingly. This came about as most services were consumed where supplied so the basic rule ensured that tax was accountable in the country of the supplier. As the international trade in services has developed over the last 25 years a large number of exceptions to this basic rule were written in to European law such that today, for supplies to taxable persons, services are taxed either where performed or in the country of the customer. The continual growth in the range of services has highlighted the shortcomings and complexity of the existing system and has increased the pressure for change.

12. But the overall legal situation in the European Union today remains such that the basic, or fall back, rule for the place of supply (*i.e.* the place of taxation) of services is where the supplier is located. For any service to be taxed anywhere else it must be defined as an exception to this basic rule. Any European court asked to determine a place of supply would need to be convinced that the place of supply is other than the place where the supplier is located. As a result, under the European Approach, accurate definitions of the relevant supplies are essential if the intention is to tax e-commerce at the place of consumption. Otherwise, unless a particular international service is mentioned specifically, European courts will classify it as taxed where the supplier is established, regardless of how it would be considered by other jurisdictions.

13. From July 2003 e-commerce falls into this exception category in the European Union and it follows, therefore, that this approach essentially calls for carving out a separate tax category for e-commerce supplies. In theory, this might be a fairly straightforward exercise; legislators could add another tax category to cover electronically supplied services. However, in practice this is more difficult and made more so by the changing technology and new business models it facilitates.

14. The problem with carving out a separate category for electronically supplied services, or, indeed, services generally, is that it may lead to conflicts. If these services are not clearly defined and if all countries do not apply the same rules to determine the place of consumption then double or unintentional non-taxation becomes more likely. These difficulties will continue as definitions will inevitably become out of date and countries struggle to maintain any alignment of definitions.

15. The New World approach differs from the European approach in that it does not depend on a definition of the type of service as a step in determining the “place of supply”. As a result it is unnecessary to carve out a separate tax category for e-commerce supplies. Rather, the place of supply, export and import rules operate together to determine if consumption of a service is considered to have taken place within the taxing jurisdiction. These rules may be based on a pure consumption test or on a “proxy” for a pure consumption test (*i.e.* one that approximates where actual consumption occurs for the place of actual consumption.) There is no requirement to differentiate between electronic and traditional services as the rules apply to services in general, and therefore in the context of e-commerce, services delivered electronically and services delivered in a traditional manner are treated equally. Countries such as Canada, Australia, Japan, South Africa, and New Zealand have adopted this New World approach.

16. This approach to taxing services in the place of consumption, while more theoretically and structurally pure than the European approach, is not without potential problems. Proxies that are used to determine where consumption of a service occurs are not precise concepts and may be open to interpretation. The risk of double or unintentional non-taxation arises when these proxies or their interpretation differ materially between countries. While the New World approach more consistently achieves the principle of taxation in the place of consumption than the European model, consistency in its application between countries is required to minimise the potential for double or unintentional non-taxation. Accordingly a more detailed examination of the proxies used for place of consumption or supply with a view to providing guidance on the interpretation of common and general terms would be useful.

17. In the OECD’s 2001 Guidelines on the Place of Consumption, the customer’s “normal place of residency” is suggested as a proxy for “place of consumption” in business-to-consumer transactions. In the context of e-commerce transactions, this would provide certainty and simplicity. However, until countries apply that interpretation and where countries invoke an alternative proxy there is a risk that differing rules could lead to double or no taxation. Countries will need to be alert to this risk. The use of a customer’s normal place of residence as a proxy for the place of consumption does have practical problems and issues. There must be recognition that it may not be easy for businesses to readily confirm or verify the customer’s jurisdiction of residence. Further reference to this issue is provided through the report to Working Party 9 on Verification of Customer Status and Jurisdiction.

18. While widespread use of “normal place of residence” would be a significant step towards more certainty, it can still cause unintentional conflicts. By limiting the application of this recommendation to e-commerce transactions, virtually identical transactions can result in different tax treatment simply because the supply’s mode of delivery is different. For example, a supply by definition could be considered by one jurisdiction as an electronic supply taxable in the place where the customer resides, whereas the vendor’s jurisdiction may regard it as a traditional supply taxable in that jurisdiction.

19. The analysis undertaken by the Project Team to assess the potential for double or unintentional non-taxation highlighted the complexities facing both governments and business in determining the taxation of international services more generally. Transactions as diverse as financial services, auction, and advisory services were considered but it was clear that there were many variables. As well as the difficulties involved in determining the place of location other issues such as exemption, tax status of customer and definitions (of services and proxies) also impact on the tax decision process. The Team concludes from this that attempts to consider the taxation of electronic commerce in isolation from other features of international taxation (especially of services) run a risk of breaching the neutrality aspirations of the Ottawa Framework.

### *Bundling*

20. Bundling of products has been an issue for taxpayers and tax administrators for a long time. The problems have, traditionally, been caused through the tax base and the application of multiple tax rates. E-commerce will inevitably contribute to these problems through its ability to effect the combined delivery of individual products (any mix of goods, services or intangible property) that could be viewed as a number of separate individual supplies. For example, an academic book publisher may sell copies of a book to a university and, at the time of the sale, make available, through a password-protected environment, on-line access to an electronic version. The question arises as to what is being supplied: a physical book, an on-line service, or some other yet to be defined hybrid product.

21. Many countries have developed approaches to resolving these tax base issues, sometimes through judicial interpretation, but the growth of cross-border trade in services and the development of e-commerce technologies are creating a new type of bundling issue. A bundle of "e-products" may well result in different countries having the right to tax different parts of the supply because they have different place of supply rules or define the items subject to tax differently. For example, a telecommunications company may supply access to telecommunications services on a mobile telephone, while at the same time making available items of content for downloading to customers' phones. The telecommunications services are often taxed on the basis of "use and enjoyment," but the content tends to be taxed on the basis of normal residence, creating a conflict in the transaction's tax treatment. This potential problem is exacerbated where customers make a single payment in advance of consuming a bundle of services (a common model for mobile commerce), as service providers may have difficulty in allocating payments received to services with varying tax treatments in advance of actual consumption by consumers.

22. Many countries have specific rules on the place of taxation for telecommunications services, which are more specific than a general rule that would rely on the customer's residence. Mobile telecommunications suppliers have developed billing systems that tax telecommunications service by reference to the particular telecommunications rules operating in each country. This means that different taxation rules may apply to telecommunications services and information services where customers travel out of their country of residence. Because of the significant problems that arise due to the application of different rules to telecommunications, consideration should be given to including the taxation of those services in uniform consumption tax rules. Inconsistencies that result due to piecemeal changes that have been made in the past create tensions that can only be remedied by a consistent approach to all consumption tax rules.

23. Australia has avoided this bundling problem in the context of mobile telecommunication services by taxing all telecommunications supplies in the same way they tax all other supplies of services. That is, at the place of consumption, which (for telecommunications services) is where the recipient is located at the time of the supply. This means that a supply through a mobile communication device that essentially consists of two parts, access to telecommunications services and the downloading of content will be subject to GST in the same way for both parts of the supply. Accordingly, there is no need to "unbundle" the supply.

24. Similarly, Japan takes a simple approach that would encourage compliance. It has a broad-based low rate policy compared to most countries and therefore the issue of bundled supplies rarely arises. It has very few zero-rated supplies, and there are no specific rules for telecommunications services. Any country operating a broad-based single rate system will have fewer definitional problems. Whilst this type of solution provides answers to domestic bundling and double or unintentional non-taxation, they do not

address the problems with respect to cross-border transactions. Further, whilst the Project Team recognises this as a desirable outcome for those who have to administer these taxes, it also recognises that the reality of multiple rates (and the consequent definitional issues) is likely to remain a feature in most countries for the foreseeable future.

### **Approaches to Double or Unintentional non-taxation**

25. When the European Union Directive enters into effect, certain instances of double taxation will be eliminated. The Directive will effectively remove the major cause of double taxation for outbound digitized products, but the risk of double taxation remains if other countries are not applying the Ottawa principle of taxation in the place of consumption. As such the TAG encourages Working Party 9 to assess the incidence of, and reasons for, double taxation.

26. Unlike direct taxes, there are no existing procedures for addressing cases where double or unintentional non-taxation occurs in the indirect tax area. The TAG believes that Working Party 9 should consider a variety of approaches to address this area thereby minimising potential disputes, such as:

- Incorporating language into new bilateral Double Tax Agreements in order to take advantage of the Mutual Agreement Procedure contained in Article 25 of the Model Tax Convention on Income and on Capital;
- Adopting an advance ruling process;
- An information exchange mechanism between jurisdictions.

27. The Project Team understands that work is under way within Working Party 8 and its Tax Information Exchange Systems sub-group to consider exchange of information on consumption taxes. The Team would encourage this essentially where such exchanges would lead to elimination of double or unintentional non-taxation.

28. It is important to consider the cost of administration for such schemes. Progress towards a solution to double and unintentional non-taxation is likely to be slow, but first steps should be taken now so that these various approaches can be explored.

29. Where double or unintentional non-taxation occurs, it will be important to understand whether it occurred as a result of:

- Conflicting place of supply rules;
- Conflicting definitions;
- Conflicting tax results arising from differences in verification requirements for either jurisdictional determination or taxpayer status (for purposes of determining whether to tax or zero-rate; or
- Incompatible approaches to treating bundled supplies,

in order for appropriate solutions to be found. The development of bilateral and multi-lateral fora through which taxpayers could raise issues of double taxation would enable governments to gain greater knowledge about the cross-border impact of their particular approach to consumption taxes.



30. To encourage compliance and avoid unintentional non-taxation for business to consumer transactions, simplified registration schemes should be considered where consistent with the overall design of the national consumption tax system. Furthermore, if the OECD could use benchmarking techniques to study these cases and their resolution it might be possible to identify “best practices” that would ultimately lead to more consistent approaches to consumption taxes that encourage compliance and thereby contribute to achieving the Ottawa goals.

31. The potential for double taxation of supplies may constitute an impediment to the development of e-commerce and cross-border trade. The CT TAG should encourage Working Party 9 to leverage the OECD’s vast experience preventing double taxation in order to make recommendations to OECD member and non-member countries. BIAC could assist in this process in its capacity as a business advisory forum.

32. It ultimately may be more productive to think in terms of the appropriate tax treatment for all supplies that can be traded cross-border or delivered to remote customers, rather than just e-commerce. The most straightforward option for achieving neutrality and consistency in all cross-border transactions is to tax all transactions at the place of local consumption. One option would be to require suppliers to register and collect tax in every jurisdiction where their non-business customers reside. The biggest downside of this option, however, is that it creates a substantial administrative burden for governments and suppliers, because suppliers would have to identify, on a transaction-by-transaction basis, the consumer's normal place of residency and maintain that information for audit purposes, while governments would face a significant increase in filings. To reduce the administrative burden for governments and suppliers and to encourage compliance, governments need to significantly simplify their consumption tax compliance requirements. The CT TAG therefore encourages Working Party 9 to pursue its work on technological tax collection mechanisms with a view to simplifying compliance.

### **Other Issues**

#### *a) Availability of tax rate information*

33. Most countries apply the standard rate of tax to e-commerce products and consequently it is unlikely that problems of classification frequently associated with reduced rates and exemptions will result. Even if the standard rate applies to e-commerce products, businesses will have to be aware of those rates if they are to successfully comply with the requirements of collecting and accounting for tax in foreign jurisdictions. Ready access to this information should be made available by governments on a web-site that is updated regularly for rate changes. Governments should be mindful of the need to provide adequate notice of rate and other legislative changes in order for businesses to have sufficient time to update operating software. Compliance and accuracy will be greatly improved if businesses have sufficient lead-time to learn about and incorporate these changes into their billing systems.

34. The Project Team notes with satisfaction the decision of Working Party 9 to make available the tables published in Consumption Tax Trends on the OECD web site. In order for this to be of real value the Tables should be maintained in an up to date manner, providing advance information of rate changes, thus allowing business time to adapt their billing and accounting systems.

#### *b) Registration procedures*

35. Following the traditional model, requiring businesses to register in jurisdictions where they have private (as opposed to business) customers will create administrative burdens. The simplified registration procedures recommended for consideration by the CT TAG in the 2001 Report would help ease compliance burdens. The European Union in its VAT Directive for e-commerce has recently introduced this concept into its legislation, restricted for the moment to non-EU companies delivering e-commerce services, allowing the option of simplified registration, filing, and payment mechanisms. Additional work to simplify collection even further using technology is under way within Working Party 9 and the CT TAG supports the need for this work to continue.

*c) Impact of Differing Distribution Channels on Neutrality*

36. Some business representatives on the CT TAG feel that the application of the Guidelines in the 2001 Report leaves questions concerning neutrality with respect to certain products unresolved, or resolved in such a way that they feel discriminates against e-commerce products. An example is the case of electronic newspapers which, when supplied electronically, are treated as services and normally taxed at a standard rate, compared to their physical counterparts which may be subject to a reduced rate. A similar neutrality argument arises in countries that tax goods but not services, where the reverse effect applies.

37. On-line versions of newspapers tend to be very different in that they have added functionality such as the ability to access archived articles or updated information such as stock market movements. Such additional functionality, it is argued, fundamentally changes the product to the point where the tax treatment should also change. As the reduced rate would be applicable only to an on-line version that replicates the conventional product (*e.g.* in a pdf format) there would be a disincentive to develop an interactive version, as that would lose the reduced rate. But even if the reduced rate were applied to a site with greater functionality than the replica version competitive distortions would arise. Many Internet news sites do not publish conventional newspapers so the question would then arise as to the equity between news sites. It is important to note that this issue is not major, in terms of the range of electronic commerce, but for those businesses that are adversely affected it is a significant issue and it may be anticipated that these businesses will continue to press governments to address their concerns.

*d) VAT Treatment of Bad Debts by Foreign Tax Jurisdictions*

38. Not all countries provide relief from VAT/GST in the form of refunds to the supplier of output VAT/GST previously paid to the authorities where a customer fails to pay for the supply received. Some countries that do provide this type of relief attach very onerous obligations on the supplier to prove a debt is bad before the refund can be paid – for example, proof that the customer was officially bankrupt or that court claims have been made to recover the outstanding debt. The topic of bad debts is particularly relevant to the E-commerce sphere as online credit card transactions suffer a disproportionately high percentage of repudiation. An industry presenter at one of the Ottawa preparatory meetings in 1998 indicated that as much of 40% of on-line transactions go “bad” as opposed to 2-3% of regular sales

39. Given this specific background it is urged that countries consider bad debt relief provisions that recognise the disproportionate compliance impact on e-commerce suppliers. Revenue Authorities may also give consideration to allowing suppliers to account for tax on a cash-received as opposed to sales made basis as a simple way to achieve this.

*e) Tax Treatment of Credits/Adjustment notes by Foreign Tax Jurisdictions*

40. As for bad debt relief, not all countries allow a reduction of output tax when a credit is given to a customer and some attach very strict conditions to the use of credit notes in order to reduce output tax due. Given the background that on-line transactions carry a risk of failure due to network or other problems, e-commerce suppliers will wish to retain customers’ goodwill in these circumstances by giving them credits against payments received. Countries should consider adopting a credit or adjustment note provisions that recognise the disproportionate compliance impact on e-commerce suppliers.

## **Roles of OECD and BIAC**

41. In order to resolve these complex issues, it is important to identify one or more organizations to take a leadership role in facilitating short and long-term consensus. The OECD and BIAC are two such organizations.

42. Business members of the CT TAG are sensitive to the fact that tax policy is ultimately determined by the appointed bodies of sovereign nations and is not determined by the OECD. However, in the area of direct tax, the OECD has had a very significant role in the development of international consensus around issues such as transfer pricing and the structure of agreements for the avoidance of double taxation. The consensus developed naturally from the primary purpose of the OECD, which includes the fostering of trade and economic development. Recognizing the risk that double taxation can act as an impediment to trade, the OECD has developed and continues to evolve principles that define best practices in the areas of model treaties and transfer pricing. Although the results are impressive, they have taken a number of years to achieve.

43. BIAC would serve as a natural choice to assist the OECD in monitoring the problems that business faces. BIAC has served in an advisory capacity to the OECD for many years and has the contacts and infrastructure to assist the OECD in its continuing analysis of the international tax issues associated with consumption taxes.

## **Conclusions**

44. The concept of international trade has changed dramatically as a result of globalisation. Until recently, international trade consisted, in large part, of transactions by large multinational corporations. The advent of the Internet and e-commerce has opened up new opportunities for cross-border trade—a new global marketplace enjoyed by small to mid-sized businesses as well as consumers.

45. The TAG should encourage Working Party 9 to continue its work on practical collection mechanisms based on new technology, which will enable efficient tax collection and simplified processes for both business and governments.

46. The TAG should welcome the decision of Working Party 9 to make available, through the OECD web site, up to date tables of tax rates. It urges all member countries to ensure that, where feasible they widely publicise changes in tax rates well in advance of implementation so that the necessary adaptations to accounting systems can be made in good time.

47. Tax administrators in all countries will need to take into account that transactions in the global marketplace may alter the tax consequences under their countries' tax systems, with the unintended consequence that some transactions may be subject to double or no taxation. Businesses need and expect guidance from tax administrators that will provide them certainty in determining the tax consequences in these transactions. In other words, tax administrators should articulate clear guidelines on how specific supplies will be taxed in their country. The CT TAG therefore urges Working Party 9 to stress to its member countries the need for them to publish clear guidelines to business in order to provide an environment in which compliance is encouraged.

48. Particularly in the context of a global marketplace, businesses need consistency in definitions and tests that will be used to characterize the supplies they make. Moreover, the tests adopted by tax

administrators must be fairly simple and straightforward to apply, based on currently available and widely-used technology and business systems, and, most importantly, consistent with the Ottawa Framework. Consistency in definitions and tests should ultimately lead to reduced complexity and risks in the application of consumption taxes to e-commerce. Such consistency is only attainable, however, if tax administrators take a transparent approach to taxing cross-border e-commerce supplies. Further, tax administrators should, to the extent possible, simplify the rules, tests and administrative burdens so as to increase the likelihood of compliance. Therefore the TAG welcomes the new work, approved by Working Party 9, on the approaches to the taxation of international services and the need to ensure consistency in application. In a world in which business increasingly consists of international services and intangibles this is a welcome step to ensuring better alignment of the application of consumption taxes in order to avoid double and unintentional non-taxation.

49. The TAG encourages Working Party 9 to undertake work aimed at identifying instances of double taxation, and the reasons that lead to such double taxation. Business members are willing to provide input to assist in this process.

50. The TAG encourages Working Party 9 to develop procedures and guidelines for the exchange of information in the area of Consumption Taxes, possibly through the adoption of bilateral agreements based upon an OECD model.

51. Both OECD and BIAC have been instrumental in forging the existing open relationship between governments and businesses that has been so successful in fleshing out these difficult and practical implementation issues. The TAG considers that both organisations should continue their active participation in these issues and business is ready to contribute to the further work of Working Party 9.