Taxation and Electronic Commerce
IMPLEMENTING THE OTTAWA TAXATION FRAMEWORK CONDITIONS

How should governments tax e-commerce? What does e-commerce mean for existing international tax principles and systems? What are the administrative challenges of taxing e-commerce, and how can these be tackled? How can governments harness the new technology to improve taxpayer service and reduce compliance costs? These are just some of the pressing questions addressed in this book.

This volume provides a comprehensive guide to the status of the OECD-led international work on these questions, and hence to emerging conclusions and recommendations across a wide span of tax policy and tax administration issues. It sets out the latest thinking of the OECD’s Committee on Fiscal Affairs on the taxation aspects of electronic commerce, and on progress toward implementing the Ottawa Taxation Framework Conditions. It includes a number of documents for public review and comment, and details the outputs from the past two years intensive dialogue with the international business community and with non-member economies. As such it is an invaluable reference for all those interested in how governments around the globe are responding to the taxation challenges presented by e-commerce.
Taxation and Electronic Commerce

Implementing the Ottawa Taxation Framework Conditions

OECD

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Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

– to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;

– to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and

– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and the Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).
Preface by the Chair
of the Committee on Fiscal Affairs
Electronic Commerce: Realising the Potential

The OECD has taken a significant step forward in reaching an international consensus on the tax treatment of electronic commerce.

Electronic commerce has enormous potential to change the way we work, play and organise our lives. It is already changing the ways in which multinational enterprises (MNEs) operate – making globalisation a reality – and it has enabled consumers and small enterprises to operate and shop beyond their national boundaries.

If this potential is to be fully realised we must provide a Taxation Framework which provides certainty, fairness, neutrality and avoids putting in place new tax obstacles to the development of this new form of doing business. At the same time this Framework must ensure that taxpayers pay the right amount of tax, in the right jurisdictions and at the right time.

This publication goes a long way towards implementing the Taxation Framework Conditions agreed in Ottawa in 1998. The Ottawa Taxation Framework Conditions provide the principles which should guide governments in their approach to e-commerce. It also states that e-commerce should be treated in a similar way to traditional commerce and emphasises the need to avoid any discriminatory treatment. This Framework was welcomed by Member countries and non-member economies, as well as by the business community.

The conclusions reached in this publication provide the certainty that business and governments are seeking. I am particularly pleased that the proposals set out in this publication are the outcome of discussions between OECD governments, non-OECD governments and business. Non-member economies need to be involved in the OECD work since e-commerce requires globally accepted standards. Business needs to be involved since ultimately they have to operate any tax provisions put in place by governments.

This publication covers all aspects of the 1998 Ottawa Taxation Framework Conditions:

- International tax issues.
- Consumption tax issues.
- Tax administration issues.
- Taxpayer service issues.
Several of the chapters in this publication have also recently been released for public comment. This reflects the OECD’s commitment to transparency and ensures that decisions are made in the context of wide consultation.

The Committee on Fiscal Affairs, which is the OECD body leading the work, will now be following up this work. They have agreed to continue with the Technical Advisory Groups (TAGs) and to deepen the involvement of non-member economies and business in our work.

Gabriel Makhlouf
Chair, Committee on Fiscal Affairs
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Part I

EMERGING CONCLUSIONS AND RECOMMENDATIONS
BY THE COMMITTEE ON FISCAL AFFAIRS
An Overview of Progress Since the Ottawa 1998 Conference

Electronic commerce can provide a fundamentally new way of conducting commercial transactions. It has potentially far-reaching economic and social implications on many facets of life including the environment, the nature of work, and the role of governments. Accepted ways of doing business are likely to be profoundly changed by it. The economic distance between producers and consumers will shrink, traditional intermediaries will be replaced in many instances, new products and markets will be created, and new and far closer relationships will be forged between businesses and consumers and between the different parts of global enterprises.

New challenges will arise in areas such as taxation, where governments will continue to seek to raise revenue without distorting economic or technological choices. These changes require a reassessment both of the effectiveness of government policies towards commerce and of traditional commercial practices and procedures, most of which were formed with a much different image of commerce in mind.

This chapter provides readers with a progress report on one of the most important areas in which e-commerce poses issues for government and business: taxation. The chapter describes the extensive programme of work that is currently underway by the Committee on Fiscal Affairs (CFA) to implement the Ottawa Taxation Framework Conditions.

There has been considerable speculation as to what overall response governments will adopt towards the taxation of e-commerce in this new complex environment. At one extreme, there was the view that e-commerce should in some sense be allowed to take place in a tax-free environment – either by specific legislation or by continued government inaction. At the other extreme, there has been speculation on the introduction of new taxes specifically designed to tax e-commerce (for example, the Bit tax).

Neither of these views has proved acceptable to governments. The first would lead to governments being unable to meet the legitimate demands of their citizens for public services. It would also induce tax distortions in trade patterns. The
second approach could hinder the development of e-commerce and lead to the technology becoming “tax-driven”. Certainly, e-commerce is a new and exciting development. However, there is nothing to suggest that the nature of e-commerce, nor the desire to see it develop, should exclude it from normal taxation.

At the November 1997 conference entitled Dismantling the Barriers to Global Electronic Commerce held in Turku, Finland, government and business representatives met for informal discussions on the challenges posed by global e-commerce to tax systems. Since that initial meeting much work has been done by the OECD and revenue authorities to provide greater certainty on how e-commerce will be treated for tax purposes, clarifying the risks as well as identifying opportunities.

Less than a year after Turku, at the Ottawa conference entitled A Borderless World – Realising the potential of Electronic Commerce the CFA published the Taxation Framework Conditions that were welcomed by Ministers and Business. The Taxation Framework Conditions have since been generally accepted by most countries as providing a sound basis for ongoing work on the taxation of e-commerce. The OECD, in co-operation with other international organisations, was acknowledged at Ottawa as the Organisation best placed to co-ordinate and carry this work forward.

Recapping the Ottawa conclusions

It is worth briefly recapping what was endorsed at Ottawa in October 1998 as it provides the foundation on which work over the last two years has been based. At Ottawa it was agreed that the following broad taxation principles should apply to e-commerce:

The same principles that governments apply to taxation of conventional commerce should equally apply to e-commerce, namely:

- **Neutrality** – taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and e-commerce, so avoiding double taxation or unintentional non-taxation.

- **Efficiency** – compliance costs to business and administration costs for governments should be minimised as far as possible.

- **Certainty and simplicity** – tax rules should be clear and simple to understand, so that taxpayers know where they stand.

- **Effectiveness and fairness** – taxation should produce the right amount of tax at the right time, and the potential for evasion and avoidance should be minimised.

- **Flexibility** – taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments.
As was recognised at the earlier Turku conference, these broad taxation principles may conflict and governments and businesses may have different views on the balance and priority of their applications in particular contexts. That said, the principles do provide an important reference point against which to measure and progress taxation proposals.

The CFA used the taxation principles to draw the following conclusions, reflected in the Taxation Framework Conditions:

- The taxation principles that guide governments in relation to conventional commerce should also guide them in relation to e-commerce.
- The CFA believes that existing taxation rules can implement these principles. This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to e-commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of e-commerce transactions.
- The application of these principles to e-commerce should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from e-commerce between countries and to avoid double and unintentional non-taxation.
- The process of implementing these principles should involve an intensified dialogue with business and with non-member economies.

The Ottawa conference also confirmed that it is important to make a distinction between tariffs and taxes. There is broad support of the proposition that digital products should not be subject to tariffs. This, however, is not the same as saying that there should be a tax-free environment for all e-commerce, which would be contrary to the neutrality principle set out in the Ottawa Taxation Framework Conditions.

The Taxation Framework Conditions have gained wide acceptance internationally. APEC Finance Ministers noted them at the spring 1999 meeting in Kuala Lumpur and a number of regional tax organisations have acknowledged that they form a good starting point for the debate, as have a number of major non-member countries. They are widely accepted as a sound basis for developing the necessary global consensus on the taxation issues raised by e-commerce.

**The Post Ottawa agenda**

The Taxation Framework Conditions paper set out a post Ottawa agenda that was endorsed by Ministers. It laid down a work agenda of items under the headings of:

- Taxpayer service.
- Tax administration, identification and information needs.
• Tax collection and control.
• Consumption taxes.
• International tax arrangements and co-operation.

An ambitious work programme was developed by the CFA to maintain the momentum achieved at Ottawa. Each of the CFA’s Working Parties was tasked with aspects of the Taxation Framework Conditions to progress.

However it was also recognised that greater business and non-member country input would be needed to progress and implement globally the Taxation Framework Conditions.

Five Technical Advisory Groups (TAGs) consisting of government, from both member and non-member countries, and business participants were established to provide greater business and non-member country input into the Working Parties’ deliberations.

The Committee has continued to work constructively with other organisations on issues of common interest (such as the European Commission on consumption tax matters and the World Customs Organisation on customs duties); and to make an input into the debate in Member countries (e.g. a presentation on the OECD’s work on taxation matters was made to the US Advisory Committee on e-commerce).

The Committee has also been actively pursuing further means of strengthening the international dimension to the debate – over and above that provided for through the Technical Advisory Group process. Four regional tax organisations [The Commonwealth Association of Tax Administrators (CATA), Centro Interamericano de Administraciones Tributarias/Inter-American Center of Tax Administrations (CIAT), Centre de Rencontres et d’Etudes des Dirigeants des Administrations Fiscales (CREDAF) and Intra-European Organisation of Tax Administrations (IOTA)] have agreed to organise, in co-operation with the OECD, the first global tax conference on Tax Administrations in an Electronic World. This meeting will be hosted by Canada in June 2001 and will bring together 106 countries and eight international organisations. This pioneering conference will be the first such global gathering of tax administrations and will provide tax administrators with an opportunity to share experiences on how to apply taxes to e-commerce.

Involvement of non-member countries and business via the Technical Advisory Groups

When originally set up in early 1999 the TAGs were given a two-year mandate to allow them time for a consideration of a range of tax policy and tax practice issues. The involvement of non-OECD economies and the private sector was designed to ensure that the types of policy and administrative solutions being
developed were both compatible with current and emerging business models and, as far as reasonably possible, globally applicable.

It was recognised at the outset that the business participants had a key role to play, bringing to the debate valuable business and technological knowledge and expertise. Further, it was also recognised that given the global nature of e-commerce, participation of non-member economies in the process was vital.

The five TAGs created were:

- The **Treaty Characterisation TAG** whose work primarily involved a consideration of the application of the definition of royalties in the context of e-commerce. In the course of its work, the TAG examined the distinction that can be drawn between various types of payments in determining whether a particular e-commerce payment is made for the sale or lease of property, for the provision of a service, or as a royalty.

- The **Business Profits TAG** examined how the current tax treaty rules for the taxation of business profits apply in the context of e-commerce and proposals for alternative rules.

- The **Consumption Tax TAG** focused on advising on the practical implementation of the Ottawa principle of taxation in the place of consumption. The TAG brought valuable business perspectives to the debate on alternative collection mechanism options, and on how indirect taxation systems might be streamlined and simplified in the context of e-commerce.

- The **Technology TAG** provided, in the main, expert technological input into the work of the other TAGs.

- The **Professional Data Assessment TAG** focused upon an examination of the feasibility and practicality of developing internationally compatible information and record-keeping requirements and tax collection arrangements.

All of the TAGs provided valuable input into CFA subsidiary body deliberations. The non-member and business input into the policy development process proved very important in helping to identify more soundly based and widely acceptable policy positions.

Figure 1 sets out the relationships of the various CFA subsidiary bodies involved in progressing the Taxation Framework Conditions during the years 1999-2000.

**Key elements of the CFA work programme during 1999-2000**

The work programme encompassed three broad fields of work:

- **Consumption tax issues**, where work focussed on the practical application of the Ottawa principle of taxation in the place of consumption (for cross-border transactions) and on the collection mechanisms that might best
serve to ensure the effective operation of this principle. This work has been done in close co-operation with the European Union.

- **International direct tax issues**, where work focussed on the monitoring of the application of the current rules for taxing business profits and of the characterisation of payments from different e-commerce transactions for taxation purposes, as well as longer term work on the future of the concept of permanent establishment. The permanent establishment concept is a central element in determining taxation rights under tax treaties and is defined in the OECD Model Tax Convention as, essentially, a “fixed place of business through which the business of an enterprise is wholly or partly carried on”.

- **Tax administration issues**, where work is focused both on the examination of the opportunities that the technology underlying e-commerce presents for improving taxpayer service, as well as assisting and promoting compliance; and on the challenges that e-commerce presents to established methods of audit and of tax collection, and to the ability of tax administrations to counter evasion and avoidance. Key areas of work here include developing internationally compatible identification and information requirements so that compliance costs can be lowered while making compliance easier.
Results to date

Much of the work to date has consisted of a detailed examination of the specific implementation options open to governments with a view to reaching an international consensus before any major national initiatives are taken.

While in many areas there is still significant analysis being undertaken much progress has been made, as can be seen by a review of the papers making up this report. In just two years since the Ottawa Ministerial Conference, the Committee of Fiscal Affairs:

- Has agreed upon clarification of the commentary on the Model Tax Convention ("Model") in respect of the definition of permanent establishment (PE).
- Has agreed upon clarification of the commentary on the Model in respect of income characterisation.
- Has developed, for indirect taxation, Guidelines on the definition of the place of consumption, and recommendations on related tax collection mechanisms.
- Has clearly identified the challenges presented by e-commerce in relation to tax administration and ways in which tax administrations can continue to collect tax in this new environment.
- Has identified a series of best practices that can guide tax administrations in the area of these new technologies to improve the service provided to taxpayers and reduce compliance and administrative costs of collecting taxes.
- Has, more generally, through the TAG progress, further developed a constructive working relationship with the international business community and with non-members, and so formed the basis for a genuine international consensus based on the Taxation Framework Conditions.
- Has developed strategic partnerships with regional and other tax organisations as a means of taking forward the post-Ottawa agenda.
- Has narrowed the focus of the main fields of further work to a number of key issues, including inter alia:
  - On direct tax issues, the allocation of income to a permanent establishment.
  - On consumption tax issues, the role of technology-based systems in tax collection.
  - On tax administration issues, the means to address significant compliance challenges and to exploit taxpayer service opportunities.
A note on the types of papers in this Report

The compilation of papers setting out the breadth of interrelated work on e-commerce undertaken by the CFA and its subsidiary bodies form the rest of this Report. The papers can be classified into four categories:

- Information papers by the CFA Working Parties, where agreement on an issue, such as the clarification of the application of the PE concept, has been reached and the reader is informed as to the reasoning behind this.

- Discussion drafts by the CFA Working Parties, where preliminary recommendations are put forward and the reader is invited to comment on the options and analysis.

- Background papers containing the main findings and conclusions of the Technical Advisory Groups to the CFA Working Parties. These papers served as important input to the CFA Working Party analysis of the issues involved. The complete report of each of the TAGs against its mandate is available at www.oecd.org/da/ under “Public Release of OECD Reports”.

- Process and planning papers outlining the processes used in progressing the Taxation Framework Conditions and plans for the next phase of implementation.

Readers wishing to comment on the contents of these papers are invited to send their views to Jeffrey Owens, Head of Fiscal Affairs (daffa.contact@oecd.org).
Context and rationale for concerted approach

Context

The CFA's current Programme of Work addressing the taxation aspects of electronic commerce is firmly based on the Ottawa Taxation Framework Conditions, welcomed by Ministers in October 1998. The main conclusions of the Taxation Framework Conditions are that:

- The taxation principles that guide governments in relation to conventional commerce should also guide them in relation to electronic commerce.
- The CFA believes that existing taxation rules can implement these principles. This approach does not preclude new administrative or legislative measures, or changes to existing measures relating to electronic commerce, provided that those measures are intended to assist in the application of existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.
- The application of these principles to electronic commerce should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries, and to avoid double and unintentional non-taxation.
- The process of implementing these principles should involve an intensified dialogue with business and with non-member economies.

The broad taxation principles which should apply to electronic commerce, as identified in the Taxation Framework Conditions, are:

Neutrality

i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce.
Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

**Efficiency**

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

**Certainty and simplicity**

- The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

**Effectiveness and fairness**

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

**Flexibility**

- The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

In its work, the Working Party No. 9 on Consumption Taxes (the "Working Party") has consistently sought to achieve a balance between all these principles. It recognises that there are circumstances in which the principles may compete, and that government and business may have different views on what the balance and priority of their application should be in particular contexts. This underlies the importance of government-business dialogue. The business community places a particular focus on neutrality in certain cases, seeing this as a priority principle, which should inform the reading of all the others. The Working Party, while mindful of that particular business focus and determined to foster consensus wherever possible, nonetheless believes it is important to give due weight to all the principles, recognising that they form a package.

In the field of consumption taxes, the core elements of the Taxation Framework Conditions were developed as follows:

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.

- For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.

- Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, countries
should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

- Countries should ensure that appropriate systems be developed in co-operation with the World Customs Organization (WCO) and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers.

**Working Party No. 9 Programme of Work**

Following the 1998 Ottawa Ministerial Conference, a new work programme on consumption tax aspects of electronic commerce was established by Working Party No. 9 and approved by the CFA in January 1999, as part of its consolidated work programme on electronic commerce.

**Working Party No. 9 – Sub-group on Electronic Commerce**

To advance these aspects of the post-Ottawa agenda, Working Party No. 9 created a Sub-group on Electronic Commerce. Working to a mandate which the Working Party approved in February 1999, the Sub-group focused on three major areas of analysis: the practical application of the principle of taxation in the place of consumption; the analysis of different tax collection mechanisms; and the examination of the possibilities for taxpayer and consumer identification, access to information and administrative simplification. In addition to the core foundation of the Taxation Framework Conditions, the Sub-group drew on the various implementation options identified in the companion document “Electronic Commerce: A Discussion Paper on Taxation Issues” (which was also released at the time of the Ottawa Ministerial Conference in 1998).

The Sub-group and Working Party also benefited from the input of two of the five Technical Advisory Groups (TAGs), one considering tax policy and administrative issues (Consumption Tax TAG), the other (jointly supervised with the Forum on Strategic Management) advising on technology issues (Technology TAG). This Report reflects the conclusions of the Working Party, and makes specific reference to the input, advice and recommendations of the TAGs. (The reports submitted by the two TAGs are available separately.)

**Main conclusions and recommendations**

**Introduction**

Based on the detailed analytical work undertaken by its Sub-group on Electronic Commerce, the main conclusions and recommendations of the Working
Party, at this stage of the process, are set out below. Draft Guidelines on the place of consumption for the purposes of consumption taxation of cross-border services and intangible property, and recommended approaches to the practical application of the Guidelines, are attached as Appendix I to this chapter.

**Guidelines on the definition of the place of consumption**

The practical implementation of the Taxation Framework Conditions, as they relate to consumption taxation of international cross-border electronic commerce, can indeed be successfully pursued through the application of the principle of taxation in the place of consumption. Existing arrangements in relation to international trade in goods (for example, collection of tax due at importation) currently meet the needs of governments in terms of effective tax collection, although there is a recognised need to maintain efforts to simplify and streamline such systems (so as to accommodate, in particular, the growth in the volume of such traffic). There is, however, a specific need to address the international treatment of cross-border trade in services and intangible property, according to the following principles:

i) The application of the Taxation Framework Conditions to international trade in services and intangible property can best be achieved by: 1) defining the principle of taxation in the place of consumption more clearly, and 2) identifying collection mechanisms that can support the practical operation of that principle.

ii) This principle should therefore be expressed in the form of OECD “Guidelines on the Definition of the Place of Consumption for Consumption Taxation of Cross-Border Services and Intangible Property”. The Working Party has developed a draft of such Guidelines (see Appendix I to this chapter, Part A).

iii) Such Guidelines should define the place of consumption (and so of taxation) by reference, for business-to-business (B2B) transactions, to the jurisdiction in which the recipient has located its business presence, and, for business-to-consumer (B2C) transactions, by reference to the recipient’s usual jurisdiction of residence. Further work is required on appropriate means of verifying the latter.

**Recommendations on collection mechanism options**

The most viable collection mechanisms to support the practical application of such Guidelines lie:

i) In a reverse charge or a self-assessment mechanism for B2B transactions; and
In the near term (pending adoption of technology-facilitated options), in some form of registration-based mechanism for B2C transactions. The latter has its shortcomings (see the “Opportunities for simplification” section below) and there is a recognised need to promote simplified approaches to registration of non-resident suppliers.

The Working Party has developed draft recommendations on the practical application of the principle of taxation in the place of consumption (see Appendix I to this chapter, Part B).

In the medium term, particularly in the context of collection mechanisms for B2C transactions, technology-based options (of which there are several variants, including some which would rely on a trusted third party and/or the use of digital certificates) offer genuine potential. More detailed examination of this potential, and how best governments can support and utilise it, both to facilitate compliance and simplification, is an important field of further work, which the Working Party recommends that it should undertake with urgency in 2001. The Working Party recognises that achieving this is a dynamic process, as it would require certain changes in the existing and evolving systems, in both the public and private sectors. The Working Party therefore recognises an indispensable need, in its further work, for active co-operation with the business community (developing upon, for example, the advice which has been submitted by the Technology TAG), and with other international groups setting or co-ordinating standards concerning electronic commerce.

**Related issues**

**International administrative co-operation**

The dramatic growth in cross-border e-commerce presents new international challenges for indirect tax authorities, underlining, in particular, the need for substantially greater levels of international administrative co-operation. Drawing upon work undertaken to date under the auspices of the CFA, the Working Party intends to examine this issue in more detail during 2001 and to identify practical steps that can be taken and/or promoted to enhance such administrative co-operation.

**Dialogue with business and non-members**

The dialogue with the business community and non-members, as part of the post-Ottawa process, has proved valuable, particularly in identifying current and emerging business models and practices. Such dialogue should continue as part of ongoing work on selected issues. The business community is broadly supportive of the emerging conclusions in this Report (particularly in relation to the definition of place of consumption and the recommended use of self-assessment/reverse
charge mechanisms for B2B transactions). The business community is concerned to ensure that taxation-related measures do not hamper the growth of electronic commerce, and that they take proper account of such important issues as consumer privacy. It remains concerned about the potential compliance burdens that a registration model for B2C transactions might entail; and the lack, more generally, of technological tools which can immediately and robustly support any of the tax collection models which have been examined. The business community believes that only partnerships with government will lead to viable compliance models that both ensure the integrity of the tax system and are cost-effective. It remains committed to continued co-operation with governments to this end.

Opportunities for simplification

The Working Party recognises the important role that simplification can play in addressing business concerns, minimising compliance costs and reducing administrative costs. In terms of B2B transactions, the endorsement of a reverse charge/self-assessment approach results in significant simplification for suppliers. Additionally, the Working Party recognises the advantages of some form of simplified approach to registration as advocated by the business community. It recognises, too, the desire of the business community to see some practical steps toward simplification of some elements of the international indirect tax regime (for example, facilitation of cross-border electronic invoicing). A number of such options for simplification have been identified and will require further work. The Working Party recommends that it undertake such work (in close co-operation with the business community) to prioritise simplification options and to identify those that require and merit co-ordinated international action to facilitate their effective operation.

Further work

The Working Party recommends that further work be undertaken in several fields. These include:

i) Practical and effective means of verification of the declared jurisdiction of residence in B2C transactions.

ii) Practical and effective means of verifying the status of the recipient (business/consumer).

iii) The role of registration thresholds in minimising compliance requirements of non-resident suppliers.
iv) The relative feasibility of technology-based collection mechanisms; and the use of “intelligent networks”, as well as tools and standards (such as XML), to facilitate collection and remittance.

v) Practical measures to promote international administrative co-operation.

vi) Simplification options and initiatives.

vii) Compliance-related issues, in conjunction with the Forum on Strategic Management, focusing on areas of risk to effective tax collection.

viii) The longer-term possibility of the expansion of technology-based mechanisms toward systems that would deal not only with services and intangible property but with a larger set of transactions (i.e. goods and services more generally), and so provide a more comprehensive solution for both business and governments.

Publication of report

Subject to the CFA’s approval, the Working Party recommends that this report be published for a period of public review, inviting comments, for example, on the emerging conclusions. The report would also benefit from discussion at the Montreal Global Conference, “Tax Administrations in an Electronic World”, in early June 2001. Taking account of such additional inputs, and in the light of further dialogue with business, the Working Party would then revise the report to reflect definitive proposals and recommendations and submit it to the Committee’s next meeting at the end of June 2001.

Supporting analysis and arguments

Introduction

The discussion in this section relates only to consumption taxes at the national level. Sub-national tax regimes were recognised but not considered in detail. Attention should be given to these issues, in the international context, by authorities responsible for consumption tax systems.

This report focuses on cross-border supplies of services and intangible property capable of delivery from a remote location. Existing tax collection mechanisms in place to deal with the taxation of international trade in goods operate effectively, although there is an accepted need to maintain efforts (and, in particular, to support the WCO’s work) to simplify and streamline such systems, so as to cope with the significant growth, driven by electronic commerce, in the volume of such traffic.
Place of consumption

Context

The Taxation Framework Conditions concluded that the consumption tax rules for cross-border electronic commerce trade should result in taxation in the jurisdiction in which consumption takes place. Taxation at the place of consumption promotes certainty and prevents double taxation or unintentional non-taxation where two jurisdictions employ non-compatible place of taxation rules (i.e. at source and at destination). Equally important, tax at the place of consumption will serve to create a level playing field and is thus more neutral within and amongst conventional and electronic forms of commerce.

The Taxation Framework Conditions also directed revenue authorities to work through the OECD to identify concrete steps to implement the Taxation Framework Conditions and to consider the feasibility and practicality of those steps, including reaching agreement on a definition of the place of consumption, and on internationally compatible definitions of services and intangible property. The result of this analysis has been distilled into Guidelines on the definition of the place of consumption for cross-border services and intangible property.

Analysis

The place of consumption for the cross-border supply of conventional goods (e.g. a compact disk) can be based on the recipient’s address for delivery. If tax is not otherwise payable, then appropriate customs systems can collect tax on the importation of physical goods without unduly impeding revenue collection and the efficient delivery of products to consumers. Moreover, due diligence by the supplier and verification by revenue authorities is relatively simple. (Systems development by, for example, “fast parcel” carriers, are improving this position further.)

In contrast, where products are digitally downloaded or electronically delivered via the Internet, there is no physical delivery address for the supplier to rely upon. This, therefore, has the potential to create difficulties for revenue authorities as well as for suppliers (e.g. corroborating the “export” of a product, and so its exemption from tax).

Services may be broadly categorised as either those that are tangible, where the place of consumption can be readily identified, or those that are intangible, where the place of consumption may be uncertain. While this categorisation is not a technical one, it helps to illustrate how, in relation to certain transactions, difficulties in determining the place of consumption can arise.
Examples of tangible services include services relating to specific areas of land, including buildings (estate agents, hotel accommodation, and architects); transport (including related services such as handling); and services relating to physical performance (sporting events, concerts, hairdressing services, and restaurants). Each of these services is either physically performed or takes place at an identifiable location and may therefore be said to be consumed at that location. Therefore, determining the place of consumption for tangible services can often be defined as the jurisdiction where the service is actually performed.

Examples of intangible services include consultancy, accountancy, legal and other “intellectual” services; banking and financial transactions; advertising; transfers of copyright; provision of information; data processing; broadcasting; and telecommunications services. These services cannot readily be seen to be physically performed or to take place at a particular location and are often deemed to be consumed where the provider or customer is located. Any services capable of electronic delivery (including many of those above) are similarly intangible and therefore represent a challenge in defining a practical consumption test. Other types of intangible services will, no doubt, be developed as technology advances.

The Working Party’s work to date has mainly focused on the issue of taxing intangible services and property set against the Taxation Framework Condition of taxation at the place of consumption. Taxation at the place of consumption should, from an international point of view, lead to an equivalent burden of consumption taxes on the same products in the same market. The business members of the Consumption Tax TAG agree on this principle. With that perspective in mind, identifying an efficient definition of consumption was key to this task.

- Pure definition of consumption

Under a pure consumption test, intangible services would be defined as consumed in the place where the customer actually consumes or uses the services (irrespective of the contract, payment, beneficial interest, or the location of the supplier or customer at the time of the supply). With a pure definition of consumption, tax should in principle accrue to the country in which the actual consumption takes place – for all transactions, whether business-to-business or business-to-consumer.

However, the global nature of e-commerce, combined with the mobility of present-day communications, puts in question the practicability of a pure consumption test. If, for example, a US business contracts with a UK business customer to provide consultant services to its branches in Japan, consumption could be said to take place in the United Kingdom, where the customer’s headquarters is located, because the services benefit the whole business. Alternatively, consumption could be said to take place at each branch in Japan, because the services are actually...
used there. As a second example, a French business contracts with a Canadian business to provide electronically delivered services. The staff of the Canadian business use portable computers and receive the services all over the world. Consumption would take place in whichever country the staff member actually uses the services.

A pure place of consumption test would, today, result in a significant, and in some cases an impossible, compliance burden for vendors (e.g. determining the exact place of consumption and valuing consumption in multiple jurisdictions) and administrative difficulties for revenue authorities (i.e. identifying and verifying taxable supplies). The Technology TAG has, however, encouraged governments to remain open to a possible shift toward actual place of consumption, particularly in the light of the deployment of third-generation wireless and other technological developments that may help, in the medium term, to determine the location of the consumer at the time of an on-line purchase.

- Practical alternatives for defining place of consumption

The Working Party confirmed that the required approach should take account of the consumption principle while both ensuring certainty for businesses and tax administrations and avoiding distortion of competition through double or unintentional non-taxation. In particular, compliance burdens should be kept to a minimum and the approach should allow for easy and efficient collection by tax administrations. Unless collection burdens are kept to a minimum, compliance will suffer.

For B2B transactions, the Working Party reviewed a number of alternatives including the location of the supplier’s profit-generating operations; place of contract; location of the customer; and location of the supplier or the recipient’s business. In the latter case, the location, or “business presence”, of the recipient would be an establishment to which the supply is made. This might include the headquarters, a branch, a registered office, or a seat of economic activity. Yet another approach would be to tax services where they are performed, but where they are performed in more than one place, the location of the supplier would be the deemed place of taxation. In relation to any of these approaches, specific anti-avoidance rules may be required.

For B2C transactions, a number of options were identified, including the recipient’s permanent address or usual place (jurisdiction) of residence; his or her centre of vital interests; and where he/she is a national. The Working Party recognised that the supplier would need to be able to identify the location and tax status of private customers with ease and certainty. It is unlikely, however, that a supplier would ever have sufficient information to determine the private customer’s “centre of vital interests” or nationality.
Emerging conclusions – place of consumption

- Business-to-business transactions

In terms of B2B transactions, the Working Party confirms the benefits of treating intangible services as consumed where the recipient has located its business presence, and so concludes that a Guideline should be framed in these terms. The business members of the Consumption Tax TAG agree with that option, which appears to them workable and well-grounded in existing practices. Where there is a choice of locations, such as a headquarters in one country and a branch in another, the business presence should be considered as the establishment (for example, headquarters, registered office or branch of the business) of the recipient to which the supply is made. In certain circumstances, revenue authorities may use a different criterion to determine the actual place of consumption to ensure that the business structure or the mobility of communications is not used to avoid taxes by routing services through temporary establishments in non-tax or low-tax jurisdictions. The business members of the Consumption Tax TAG underlined the importance of the contract in determining the applicable taxing jurisdiction.

- Business-to-consumer transactions

The Working Party concludes that a Guideline based upon the jurisdiction in which the customer has his/her usual place of residence is the most practicable, albeit not the most theoretically pure, definition of “place of consumption” for B2C transactions. Where a consumer has more than one country of residence the place of consumption should be the jurisdiction in which the consumer spends the majority of his/her time. The business members of the Consumption Tax TAG consider the concept of treating the customer’s normal jurisdiction of residence as the place of taxation as a significant step in achieving neutrality between e-commerce transactions and conventional forms of transactions. The Technology TAG has highlighted the significant problems which are currently presented in attempting to identify the jurisdiction of a “virtual” customer. It argues that, with the major exception of digital certificates, technology is likely to be able to determine a consumer’s location only in the longer term. Hence its support for leaving open the possibility of revisiting, in the longer term, the practical application of the place of consumption for B2C transactions.

- Verification

Having established the place of consumption for private consumers, the Working Party focused on the practicalities of determining and verifying this structure. It is important to stress that some type of verification is necessary even in circumstances where the intangible service or product is not subject to taxation in
the jurisdiction of the customer. In these cases the supplier may have to provide proof of “export” in order to relieve the supply of tax. This led to an analysis of a number of approaches/proxies for usual jurisdiction of residence including: jurisdiction of residence as declared by the recipient to the supplier; country of residence as evidenced by credit card information; a personal tax identification number declared by the recipient to the supplier; and identification of source server/Internet service providers. The options were assessed in terms of simplicity for business and consumers, certainty of application, effectiveness (i.e. whether the option would accurately reflect the place of consumption), and technological feasibility.

The determination of jurisdiction of residence in the context of on-line transactions is not without difficulty. The actual level of verification required by revenue authorities may vary depending on the nature of the transaction. In some instances, there may still be a billing address (e.g. for a subscription service) to which a statement or bill is sent. In many cases a recipient will self-identify his/her country of residence (e.g. by way of pull-down menu). However this, on its own, is unlikely to be sufficient for the purposes of revenue authorities.

In its exploration of the various options by which jurisdiction might be confirmed, the Working Party was advised, in some detail, by the Technology TAG. The latter agreed that none of the technological options was sufficiently accurate as to be viable at this stage, and recommended that the focus should lie on digital certificates as a medium-term option which offered the most promise (in that they were in commercial deployment now; had a clear business-driven rationale, if not a consumer-driven one; looked likely to develop further as an integral element of applications; and so could well meet taxation-related ends). On the basis of in-depth consultations with representatives of the credit card industry, the Technology TAG found credit card-related information to be inaccurate as evidence of jurisdiction/residence. Pursuit of this option would, in the TAG’s view, be disruptive to on-line business transactions, and would only serve to encourage alternative payment methods. The Technology TAG further concluded that the use of Internet provider (IP) number tracing as a proxy for jurisdictional verification had limits in terms of its reliability and capacity to be manipulated (i.e. to show an incorrect IP address). That said, some government members of the TAG felt that such avenues were still worth pursuing further, as an interim, if limited, improvement in location information. Business members counselled against this, however, citing concerns about reliability, about the potential impact on transaction times, and about potentially substantial costs of implementation.

Business and government members of the Technology TAG and Consumption Tax TAG fully recognise the need to identify a practical short-term solution to meet the needs of governments, without negatively impacting upon the ability of business to engage in on-line commerce or imposing unreasonable compliance
burdens. Viable interim solutions might well not be technological – for example, they might rely on the use of a merchant’s internal databases, or any publicly or commercially accessible data. Finally, and more generally, the Technology TAG highlighted increasing consumer sensitivity about personal privacy and data protection, and industry responsiveness to such concerns. Commercial systems design was reflecting these concerns, and businesses were reluctant to seek to collect more information from customers than they needed for commercial purposes. This trend was also showing through in the future development of payment systems. It was important, therefore, that considerations such as these be fully taken into account by governments as they explore the verification issue further.

The Working Party recognises that there is no immediate, comprehensive answer to the particular question of verification of jurisdiction for B2C on-line transactions. It recognises too that this sector of e-commerce currently represents a relatively small proportion of total e-commerce, and so accepts that the response to the current “problem” must be proportionate (just as is true for collection mechanisms for this sector). It remains important, therefore, to seek to identify a practical and pragmatic approach in the near term pending the emergence of more fully technology-enabled methods of such verification. While mindful of the Technology TAG’s advice as to the deficiencies of the technological options examined to date, the Working Party nonetheless believes that some further work should be undertaken to evaluate more critically those limitations. In particular, the Working Party wishes to satisfy itself that the limitations are such that they rule out some of the options (such as IP tracing, or credit card indicia), even as interim (and “less than perfect”) arrangements. The Working Party intends to undertake this further work (to examine and evaluate various technological and non-technological options in this field) as a priority in 2001, continuing to work very closely with the business community (given, in particular, its concerns about potential burdens and costs).

**Tax collection mechanisms**

**Context**

The Taxation Framework Conditions also led the Working Party to develop and consider the feasibility and practicality of options to ensure the effective administration and collection of consumption taxes within the context of e-commerce. The results of the Working Party’s work in this area to date are expressed in terms of recommended approaches to the practical application of the Guidelines. This reflects a recognition that, unlike the core place of consumption principle itself, countries may choose different collection mechanisms without creating international distortions in the marketplace.
Analysis

The Working Party focused on five tax collection mechanisms: self-assessment/reverse charge, registration of non-residents, tax at source and transfer, collection by trusted third parties (such as financial intermediaries), and technology-based solutions. Each of the collection mechanisms was evaluated in terms of its feasibility of implementation, its effectiveness in capturing imported intangible services and property, its compliance burden for businesses, and its administrative burden for governments. In undertaking its analysis of these options, the Working Party benefited greatly from the advice of the Technology TAG, which helpfully undertook a parallel exercise of evaluation from a specifically technological perspective.

- Self-assessment/reverse charge

Under a self-assessment or reverse charge system, recipients would be required to determine the tax owing on imports of services and intangible property, and to remit this amount to the domestic tax authority. Where currently in use for B2B transactions (in most OECD Member countries), the system has proven feasible and effective, and it carries a low compliance and administrative burden. Self-assessment/reverse charge, however, has not been effective in ensuring the collection of tax on transactions involving private recipients (B2C).

The business members of the Consumption Tax TAG expressed their strong endorsement of “self-assessment/reverse charge” as a model for B2B transactions. The Technology TAG identified no technology-specific issues with such a model. For B2C transactions, however, the Technology TAG concluded that self-assessment was the least practical option from a technology perspective.

- Registration

A registration system would oblige non-resident businesses to register in a jurisdiction and to charge, collect and remit the consumption tax to that country. From an administrative point of view, for the most part this option is feasible, effective and would promote neutrality. Difficulties arise in terms of identifying non-resident suppliers, as well as in imposing registration requirements and enforcing obligations on non-residents. This option could increase the cost of tax administration (e.g. registering, auditing, collections, etc.). Registration would also impose significant compliance costs on non-resident suppliers, particularly for those making supplies in multiple jurisdictions with relatively few sales in each jurisdiction. The Technology TAG expressed particular misgivings about traditional registration-based collection mechanisms, pointing to the current lack of technological tools to support them, and the potential for greater complexity of business systems that registration approaches entailed.
The Working Party studied the advantages and disadvantages of registration thresholds for B2C transactions on the basis of competitive equity between domestic and non-domestic suppliers, and the compliance burden imposed on private-sector stakeholders. The Working Party examined three types of consumption tax thresholds: thresholds for registration, thresholds for distance selling, and thresholds for simplified taxing and/or reporting requirements.

Thresholds ensure that the compliance burden is eliminated where it would reduce or negate the incentive to carry on business activity, *e.g.* for small and medium-sized enterprises (SMEs). Thresholds may also ease compliance by excluding businesses (not necessarily small ones) on the basis that they make only a limited number of supplies into the jurisdiction. This is particularly important where the aggregate of that activity may significantly contribute to the jurisdiction’s economy. Additionally, thresholds can act to reduce the administrative burden, by permitting tax administrations to focus resources where the return is likely to be high. The principal disadvantage of registration thresholds, however, is the risk to neutrality/competitive equity between taxpayers below and above the threshold (although this is not a “new problem” for those revenue authorities that already operate a registration threshold for indirect taxation). For its part, the Technology TAG questioned the practical relevance of registration thresholds, given the lack of accurate technologies to identify B2C sales of digital products into a jurisdiction.

The Working Party recognised that the threshold model is fairly well established internationally. It is likely that tax administrations will choose to take a similar approach to e-commerce. In light of this, the Working Party recommends that Member countries accept the principle that registration thresholds should apply in a non-discriminatory manner. Other issues, such as compliance costs for taxpayers and administrative costs for revenue authorities, will also need to be taken into account.

The potential compliance burdens associated with a mechanism based upon registration of non-residents were a particular concern of the business members of the Consumption Tax TAG. Such burdens might stem simply from the volume of registrations required (assuming sales into a large number of jurisdictions); or from associated hard costs (such as a requirement to appoint a fiscal representative which, in addition, was incompatible with e-commerce business models). The business members of the Consumption Tax TAG thus strongly urged governments to consider steps by which such registration requirements could be substantially minimised (see the “Simplified interim approach” section below). The Technology TAG echoed concerns about compliance costs for business, and pointed out that there were some technology-based steps that governments could take to reduce the costs associated with collection models generally. An example of such support lay in the availability of on-line, Internet-based data sources (such as on tax liability

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and rates). Such initiatives (reflecting a partnership approach) on the part of governments had a key role to play in supporting several of the possible collection mechanisms.

- **Tax at source and transfer**

  The Working Party also examined the tax at source and transfer option as a tax collection alternative that would reduce the significant compliance costs associated with the registration option. A business would collect consumption tax on “exports” to non-residents and remit the amount to their domestic revenue authority, where it would be forwarded to the revenue authority in the country of consumption. The significant increase in the cost of administration, in addition to the need for international agreements regarding enforcement, collection and revenue transfers, places the feasibility of this option in question, at least in the short to medium term. From a purely technological perspective, the Technology TAG advised that such a collection mechanism was feasible, arguing that technology could well be creatively harnessed to facilitate such an approach and address its perceived shortcomings. Administrative costs, for example, could be minimised through the use of “intelligent networks”, which could route payments through to the appropriate revenue authorities. The Technology TAG recommended further work in this field to examine the potential more systematically. A variation on the model, to which the Technology TAG also drew attention, would be the introduction of a trusted third party to undertake the collection function(s). But, for the Working Party, this variant raised its own set of significant questions, such as how the costs would be met/shared, and how revenues would be assured.

- **Collection by third parties**

  Additionally, the Working Party considered an entirely new system whereby third parties (such as financial intermediaries) would be enlisted to collect consumption taxes on payments between recipients and suppliers of digital supplies. The third party would then remit the tax to the country of consumption. Adopting this system would involve significant start-up costs and fundamentally change the operation of most consumption tax systems. The Working Party recognised that the system could be effective, but the question remained focused on the feasibility of shifting the onus of collection onto, for example, financial institutions. The Technology TAG likewise argued that the responsibility for collection should not be imposed upon any third party intermediary or set of intermediaries. Any such third party participation should, in the TAG’s view, be voluntary and based upon market-driven commercial viability, recognising that such a model could be successful if third parties were provided with appropriate incentives.
Finally, there was significant discussion about various technology-based or technology-facilitated solutions to tax collection. One such approach would involve the use of tamper-proof software, which would automatically calculate the tax due on a transaction and remit (through a financial intermediary or a trusted third party) the tax to the destination jurisdiction. Bilateral agreements would provide for the verification by the tax authority in the “supplying” jurisdiction (on behalf of the “consuming” jurisdiction) of the installation and operation of such software. Private-sector software providers would probably be best positioned to develop the software, with necessary input from tax administrations. In some instances tax administrations might even choose to take the lead in such development. The Working Party recognised that this type of approach, in principle, could be an option for the medium to longer term, and so recommends that evaluation of the potential, and relative feasibility, of technology-based and/or technology-facilitated collection mechanisms, as part of overall tax compliance strategies in this area, be undertaken as a priority element of further work, commencing early in 2001. Such evaluation should continue to draw on the advice and expertise of the business community.

The business members of the Consumption Tax TAG stressed that technology should not be relied on, of itself, to provide “solutions” to the issues facing revenue authorities, although technology might assist in developing alternative tax collection mechanisms in the future. The business members of the TAG also expressed the view that, over the longer term, a coherent option might emerge from a combination of the elements studied by the Working Party. In other words, there might be a role for third parties, for revenue authorities in the jurisdiction of the vendor, as well as for supporting technology. Technology could support any part of the overall compliance model, but the integrity of the tax system overall should be paramount.

For its part, the Technology TAG similarly encouraged governments not to regard the models examined as mutually exclusive, and to explore possible hybrids which would draw from different models. So, for example, on the basis of the options considered to date, the Technology TAG’s own favoured approach, from a technological perspective, would be to combine elements of global registration, tax at source and transfer, and trusted third party models. The Technology TAG further advised that any steps taken in the short term should avoid compromising longer-term opportunities. If possible they should even support the latter, for example, by providing for a limited initial implementation of a particular method. The Technology TAG concluded that a hybrid/combined approach was the most desirable option, and so recommended that it be pursued vigorously. Finally, the Technology TAG underscored the importance of continuing to work
closely with business groups, to tease out, for example, the risks and opportunities associated with models based on the use of trusted third parties.

Addressing the collection mechanism debate more generally, the Technology TAG underlined that B2C on-line trade was very much in its infancy, and so argued that compliance costs should be very critically assessed in relation to the expected revenue yield: i.e. a balance should be sought between the two. In the short term, there would be risks in seeking to implement a collection model without appropriately low compliance costs, not least because of the current limitations of technological tools to support low-cost administration. A consistent theme of the Technology TAG's advice to governments has been that the latter should only pursue collection "solutions" that serve both commercial and tax administration purposes.

- Simplified interim approach

While endorsing self-assessment/reverse charge as a coherent option for B2B transactions on an ongoing basis, in the short term, and without prejudice to the pursuit of longer-term technology-based solutions, the business members of the Consumption Tax TAG felt that, for B2C transactions, only the registration option was practicable, although its long-term viability was questionable.

Recognising the current needs of governments to address B2C transactions, the business members of the TAG proposed a "simplified interim approach" to registration as the best short-term interim approach for B2C transactions. Business TAG members argued that simplicity would be the key element in encouraging high levels of compliance. To this end they suggested that non-resident suppliers be obliged to register through a simplified (electronic) procedure including only very basic data (e.g. name, address and nature of business). Under such a simplified procedure the liability to account for tax would remain with the supplier. They stressed that the tax reporting requirements should be both simple and clear – including a straightforward calculation (e.g. jurisdictional revenues x tax rate). A key aspect of the approach would be that recovery of input tax would not be available. Normal, full registration, including a full return with input tax recovery, would remain available to interested businesses. The business members of the TAG felt that in circumstances where such registered businesses acted in good faith and demonstrated a reasonable effort to accurately determine the jurisdiction of consumption, but without success, then the registrant should not be held liable for the tax. Similarly, they suggested that revenue authorities should expect good faith and best efforts by business to comply with the rules, and in return the authorities should respect the reports filed by registrants. Finally, they encouraged revenue authorities to concentrate their efforts on the non-compliant, by using existing instruments and other arrangements for mutual administrative co-operation, and
by taking collective responsibility for distributing information about each other’s tax obligations so as to inform vendors who are unaware of their obligations in foreign countries.

Many of the Working Party members expressed concerns that the system under the proposed “interim approach” discussed in the preceding paragraph – with obligations limited to “good faith” on the part of the registrant – would have implications for the credibility of the tax regime. Nevertheless, the Working Party saw a great deal of merit in pursuing a form of simplified registration as suggested by the business members of the TAG. More work on the specifics is required to identify how best such an approach can be pursued. This is a priority topic for further work in 2001.

**Emerging conclusions – tax collection mechanisms**

- **Business-to-business transactions**

  The Working Party welcomes the endorsement by the business members of the Consumption Tax TAG of the self-assessment/reverse charge model for B2B transactions. Consistent with the Taxation Framework Conditions, the Working Party recommends that in cases where the supplier is not registered and is not required to be registered under existing mechanisms for B2B transactions, countries should pursue a reverse charge or self-assessment system in order to protect both revenues and the competitiveness of domestic suppliers.

- **Business-to-consumer transactions**

  The Working Party’s work on collection mechanisms identified the merits and the drawbacks of each of the alternative tax collection mechanisms. Moreover, the Working Party explored possible approaches to rectifying the deficiencies with each option. Nevertheless, in the short term, for B2C transactions, there is no single option that is without significant difficulties. That said, in the short term the Working Party recommends, for B2C transactions, pursuing a system of simplified registration for non-resident suppliers, which ensures that the potential compliance burden is minimised, consistent with the effective collection of tax. In the medium to long term a move towards technology-based options should be envisaged, and further detailed work should be undertaken in 2001 to assess their relative feasibility and to identify what steps should be taken internationally to promote and/or facilitate them.

  Insofar as the recommended approach to tax collection involves two different models (one for B2B, and one for B2C) there is a related need to provide appropriate means for suppliers to distinguish between the two types of customers. For B2B transactions, most obviously, it will be necessary to confirm the “business”
status of the customer so as to justify export exemption by the supplier. The Working Party recognises that a variety of approaches can be adopted to this practical question, with the distinction being based on suitable criteria acceptable to the relevant revenue authorities. Such criteria might be a VAT registration number, a certificate of tax status issued by the tax authority of the recipient country, or other information available as part of the transaction (such as the nature of the product being provided). Further work is necessary in this field to confirm practical criteria which can be applied readily by business while providing revenue authorities with adequate assurance (for example, of the grounds for relieving an export transaction from tax).

Some members of the business community have argued that the limited revenues currently at stake in respect of B2C on-line transactions, combined with the current lack of tools for effective tax compliance and enforcement, make it appropriate to consider application of a zero rate of VAT to such digital transactions for a limited period until such time as a comprehensive technology-based mechanism is developed and deployed. The Working Party cannot support such a proposition. It would introduce a tax-based distortion of competition into the market, by positively discriminating in favour of digital delivery as compared with conventional delivery. This would fundamentally contradict the principle of neutrality. Attempts to overcome that distortion by, in turn, extending the zero rate to equivalent conventional products would represent an unacceptable erosion of the tax base.

**Compliance and administrative co-operation**

**Context**

The Taxation Framework Conditions directed revenue authorities to minimise compliance costs for taxpayers and administrative costs for revenue authorities as far as possible. At the same time, they recognised the need to minimise the potential for tax evasion and avoidance, while keeping counter-acting measures proportionate to the risks involved. Implementation of any necessary compliance measures should not only be designed to reduce the risk of revenue loss but also, at the same time, to avoid distortion of competition to the detriment of voluntary compliant taxpayers.

The Taxation Framework Conditions also concluded that revenue authorities should maintain their ability to secure access to reliable and verifiable information on taxpayers, improve the use of existing bilateral and multilateral agreements for administrative assistance, and develop international mechanisms for assistance in the collection of taxes.
Analysis

In relation to the estimation of revenue yield “at risk” in the context of e-commerce, the Working Party concluded that it is possible, with reasonable assumptions, to narrow the focus to imported, taxable, digitally delivered products and services purchased by private consumers. It is less likely that businesses might seek to avoid consumption taxes on these types of purchases, because most would be able to receive an input tax credit/deduction and/or the benefit of being able to claim the purchase as an expense to reduce reported taxable income. Examination of currently available products on the Internet aimed at private consumers suggests that an estimate of potential revenue at risk would not be large in relation to overall consumption tax revenues. However, it is important not to underestimate the competitive implications of a failure to capture these transactions within the tax system.

The Working Party also noted that the compliance tools or steps that could be taken were very much dependent on which tax collection mechanisms were adopted. For B2B transactions, the use of a reverse charge or other self-assessment mechanisms would significantly decrease the risk of tax evasion and avoidance. For tax collection mechanisms which also involve a conditional zero-rating of “exported” supplies of services and intangible goods, some compliance tools have been examined. This led to an analysis of possible indicia of the customer’s place of residence such as credit card information, personal identification number or identification of source server/Internet service provider. The impact of compliance software produced by the private sector was also discussed, as well as technology-based options for tax collection mechanisms.

The business members of the Consumption Tax TAG highlighted the fact that such compliance models centred all responsibility and liability on the supplier. They encouraged governments to consider mechanisms which would assign responsibility for different aspects of compliance to different parties involved in the transactions, including the customer. They also stressed the need to keep the system as simple as possible, adapted to the different kinds of businesses, with the minimum compliance burden, in order to encourage voluntary compliance.

The Working Party and the business members of the Consumption Tax TAG broadly share the overall assessment of the potential role of technology in supporting collection and compliance models. The role of technology should be creatively examined, recognising that in some instances such technology would itself need the active support of governments (for example, through the availability of on-line data on liability and rates).

Another aspect of the wider compliance debate is the recognised need for a strengthening of international administrative co-operation. The Working Party noted the emergence of technical instruments to allow timely and secure
exchange of information between revenue authorities. It also recognised that a better utilisation of existing administrative co-operation instruments (such as bilateral tax treaties, and the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters) could contribute to alleviating the compliance burden of businesses and improving the effectiveness of tax administration. It notes too that the business community has emphasised the importance that they attach to governments making progress toward such improved international co-operation.

**Emerging conclusions – compliance and administrative co-operation**

- **Compliance**

  For B2B transactions, the Working Party concludes that adoption of a self-assessment/reverse charge collection mechanism substantially addresses the main compliance challenges in this field.

  For B2C transactions, the Working Party recognises that ensuring effective compliance is less easy. A realistic balance must be sought between the needs of revenue authorities and the interests of business and customers (in terms, for example, of speed of transaction, and compliance costs). This is particularly important in relation to the degree of verification of the status and declared jurisdiction of residence of the consumer. In this area, further work is required to confirm an acceptable mechanism. The business community stressed the need in their view, when evaluating such mechanisms, to take particular account of the balance between the compliance/collection costs and the actual/forecast revenue yield.

- **Administrative co-operation**

  There is an evident need to strengthen international administrative co-operation between revenue authorities. The Working Party recommends that the existing legal instruments for administrative co-operation be further evaluated, specifically in the context of the growth of electronic commerce and the various tax collection mechanisms which have been examined. It recognises the close relationship between efficient and effective co-operation among revenue authorities and the possible implementation of the alternative tax collection mechanisms, given that most of the latter would necessitate a very strong level of administrative co-operation.

**Simplification**

Simplification has emerged as an important theme running through much of the Working Party's study of the consumption tax aspects of electronic commerce.
It has been clearly and consistently identified by the business community (through the Consumption Tax TAG, but also more generally) as a priority concern. The business community argues that simplification of certain selected elements of indirect tax regimes is a key means toward removing potential tax-related barriers to the development of cross-border e-commerce and, in turn, toward facilitating compliance. With simplification, business argues, comes increased levels of voluntary compliance, reduced compliance costs for business, and, as a logical corollary, reduced administrative costs for governments.

In the first instance, it is important to recognise that endorsement of the reverse charge/self-assessment approach in the context of B2B transactions delivers significant simplification. As a result, non-resident vendors who deal exclusively with business customers and who are not registered are not required to be registered under existing mechanisms will have few, if any, additional obligations arising from consumption taxes.

Therefore, the issue of simplification for non-resident business arises in two contexts: for those businesses that deal with private consumers and for those businesses that are established in more than one jurisdiction. As outlined in under the “Collection by third parties” section above, the business members of the Consumption Tax TAG proposed a “simplified interim approach” to registration. This merits serious consideration.

The Consumption Tax TAG also presented a number of other simplification initiatives and suggestions. These included:

- Facilitation of electronic invoicing, through a standardisation of invoice formats and associated procedures – to be based, ideally, on an OECD-brokered “model” (drawing, perhaps, on current work within the European Community).
- Facilitation and promotion of electronic VAT reporting/record-keeping systems more generally, to be supported by government – again, if possible, with an OECD “standard”.
- Standardisation of audit requirements and ideally procedures, employing new technology wherever possible.
- Introduction of an on-line mechanism, supported by government, whereby businesses could check the validity of VAT registration numbers, and gain access to other tax-related data (e.g. on liability and rates).
- Abolition of requirements, for non-resident businesses, to appoint fiscal representatives and/or post security (bank guarantees).
- Standardisation of the tax (VAT/GST) return, in terms of the core fields of data required, and of associated procedures (such as electronic filing and storage) – again based on an OECD “model”, and/or recommendations.
Consideration of mechanisms to provide for advance binding VAT rulings, for simplified arbitration procedures to resolve disputes between revenue authorities (e.g. as to where the tax is due), and of the possibility of extending the OECD international competent authority procedures to include consumption taxes.

The breadth of these suggestions means that it will be important for the Working Party to prioritise such options and initiatives and to take a realistic view as to what can and should best be pursued at the international level through further OECD-led work. The Working Party concurs with business on the greater relevance of practical procedural steps to make voluntary compliance more likely. It welcomes too the recognition by the business community that some of their suggestions are by their very nature for the longer term (where, for example, they would require international negotiations as such). This underlines the need to take a view as to relative priorities.

**Emerging conclusions — simplification**

The Working Party recognises the key role of simplification in the facilitation of compliance, and in addressing business concerns more generally. It notes too that in many instances the initiative necessarily lies at the national (domestic) level, and that there are inherent limitations upon what can realistically be achieved at the international level. That said, the Working Party recommends that it undertake an evaluation (in close co-operation with the business community) of the relative feasibility of options so as to identify those which can either be promoted internationally (for example in terms of recommended good administrative practice) or require further concerted development through the OECD.

**Evaluation of the TAG process**

The close working relationship with business and non-member economies, facilitated through the TAG process, has proved valuable to the Working Party as it has taken forward the post-Ottawa agenda. Business input into the debate has been particularly strong, from both the Consumption Tax TAG and the Technology TAG. The sharing of papers, and joint meetings, proved useful ways of advancing the debate and sparking new ideas and perspectives. Such dialogue, which strengthened and deepened over time, has greatly assisted governments in their examination of the issues. Non-member input has likewise proved valuable, helping to bring a global perspective to the issues under consideration.

Notwithstanding some variations in the level of active participation, the TAG process has thus been an important feature of the work programme to date, and should be continued – subject to some refinement in the composition, structure and mandates of the TAGs (which the CFA will be addressing separately). For its
part, the Working Party recommends that efforts be made to strengthen non-member participation in future TAGs, by involving a larger number of countries and encouraging a more active involvement. Business participation might also usefully be reviewed to provide a stronger voice for the interests of SMEs. Finally, TAG participation might also be broadened to bring in other interests/perspectives (such as academics, and consumer representatives).

Areas for further work

This chapter reflects the status of the Working Party’s post-Ottawa work programme as at the end of 2000. As such it is, in part, a report on work in progress. But it is designed too to offer a clear signal of the probable way forward, in the near term, on the principal issues. Publication of this report, subject to the approval of the CFA, will provide an opportunity for additional comment on the emerging conclusions identified in the report.

The Working Party recognises that further work is required in a number of areas, and recommends that this be pursued actively in 2001. Such further work is necessary in respect of:

i) Verification of the declared jurisdiction of residence of the consumer in B2C online transactions – to identify practical and effective methods which appropriately balance the needs of revenue authorities with the interests of business/consumers.

ii) Verification of the status of the customer – to identify practical and effective options of distinguishing between business and private consumers, which provide sufficient assurance to revenue authorities while minimising specific demands upon business.

iii) Registration thresholds – to clarify further the role that they can play in minimising compliance requirements upon non-resident suppliers.

iv) Technology-based and technology-facilitated collection mechanisms – to assess their relative feasibility, their potential time frames, and the role that related standards and tools can play in supporting tax-related functions.

v) International administrative co-operation – to identify more clearly the role that this can play in supporting efficient and effective tax administration, and what practical steps can realistically be taken to strengthen and develop such co-operation.

vi) Simplification options and initiatives – to evaluate rigorously relative priorities, taking account, in particular, of business views, and to identify those options which merit concerted international action.
vii) **Compliance-related questions** – to identify particular areas of risk in relation to effective assurance and compliance, and to examine any measures that might, as necessary, be adopted to address such risk.

viii) **Longer-term strategies for exploiting the potential of technology-based mechanisms** – to assess how such mechanisms might go beyond the immediate concern of international trade in services and digital products, and provide technology-facilitated “solutions” for tax collection in relation to a much larger set of transactions (*i.e.* goods and services more generally). Business-driven initiatives already being pursued in relation to international B2C transactions in goods should be examined in this context.
Notes

1. In February 2001, this chapter was released to the public for a period of public comment (through June 2001). It is therefore not a final text and should not be cited from or referred to as such.


3. The members of the Sub-group are: Australia, Canada (Chair), France, Germany, Ireland, Italy, Japan, Korea, the Netherlands, Norway, Singapore, Sweden, Switzerland, United Kingdom, United States and the European Commission.

4. See www.oecd.org/daf/fa for a link to this document. See “Electronic Commerce” then “1998 Ottawa Ministerial”.


6. In this context, “business-to-business” means transactions involving not only commercial entities but also other entities that are obliged to register and account for tax, or to be identified for tax purposes.
Appendix I
Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-commerce

A. Guidelines on the Definition of the Place of Consumption

Introduction

1. In 1998, OECD Ministers welcomed a number of Taxation Framework Conditions relating to the consumption taxation of electronic commerce in a cross-border trade environment, including:
   - In order to prevent double taxation, or unintentional non-taxation, rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place.
   - For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.
   - Where businesses acquire services and intangible property from a non-resident vendor, consideration should be given to the use of reverse charge, self-assessment or other equivalent mechanism.

2. The Guidelines below are intended to achieve the practical application of the Taxation Framework Conditions in order to prevent double taxation or unintentional non-taxation, particularly in the context of international cross-border electronic commerce. Member countries are encouraged to review existing national legislation to determine its compatibility with these Guidelines and to consider any legislative changes necessary to align such legislation with the objectives of the Guidelines. At the same time, Member countries should consider any control and enforcement measures necessary for their implementation.

Business-to-business transactions

3. The place of consumption for cross-border supplies of services and intangible property that are capable of delivery from a remote location made to a non-resident business recipient should be the jurisdiction in which the recipient has located its business presence.

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1. This will normally include a “taxable person” or an entity who is registered or is obliged to register and account for tax. This may also include another entity that is identified for tax purposes.

2. The “business presence” is, in principle, the establishment (for example, headquarters, registered office, or a branch of the business) of the recipient to which the supply is made.
4. In certain circumstances, countries may, however, use a different criterion to determine the actual place of consumption, where the application of the approach in paragraph 3 would lead to a distortion of competition or avoidance of tax.3

Business-to-private consumer transactions

5. The place of consumption for cross-border supplies of services and intangible property that are capable of delivery from a remote location made to a non-resident private recipient4 should be the jurisdiction in which the recipient has their usual residence.5

Application6

6. 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.7, 8

7. 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.

8. 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 recognised that specific types of services, for example, some telecommunications services, may require more specific approaches to determine their place of consumption.9

3. The "business presence" is, in principle, the establishment (for example, headquarters, registered office, or a branch of the business) of the recipient to which the supply is made.

4. In other words, a “non-taxable person” or an entity not registered and not obliged to register and account for tax.

5. It is recognised that implementing this Guideline will not always result in taxation in the actual place of consumption. Under a “pure” place of consumption test, intangible services are consumed in the place where the customer actually uses the services. However, the mobility of communications is such that to apply a pure place of consumption test would lead to a significant compliance burden for vendors.

6. In accordance with the Ottawa Taxation Framework Conditions, specific measures adopted in relation to the place of taxation by a group of countries that is bound by a common legal framework for their consumption tax systems may, of course, apply to transactions between those countries.

7. While these Guidelines are not intended to apply to sub-national value-added and general consumption taxes, attention should be given to the issues presented, in the international context, relating to these taxes.

8. The objective is to ensure certainty and simplicity for businesses and tax administrations, as well as neutrality via equivalent tax implications for the same products in the same market (i.e. avoiding competitive distortions through unintentional non-taxation).

9. When such specific approaches are used, the Working Party recognises the need for further work and for international co-ordination of such arrangements to avoid double or unintentional non-taxation.

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Consumption Taxation of Cross-border Services and Intangible Property in the Context of E-commerce

B. Recommended Approaches to the Practical Application of the Guidelines on the Definition of the Place of Consumption

Introduction

1. Three tax collection mechanisms are typically used in consumption tax systems: registration, reverse charge/self-assessment, and collection of tax by customs authorities on importation of tangible goods. Under a registration system, the vendor of goods and services registers with the tax authority and, depending on the design of the tax, either is liable to pay the tax due on the transaction to the tax authority, or collects the tax payable by the customer and remits it to the tax authority. Under the reverse charge/self-assessment system, the customer pays the tax directly to the tax authority. The third approach, collection of the tax on the importation of tangible goods by customs authorities, is common to virtually all national consumption tax systems where national borders exist for customs purposes.

2. Since registration and self-assessment/reverse charge mechanisms are currently in use in the majority of consumption tax systems, they represent a logical starting point in determining which approaches are most appropriate to apply in the context of electronic commerce transactions involving cross-border supplies of services and intangible property.

3. While emerging technology promises to assist in developing innovative approaches to tax collection, and the global nature of electronic commerce suggests that collaborative approaches between revenue authorities will become increasingly important, Member countries agree that in the short term, the two traditional approaches to tax collection remain the most promising. However, Member countries agree that their application varies depending on the type of transaction.

Recommended approaches

Business-to-business transactions

4. In the context of cross-border business-to-business (B2B) transactions (of the type referred to in the Guidelines), it is recommended that in cases where the supplying business is not registered and is not required to be registered for consumption tax in the country of the recipient business, a self-assessment or reverse charge mechanism should be applied where this type of mechanism is consistent with the overall design of the national consumption tax system.

5. In the context of B2B cross-border transactions in services and intangible property the self-assessment/reverse charge mechanism has a number of key advantages. Firstly, it can be made effective since the tax authority in the country of consumption can verify and enforce
compliance. Secondly, given that it applies to the customer, the compliance burden on the vendor or provider of the service or intangible product is minimal. Finally, it reduces the revenue risks associated with the collection of tax by non-resident vendors whether or not that vendor’s customers are entitled to deduct the tax or recover it through input tax credits.

6. Member countries may also wish to consider dispensing with the requirement to self-assess or reverse charge the tax in circumstances where the customer would be entitled to fully recover it through deduction or input tax credit.

Business-to-consumer transactions

7. Effective tax collection in respect of business-to-consumer (B2C) cross-border transactions of services and intangible property presents particular challenges. Member countries recognise that no single option, of those examined as part of the international debate, is without significant difficulties. In the medium term, technology-based options offer much potential to support new methods of tax collection. Member countries are expressly committed to further detailed examination of this potential to agree on how it can best be supported and developed.

8. In the interim, where countries consider it necessary, for example because of the potential for distortion of competition or significant present or future revenue loss, a registration system (where consistent with the overall design of the national consumption tax system) should be considered to ensure the collection of tax on B2C transactions.

9. Where countries feel it appropriate to put into effect a registration system in respect of non-resident vendors of services and intangible property not currently registered and not required to be registered for that country’s tax, it is recommended that a number of considerations be taken into account. Firstly, consistent with the effective and efficient collection of tax, countries should ensure that the potential compliance burden is minimised. For example, countries may wish to consider registration regimes that include simplified registration requirements for non-resident suppliers (including electronic registration and declaration procedures), possibly combined with limitations on the recovery of input tax in order to reduce risks to the tax authority. Secondly, countries should seek to apply registration thresholds in a non-discriminatory manner. Finally, Member countries should consider appropriate control and enforcement measures to ensure compliance, and recognise, in this context, the need for enhanced international administrative co-operation.
Chapter 3

Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities

Background to the work of the Forum on Strategic Management on electronic commerce

General background

At the November 1997 conference entitled “Dismantling the Barriers to Global Electronic Commerce” held in Turku, Finland, government and business representatives met for informal discussions on the challenges posed by global electronic commerce to tax systems. Since that initial meeting much work has been done by the OECD and revenue authorities to provide greater certainty on how electronic commerce will be treated for tax purposes, clarifying the risks as well as identifying opportunities.

Less than a year after Turku, the Committee on Fiscal Affairs (CFA) had formulated the Taxation Framework Conditions that were welcomed by OECD Ministers at the Ottawa conference, and that have since been generally accepted worldwide as providing a sound basis for ongoing work. The OECD, in co-operation with other international organisations, was acknowledged as the organisation best placed to co-ordinate and carry this work forward.

At Ottawa it was also recognised that greater business and non-member economy input would be needed to implement globally the broad taxation principles and the other elements of a Taxation Framework that had been identified.

An ambitious work programme was developed to maintain the momentum achieved at Ottawa. Each of the CFA’s subsidiary bodies was tasked with aspects of the Taxation Framework Conditions to study and develop. Five Technical Advisory Groups (Business Profits, Income Characterisation, Consumption Tax, Technology, and Professional Data Assessment) consisting of government (from both Member and non-member countries) and business participants were established to provide input into the deliberations.
Recapping the Ottawa conclusions

It is worth briefly recapping what was endorsed at Ottawa in October 1998 as it provides the foundation for the work of the last two years. At Ottawa it was agreed that the following broad taxation principles should apply to electronic commerce: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.

As was recognised at the earlier Turku conference, these broad taxation principles may conflict and governments and businesses may have different views on the balance and priority of their applications in particular contexts. That said, the principles do provide an important reference point against which to measure and develop taxation proposals, particularly those relating to tax administration.

The CFA used the taxation principles to draw the following conclusions, reflected in the Taxation Framework Conditions:

- The taxation principles that guide governments in relation to conventional commerce should also guide them in relation to electronic commerce.
- The CFA believes that existing taxation rules can implement these principles. This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.
- The application of these principles to electronic commerce should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double and unintentional non-taxation.
- The process of implementing these principles should involve an intensified dialogue with business and with non-member economies.

In the field of tax administration, these principles and conclusions were developed into the following Taxation Framework elements:

Taxpayer service

- Revenue authorities should make use of the available technology and harness commercial developments in administering their tax system to continuously improve taxpayer service.

Tax administration, identification and information needs

- Revenue authorities should maintain their ability to secure access to reliable and verifiable information in order to identify taxpayers and obtain the information necessary to administer their tax system.
**Tax collection and control**

- Countries should ensure that appropriate systems are in place to control and collect taxes.
- International mechanisms for assistance in the collection of tax should be developed, including proposals for an insert of language in the OECD Model Tax Convention.

Recognising that much remained to be done, the Taxation Framework Conditions mapped out an agenda for future work that included the following in relation to the field of tax administration:

**Taxpayer service**

- Developing an international consensus on ways to simplify taxation systems to minimise the cost of tax compliance, particularly for small to medium-sized enterprises (SMEs).

**Tax administration, identification and information needs**

- Adopting conventional identification practices for business engaged in electronic commerce.
- Developing internationally acceptable guidelines on the levels of identification sufficient to allow digital signatures to be considered acceptable evidence of identity in tax matters.
- Developing internationally compatible information requirements, such as acceptance of electronic records, format of records, access to third-party information and other access arrangements and periods of retention and tax collection arrangements.

**Tax collection and control**

- Designing appropriate strategies and measures to improve tax compliance with regard to electronic commerce transactions, including measures to improve voluntary compliance.

**Progressing the tax administration aspects – the Forum on Strategic Management’s role**

The Forum on Strategic Management (FSM) is a “virtual” forum of the Heads of Revenue Authorities, or their Deputies, from all OECD Member countries. It was formed in 1997 by the CFA to discuss strategic management issues of importance to tax administration. Electronic commerce was recognised as one of those strategic issues to be considered. The CFA has tasked the FSM with overseeing the tax administration work on electronic commerce arising from the Taxation Framework Conditions.

The FSM formed a Sub-group on Electronic Commerce (the “Sub-group”) in February 1999 to progress work on the tax compliance, service and administration...
issues associated with electronic commerce. In particular, the Sub-group was tasked with consideration of the various tax administration “implementation options” identified in the CFA report “Electronic Commerce: A Discussion Paper on Taxation Issues” (which was released at Ottawa together with the Taxation Framework Conditions).

These “implementation options” were intended to stimulate discussion on the mechanisms open to governments to implement the Taxation Framework Conditions. The proposed implementation options relating to taxpayer service and tax administration were:

1. Revenue authorities may consider developing Internet web sites where information, such as tax legislation, rulings, case law, revenue statistics and forms can be viewed and downloaded.

2. Revenue authorities may consider interactive telephone answering systems for many standard inquiries.

3. Revenue authorities may consider a single e-mail access point for highly mobile taxpayers.

4. Revenue authorities may consider receiving and responding to taxpayers’ service enquiries by e-mail.

5. Revenue authorities may consider direct deposit programs for tax payments and refunds.

6. Revenue authorities may consider accepting tax return data and other information by use of the new technologies.

7. Revenue authorities may consider automated payments of social security, payroll taxes and other similar deductions.

8. Revenue authorities may consider working with other arms of government to investigate the benefits of single government registration points on the Internet.

9. Revenue authorities may consider requiring that businesses engaged in electronic commerce identify themselves to revenue authorities in a manner that is comparable to the prevailing requirements for businesses engaged in conventional commerce in a country.

10. Revenue authorities may consider encouraging business practices that identify businesses engaged in electronic commerce.

11. Revenue authorities may consider mechanisms facilitating tracing, for tax purposes, of inadequately identified web sites and other electronic places of business.
12. Revenue authorities may consider making their views on user identity known to other bodies with a role in determining the identity of parties engaged in electronic commerce.

13. Revenue authorities should express their views to the appropriate bodies to ensure that features of electronic payment systems do not exacerbate the challenges associated with the cash economy.

14. Revenue authorities should co-operate with businesses developing codes of practice or other instruments which would encourage the widespread application of appropriate technologies, such as message digests and digital notarisation, to ensure the integrity of electronic records.

15. Revenue authorities may consider expressing their views on information requirements to appropriate bodies developing standards or protocols for electronic commerce.

16. Revenue authorities may consider encouraging taxpayers that utilise encryption or security technology to also consider key recovery, trusted third party or other arrangements to guard against the inadvertent loss of encryption keys.

These “implementation options” have now been reviewed by the Sub-group with input from two of the joint government/business Technical Advisory Groups (TAGs): the Technology TAG and the Professional Data Assessment TAG, both of which reported to, and informed the broader work of, the Sub-group.

The focus of the work of the FSM Sub-group on Electronic Commerce

In early 1999, the FSM Steering Group established that, in taking forward the work on the implementation options, the Sub-group should also:

a) Determine whether the tax compliance and administration implementation options contained in the October 1998 paper “Electronic Commerce: A Discussion Paper on Taxation Issues” would, if implemented, provide tax administrations with an appropriate and effective response to some of the challenges of electronic commerce.

b) Determine which implementation options could be progressed by revenue authorities without policy change, which options would require policy change, and which would require work involving other arms of government.

c) Examine special administrative challenges posed by electronic commerce in the area of harmful tax competition.

d) Manage the work of the Professional Data Assessment (PDA) and Technology TAGs.
e) Manage relations with other subsidiary bodies of the CFA.

f) Involve non-member economies in the work of the Sub-group.

It is the FSM’s conclusions and recommendations to carry forward the OECD’s work on taxpayer service and tax compliance and administration issues, based on the work undertaken by the Sub-group, that are set out in the next part of this report.

Conclusions and recommendations

Summary of key recommendations in this report

• That Member countries actively pursue the options set out in this report to implement the Taxation Framework Conditions in relation to taxpayer service.

• That revenue authorities continue to facilitate the exchange of practices and knowledge between administrations, both Member and non-member, via the use of targeted meetings, including appropriate expert meetings; the FSM Electronic Discussion Group; and the ongoing development of the FSMKE web site.4

• That specific attention be focused on assisting s-SMEs to attain and maintain compliance, and that this be incorporated into the Sub-group’s future workplan.

• That revenue authorities actively examine, and appropriately pursue, options to implement the Taxation Framework Conditions in relation to tax administration and compliance.

• That consideration is given to the establishment of an expert Technology Panel, with business, government (Member and non-member) and OECD Committee for Information, Computer and Communications Policy (ICCP) participation, so that, for example, appropriate tax administration input into "standard setting" bodies can be provided in a more timely fashion. This Panel would take on the Technology TAG’s outstanding work and would incorporate some Technology TAG members.

• That a new TAG dealing with tax administration be created. Its role would expand on that of the PDA TAG to cover a broader range of business/tax administration issues. Its membership could encompass some of the existing PDA TAG participants, and some additional participants.

• That other ways of obtaining active non-member involvement in the development of electronic commerce taxation arrangements be pursued, such as additional joint meetings and work with other international tax fora – such as CIAT (Inter-American Center of Tax Administrations), CATA (Commonwealth Association of Tax Administrations), IOTA (Intra-European Organisation
of Tax Administrations), and CREDAF (Le Centre de Rencontres et d’Études des Dirigeants des Administrations Fiscales).

- That other activities to raise awareness of the issues associated with the taxation of electronic commerce with non-members be pursued as part of the OECD/CFA Outreach programme during 2001.
- That a small number of key non-member economies be invited to participate in the Sub-group.
- That the Sub-group prepare a work plan, building on its achievements to date, to progress these recommendations and the future work proposals identified in Part III of this report.

**Items a) and b) – tax implementation options**

To address the tasks given to it, the Sub-group, at its inaugural meeting in June 1999, proposed an ambitious work plan to advance not only the tax compliance and administrative implementation options, but also the taxpayer service options identified in the discussion paper.

At the time there was some debate amongst delegates about the wide-ranging agenda. However, it was decided that the Sub-group should encompass all aspects of the OECD’s work in the area of taxpayer service as well as tax compliance and administration. The delegates did note that since taxpayer service issues and tax compliance and administration issues are usually dealt with by different people in most revenue authorities a different set of attendees would be required to properly address the taxpayer service options. This approach was adopted successfully.

The Sub-group began its work by considering whether the tax compliance and administration implementation options raised in the discussion paper would provide revenue authorities with an effective response to some of the challenges of electronic commerce. The Sub-group also considered which implementation options could be progressed by revenue authorities without policy change, which options would require a policy change, and which would require work involving other arms of government.

As it was apparent that many of the options on the tax administration side would need technical input, the Sub-group tasked the Technology and PDA TAGs with providing such input. The Sub-group also tasked several members with providing the Technology TAG with a context paper on the tax issues.

To progress the taxpayer service implementation options, the Sub-group organised a meeting of relevant specialists, and undertook a survey of what electronic service techniques were being used by Member countries. The former took place in March 2000, when taxpayer service specialists met in Copenhagen to
share experiences in the use of electronic service delivery and to learn from other members how they were using the new technologies to improve taxpayer service. The latter was initiated in May 2000 when a survey of taxpayer service initiatives using new technology was conducted among Member countries. A paper on emerging trends is found in Appendix I to this chapter.

The Sub-group also tasked a number of its members to prepare a paper profiling the characteristics and special challenges that SMEs face, and present, in relation to electronic commerce, as compared with larger enterprises. Building on such the profiling of SMEs, the Sub-group also commissioned some of its members, co-ordinated by the United Kingdom, to draft a paper exploring the potential for offering guidance on taxation matters to SMEs engaged in electronic commerce. To illustrate evidence how such guidance could be provided the United Kingdom has included a guidance area for SMEs on the Inland Revenue web site (www.inlandrevenue.gov.uk).

In the compliance field several Member countries were asked by the Sub-group to develop a generic OECD manual for tax administration staff on gathering information from the Internet. This will be made available at the June 2001 conference in Montreal and for use by staff in other revenue authorities to assist them in their compliance work on businesses engaging in e-commerce.

To gain a greater understanding of the potential compliance risks, the Sub-group asked France to co-ordinate the identification of web sites associated with facilitating aggressive tax planning in tax havens.

The Sub-group also commissioned an initial listing of Internet “standards” bodies with a view to influencing the development and implementation of Internet protocols and practices in a way that might better support revenue authorities’ access to relevant taxpayer information or might facilitate cost-effective systems of tax collection.

The FSM notes that during the past 18 months, several Member countries have devoted time and effort to special projects designed to advance the OECD’s work in the area of tax compliance and administration issues and commends them for this. Such work is a powerful illustration of the value of the Forum as a mechanism for sharing experience.

The FSM welcomes the growing number of spontaneous bilateral and multi-lateral collaborations occurring between delegates of the Sub-group with good results. From the outset of the creation of the Sub-group, it was readily apparent that Member countries could benefit from the advice of members from countries more advanced in their e-commerce work. This has led to a heightened awareness in many countries as to the significance of the issues, utilising the OECD’s pre-eminent position to advance these global efforts.
Conclusions and recommendations

- Regarding the taxpayer service implementation options

On taxpayer service initiatives, the survey undertaken by the Sub-group found encouraging signs of the widespread adoption of new technologies by revenue authorities. Almost all respondents to the survey had established web sites that allowed the downloading of forms, and provided answers to commonly asked questions. The majority of sites allowed for online form filing. Appendix I to this chapter is a summary paper on developments and emerging trends in taxpayer service, based upon the survey.

A number of electronic service delivery trends were clearly evident, and are set out in Table 1 below. These included a shift:

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<tr>
<td>Paper based communications</td>
<td>Electronic communications</td>
</tr>
<tr>
<td>Preparer/assessor</td>
<td>Self help/expert systems</td>
</tr>
<tr>
<td>Cash/Cheques</td>
<td>Electronic Funds Transfer (EFT)</td>
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<tr>
<td>Personalized responses</td>
<td>Automated voice mail</td>
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<tr>
<td>Administration data input</td>
<td>Taxpayer data input</td>
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<tr>
<td>Segmented service</td>
<td>Integrated/one-stop shop</td>
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Some obstacles remain to the greater utilisation of electronic technology. Two of these, electronic security and electronic signatures, are in various stages of development and deployment. Another obstacle identified was the availability of computers to taxpayers. Several countries have compensated for this by allowing “form-filing” over the phone, by establishing “kiosks” in public places that allow for filing and by using third parties such as the postal authorities and agents. The new generation of relatively cheap mobile Internet-enabled devices (e.g. WAP phones) may also help bridge the current digital divide in this respect.

The FSM has found that there was considerable value in multilateral exchange of practices and experience in the area of utilising electronic means to improve service.

The FSM recognises that in implementing the taxpayer service options, set out below, each country will need to adapt its implementation strategy to reflect its own domestic legislation and policy environment. Nevertheless, the FSM recommends that member countries actively pursue the following options to implement the Taxation Framework Conditions in relation to taxpayer service:

1. To develop Internet web sites where information, such as tax legislation, rulings, case law, revenue statistics and forms can be viewed and downloaded.

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2. To develop interactive telephone answering systems for many standard inquiries.
3. To examine the feasibility of a single e-mail access point for highly mobile taxpayers.
4. To examine the feasibility of receiving and responding to taxpayers service enquiries by e-mail.
5. To explore the use of direct deposit programs for tax payments and refunds.
6. To develop systems for accepting tax return data and other information by use of the new technologies.
7. To develop systems for automated payments of social security, payroll taxes and other similar deductions.
8. To work with other arms of Government to investigate the benefits of single government registration points on the Internet.

The work of the FSM has underlined the growing importance of electronic means of delivering service to taxpayers and in reducing compliance costs. The FSM welcomes the marked trend towards greater use of electronic mechanisms such as e-mail, web based tax knowledge repositories, electronic funds transfer, etc. to improve taxpayer service by administrations.

The FSM recommends that revenue authorities continue to facilitate the exchange of practices and knowledge between administrations, both member and non-member, via the use of targeted meetings, including appropriate expert meetings; the FSM Electronic Discussion Group; and the ongoing development of the FSMKE web site. In particular the FSM will be encouraging member countries to participate in an “expo” of electronic taxpayer service initiatives at the June 2001 Montreal conference on e-commerce.

Noting the particular compliance difficulties faced by smaller Internet-based businesses operating in a global market, the FSM suggests specific attention be focused on assisting these businesses to attain and maintain compliance and that this be incorporated into the Sub-group’s future work plan. In this respect the FSM notes and welcomes the proposed evaluation by the University of Bath UK, co-sponsored by the OECD, on web site information provided by revenue authorities from the perspective of SMEs.

- Regarding the tax compliance administrative implementation options

Whilst considerable work remains to be done on the administrative options, the FSM believes that it is already in a position to encourage revenue authorities to actively examine and appropriately pursue the following options for implementing the Taxation Framework Conditions in relation to tax administration. It is recognised that progress made in implementing these options will vary between
countries depending upon their policy and legislative environment and their administrative practices:

9. Businesses engaged in electronic commerce should identify themselves to revenue authorities in a manner that is comparable to the prevailing requirements for businesses engaged in conventional commerce in a country.

10. Revenue authorities should encourage business practices that identify businesses engaged in electronic commerce.

11. Revenue authorities should examine mechanisms to facilitate tracing, for tax purposes, of inadequately identified web sites and other electronic places of business.

12. The CFA should make its views on user identity known to other bodies with a role in determining the identity of parties engaged in electronic commerce.

13. Revenue authorities should express their views to the appropriate bodies to ensure that features of electronic payment systems do not exacerbate the challenges associated with the cash economy.

14. Revenue authorities should co-operate with businesses developing codes of practice or other instruments which would encourage the widespread application of appropriate technologies, such as time-based message digests and digital notarisation, to ensure the integrity of electronic records.

15. The CFA should make its views on information requirements known to appropriate bodies with a role in developing standards or protocols for electronic commerce.

16. Taxpayers that utilise encryption or security technology should be encouraged to consider key recovery, trusted-third-party or other arrangements to guard against the inadvertent loss of encryption keys.

The FSM believes that while Option 9 can be developed domestically by revenue authorities, there would be compliance cost benefits, for taxpayers engaging in cross border e-commerce, by striving for greater consistency of approach and practice amongst administrations.

In relation to the remaining tax compliance and administration options (items 10-16), the FSM concludes that whilst they could be also advanced domestically, faster progress will be made in their implementation by international co-operation between revenue authorities.

The FSM believes that implementation Option 10, regarding the encouragement of business practices that would provide easier identification, will require
that revenue authorities work closely with other bodies, such as those associated with consumer protection and corporate registration, to develop compatible views.

In the case of implementation Options 11 through 16 inclusive, the FSM will provide a forum where revenue authorities can work together to share experiences. In the case of Options 12 through 16 inclusive, the FSM will integrate the collective views of revenue authorities and will provide the most appropriate means of communicating their views to other bodies associated with electronic commerce. The FSM recommends that revenue authorities continue to facilitate the exchange of compliance practices and knowledge between administrations, both Member and non-member, via the use of targeted meetings, including appropriate expert meetings; the FSM Electronic Discussion Group; and the ongoing development of the FSMKE web site.

Some initial progress has been made (by the Sub-group with the advice of the Technology and PDA TAGs) towards the identification of parties associated with the formation of Internet standards and practices. While a list of relevant standard bodies was developed by the Sub-group it was not possible for the Sub-group to maintain a watching brief over new standard proposals, nor prepare suitable input to those bodies on tax administration views.

The FSM notes that some administrations have maintained an ad hoc awareness of developing standards. However, it is unlikely that an approach from an individual or a revenue authority to a standards body would have the same degree of influence as an approach from the OECD/CFA, representing the combined input of Member (and, if possible, non-member) administrations.

Hence the FSM recommends that consideration be given to the establishment of an expert Technology Panel, with business, government (Member and non-member) and OECD Committee for Information, Computer and Communications Policy participation, so that appropriate revenue authority input can be provided in a more timely fashion. This panel would take on the Technology TAG’s outstanding work and would incorporate some Technology TAG members. It is clearly important that appropriate government policy input occur prior to the standard becoming “fixed" and widely deployed.

**Item c) – Special administrative challenges posed by electronic commerce in the area of harmful tax competition**

It is recognised that the mobility of electronic commerce and its geographic sensitivity to tax differentials may exacerbate harmful tax competition. Already a large number of web sites aimed at facilitating aggressive tax planning have been identified, and it is noted that a number of these sites are becoming more “professional" in their approach to soliciting clients.
Conclusions and recommendations

While a large number of web sites facilitating aggressive tax planning were identified, many of these appeared to be associated with a few promoting organisations, often based in tax havens. Most sites were physically located on servers in Member countries, most likely due to bandwidth considerations and the availability of reliable telecommunication facilities.

The FSM concludes that the ongoing development of electronic commerce underlines the importance to all countries, both Member and non-member, of curbing harmful tax competition.

Item d) – Manage the work of the PDA and Technology TAGs

The Sub-group, together with the Working Party 9 Sub-group on Electronic Commerce, managed the work of the Technology TAG since its inception. Full details of the work output of the Technology TAG are contained in the Technology TAG report.8

The FSM notes that the Technology TAG provided valuable input on jurisdictional identifiers that might be associated with electronic commerce transactions and on the practicality of proposed collection mechanisms for indirect taxes. (A summary of the main findings of the Technology TAG is found at the end of this chapter in Appendix II.)

The Sub-group also managed the work of the PDA TAG, full details of which are contained in the PDA TAG report.9

The PDA TAG carried out valuable research in the following areas: electronic commerce audit standards and protocols; data authenticity and reliability mechanisms; remote access to taxpayer data, encryption key management and recovery mechanisms; and desirable data elements for electronic commerce. The TAG also analysed the specific audit risks associated with Internet electronic commerce trading.

The FSM notes the PDA TAG’s conclusions, a summary of which is annexed (Appendix III to this chapter), and recommends that member administrations consider them and provide comments back to the Sub-group at its next meeting. Conclusions and recommendations

The FSM thanks both the Technology and PDA TAGs for the valuable input into its work. The FSM considers that business input into the policy development process has proved very important and that a mechanism to ensure widely considered business views on the practical implications of policy options is needed. The FSM found that while both the PDA and Technology TAGs provided valuable input to the Forum’s and Working Party No. 9 (WP9) Sub-group’s deliberations, the initial expectations from the process were overly optimistic. Not all members of the
TAGs were able to provide the same level of quality input and it was found that face-to-face meetings and telephone conference calls were often the best way of moving the analysis forward, rather than by e-mail or the Electronic Discussion Group. The existing TAG process, while providing valuable business input, proved somewhat cumbersome and unable to provide timely input into developing Internet standards (such as IOTP, ebXML, IPv6, etc.).

The FSM recommends that the input of business and non-member countries should continue and that for technology matters an “expert panel” approach be adopted, with business, government (Member and non-member) and OECD Committee for Information, Computer and Communications Policy participation for future input into policy decisions. It is expected that some participants of the Technology TAGs would be incorporated into this panel. This Technology Panel would provide requested technical input at Working Party, Sub-group and TAG levels.

It is also proposed that a new TAG dealing with tax administrations be created. Its role would expand on that of the PDA TAG’s scope somewhat to cover a broader range of business/tax administration issues. Its membership would encompass some existing PDA TAG participants and some additional participants may be sought. Having broader membership and a wider scope would enable teams to be formed within the TAG around topics without the formal structure of several separate TAGs. New issues arising could be dealt with more quickly from within the wider group of participants. The TAG would report to the FSM Sub-group.

**Item e) – Manage relations with other subsidiary bodies of the CFA**

In progressing its mandated work, the Sub-group established close relationships with the other subsidiary bodies of the CFA, particularly the WP9 Sub-group on Electronic Commerce. Several overlapping meetings were held to facilitate this work while minimising costs. These meetings proved the most successful mechanism to consider TAG input, and to provide directions for future work.

**Conclusions and recommendations**

The importance of face-to-face meetings was highlighted, as was the need to closely co-ordinate the timing of meetings to facilitate joint meetings between the different groups. The FSM recommends that the practice of joint meetings between the WP9 and FSM Sub-groups be continued as a mechanism for ensuring that each group remains informed of the other’s activities.

**Item f) – Involve non-member economies in the work of the Sub-group**

A number of non-members were invited to join the Technical Advisory Groups and the Sub-group. While the level of active involvement within the TAGs
from non-member countries was lower than what was envisaged, several non-member participants made valuable contributions to the work of the TAGs. (The Secretariat is reviewing the lessons learned from the process to date so that the dialogue and involvement of non-member countries can be enhanced.)

Conclusions and recommendations

The FSM considers that input of non-member countries' views on the taxation of global electronic commerce is very important. It recommends that other ways of obtaining active non-member involvement in the development of electronic commerce taxation arrangements be pursued. It notes that as part of the process of strengthening non-member involvement, over 100 countries and eight international organisations will be invited to part of the June 2001 Montreal conference “Tax Administrations in an Electronic World” being jointly organised by the OECD, CIAT, CATA, IOTA, CREDAF and Canada’s CCRA. This will be the first such global gathering of revenue authorities and it will be important to use this process to establish and enhance the “voice” of revenue authorities in relation to electronic commerce activities. The FSM suggests that more such meetings and joint working arrangements be organised.

The FSM also recommends that other activities to raise awareness of the issues associated with the taxation of electronic commerce with non-members be pursued as part of the OECD/CFA Outreach programme.

The FSM also proposes that a small number of key non-member economies should be invited to participate in the Sub-group.

Future work proposed

Important first steps have been made towards greater co-operation by revenue authorities on a global scale. The electronic commerce work is an excellent example of the changing role of the CFA and its relationship with revenue authorities in a global context.

Revenue authorities now have a much deeper understanding of the implications for them of “borderless” electronic commerce. The work of the FSM Sub-group and the Technical Advisory Groups has helped to nurture this understanding. Significant progress on moving the Ottawa tax administration implementation options forward towards an agreed revenue authority/CFA position has also been made. The FSM commends all those who have helped progress this work. There is growing realisation and acceptance by all parties of the need to derive solutions that address the global policy issues, but that can be implemented locally.

Much remains to be done. The FSM believes that the positive work of the FSM Sub-group needs to continue and that, without repeating the detail of the
recommendations in Section II, there are several main strategic strands to this future work:

Understanding the electronic commerce environment better

- The FSM recommends that further work on understanding and quantifying the risks posed by electronic commerce is warranted and that the Sub-group should continue to co-ordinate and facilitate activities in the area between members.

- The FSM recommends that the Sub-group review and report on the organisational structures and approaches used by the revenue authorities of Member countries to deal with the tax issues raised by global electronic commerce, with a view to sharing member practices.

- The FSM recommends that the Sub-group should also commission, and continue to co-ordinate, further research into areas where a more detailed understanding of the technology and trading environment is needed, such as into jurisdictional verification methods available in an electronic commerce environment.

- The FSM recommends in particular that the Sub-group co-ordinate further examination of desirable data elements associated with electronic commerce transactions, identified by the PDA TAG, in co-operation with the business community (including major accounting firms), accounting standard-setting bodies, and the International Standards Organisation (ISO).

Improving taxpayer service

- The FSM recommends that revenue authorities actively pursue the taxpayer service implementation options identified at Ottawa, recognising that each country will need to adapt its implementation strategy and timetable to reflect its own domestic legislation and policy environment.

- The FSM recommends that a long-term goal of greater consistency of revenue authority filing requirements would assist in lowering cross-border compliance costs and recommends that the Sub-group facilitate this, building on the experiences of the Copenhagen meeting.

- The FSM recommends that the Sub-group draw up guidance for businesses on how the new technologies may be used to reduce compliance costs by, for example, establishing the reliability and authenticity of electronic data and good management of encryption keys.

Progressing the Ottawa Taxation Framework Conditions

- The FSM recommends that revenue authorities actively examine and appropriately pursue the administrative and compliance implementation options put forward for discussion at Ottawa. The options should now be worked into agreed revenue authority positions, and statements of good
practice, that can be published as such. This would involve, in some instances, spelling out the detail of what is proposed as a revenue authority “standard” in co-operation with other interested parties.

- The FSM recommends that the Sub-group co-ordinate tax administration input to “standards” bodies and similar technological leaders associated (particularly with the WP9 Sub-group) with electronic commerce, appropriately advised by the proposed Technology Panel.

- The FSM recommends that the Sub-group co-ordinate discussions with software developers as to how accounting packages might be enhanced to provide both business and revenue authorities with the assurances they need as to the integrity, reliability and authenticity of electronic data and so help to reduce compliance costs (e.g. via the inclusion of mandatory journal entries for account balance changes, automatic time base message digests, the use of WORM technology, etc.)

- The FSM recommends that the Sub-group continue to facilitate the good work of administrations in collaborating and co-operating in the development of training and tools, such as computer-assisted auditing, in an electronic commerce environment.

The FSM expects that the Montreal conference will provide important input into its discussions on the future work required by revenue authorities.

The FSM asks the Sub-group to prepare a work plan, building on its achievements to date, to progress the recommendations and the future work proposals identified in the second and third sections of this chapter. This should be available to the CFA in June 2001.
Notes

1. In February 2001, this chapter was released to the public for a period of public comment (through June 2001). It is therefore not a final text and should not be cited from or referred to as such.


3. The members of the Sub-group are: Australia, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, Portugal, Spain, Switzerland, United Kingdom (Chair) and the United States.

4. The FSM Knowledge Exchange (FSMKE) is an initiative to provide an Internet-based mechanism for the sharing of information and knowledge amongst OECD Member tax administrations.

5. Australia, Canada and the United Kingdom.

6. Australia, United Kingdom and the United States.

7. Wireless Application Protocol. A mechanism that allows mobile devices, such as phones, to access the Internet.


10. Write Once, Read Many – DVD/CD technology that can only be recorded (burnt) once.
Appendix II

Emerging Trends in Taxpayer Service Initiatives using New Technology

Overview of emerging trends

The Survey of Taxpayer Service Initiatives Using New Technology was distributed to all 29 OECD Member countries in May 2000. It was conducted to catalogue technology initiatives that are providing better service and improving tax administration. The following narrative presents the results of the portion of that survey that dealt with the reduction of taxpayer burden and costs of tax administration.

The Internet and its attendant technologies have transformed the way the world transacts business. This transformation has not only made it easier to navigate in the ever-increasing global economy but it has also raised the expectations of the customer. Customers are becoming familiar with the new capabilities and they are expecting innovative concepts to be employed in all areas of their life, including taxes. It is interesting to note that while the public’s expectations have risen their use and acceptance of electronic alternatives to paper have not grown as rapidly as once hoped. Some of the listed initiatives have addressed this concern and seek to establish a comprehensive plan to remove barriers, increase benefits and broaden the appeal of electronic transactions.

While many of the projects undertaken by the Member countries have been enabled by the existence of the Internet and its emergent technologies some of these initiatives have arisen as a direct result of viewing the taxpayer as a customer. This new perspective offers a whole new approach to tax administration. Using methods employed by the private sector to better serve their customers has spawned a plethora of new ideas for revenue authorities.

This paper documents the trends detected in the world class initiatives promulgated by the countries of the OECD to reduce taxpayer burden and tax administration costs. It should be noted that many of the initiatives perform the dual function of reducing taxpayer burden and reducing the administration costs of the revenue authorities.

In general terms the trends detected are as follows:

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<th>Paper communications</th>
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Overall the human and paper elements are being removed and replaced with automated responses and expert systems employing artificial intelligence. Where the human element remains, efforts are being employed to improve efficiency and to empower employees...
to take actions, which can resolve the inquiry/problem at a single point of contact. Such ini-
tiatives involve allowing employees to access mainframe computers storing total taxpayer
data, providing expert systems to quickly find the answer for the taxpayer, accessing elec-
tronic correspondence to provide timely response and integrating all revenue systems to
communicate with each other.

**Paper communications to electronic communications**

Revenue authorities have introduced in their tax administrations processes that use
electronic media as a substitute for paper forms and manual methods currently in use. In
conjunction with this, technology to facilitate privacy and security is in various stages of test-
ing and employment. Currently a revenue authority has a functional program that permits
businesses to file employment tax returns electronically. Additionally there is a program that
allows individuals to file their income tax returns via the telephone.

**Preparer/assistor to self-help/expert systems**

There is a trend toward empowering taxpayers with the ability to research tax-related
inquiries and to complete returns on their own with minimal or no assistance necessary. One
example is the testing being performed by a revenue authority on “touch panel” public
computers that taxpayers will use in the preparation of their own returns. The system will use
screen prompts and guides.

**Cheques/cash to electronic funds transfer**

Utilising the technologies developed for retail sales transactions, revenue authorities
are enabling taxpayers to satisfy their tax obligations by electronic transmissions.

**Manual responses to automated voice/mail**

Increased use of artificial intelligence software, centralised call systems and Internet
resources to improve service rather than increasing staff years to meet customer needs are
manifestations of a growing trend. One such initiative uses an automatic e-mail management
system to read, route and respond to e-mail inquiries.

**Reactive programs to proactive programs**

Anticipating the needs and wants of customers has generated a host of initiatives. Rather
than trying to remedy situations as they arise revenue authorities are planning in advance to
try and eliminate future problems. For example, resources are being expended to develop
tax interactive web sites for teens and planning web sites specifically tailored to the young
(animation, etc.) and the elderly (large format, etc.).

**Segmented service to integrated/one-stop service**

In an effort to reduce taxpayer burden revenue authorities are exploring ways to mini-
mise the number of contacts with customers and to decrease the time required for such contacts.
Methods such as establishing a single register, via the Internet, of business information for
use by government departments and public sector partnerships are being investigated.
Taxpayer to customer

There is a growing trend toward providing more services to the ultimate user, the taxpayer. By formulating strategy and structuring the tax administration to better serve their customers revenue authorities are becoming more responsive to their market. Citizen advocacy panels, workdays devoted exclusively to taxpayers with chronic problems, and offering incentives for e-filing are only a few examples of this tendency.

Summary of specific initiatives

The initiatives submitted by the Member countries have been categorised in the order listed in Part A above. Many of the initiatives qualify under more than one category. For this paper those initiatives have been listed under the trend in which that initiative was most strongly associated.

The following summary of initiatives provides a wealth of excellent ideas to reduce taxpayer burden and tax administration costs. However, it is possible that due to legal and/or policy concerns not all tax administrations are in a position to implement these initiatives in the same manner or degree. Yet, it is obvious from the responses that much effort is being directed toward these objectives.

Paper communications to electronic communications

- Planning an electronic version of integrated tariff and a knowledge-based expert classification system for customs.
- A major modernisation program for all government agencies to enable all transactions with the government to be electronically done by 2005.
- E-filing of individual tax returns.
- Use of the Internet to provide practitioners/taxpayers the latest in tax-related news and information. The idea is to leverage access to the site to promote e-filing.
- Tax forms by fax.
- Use of customer numbers and home computers to avoid sending any paper to revenue authorities.
- The use of a Personal Identification Number (PIN) as the taxpayer's signature, thus eliminating the need to file the paper signature jurat.
- Public-switch telephone networks followed by encrypted transactions over the Internet.
- Contracting with a private vendor to conduct a test with revenue authority employees using advanced technology, which will provide electronic signatures and enhanced security for e-mail transactions. This will introduce the revenue authority to Public Key Infrastructure (PKI) technology and will help to determine whether and how the revenue authority might use PKI to electronically secure and verify two-way transactions with taxpayers and their representatives.
- Developing electronic customised tax forms for businesses based upon entity information and prior filing history.
- Using a PAYE (pay as you earn) system which electronically withholds the proper amount of taxes from wages, pensions and public benefit payments, and sends a prepared return to the taxpayer to sign (or make changes).
A plan to use financial entities in order to allow the public to file electronically.

Online service for companies to file their tax returns.

Payroll service providers filing of employment tax returns electronically.

Tax practitioners that are authorised to electronically file tax returns with the revenue authority for others. The revenue authority recognises, manages and motivates these practitioners as product and service distributors. In support of this vital channel, the revenue authority seeks to support these practitioners by establishing an Extranet consisting of a management information system, account resolution and tax law capabilities; expanding the marketing support available to them including national advertising and promotional kits; implementing a programme of product and service incentives, rewards and special recognition depending upon their success in marketing electronic tax products and services; and establishing account management programs.

Implementation of a correspondence management system that scans in taxpayer correspondence, classifies it and automatically assigns it on a nation-wide basis. Work is processed electronically and a management reports system is also integrated into it.

Preparer/assistor to self-help/expert systems

- Self-assessment returns over the Internet.
- Software application for the presentation of complex tax rules in an easily accessible format with comprehensive online help.
- Computer validation of basic keying errors and acknowledgement of receipt for tax returns.
- Web sites that provide information and help on tax matters to customers.
- Tax manuals with online availability.
- Interactive questions and answers online.
- Individual taxpayers filing over the telephone.
- Small business filing of employment tax returns over the telephone.
- A revenue authority Internet site that includes message boards, interactive chat and customer care, an online learning lab, and large-scale database support.
- Calculators and online forms: this initiative will continue to develop online calculators to ease burden and reduce errors.
- A Frequently Asked Questions and Answers (FAQ) Database: E-mail tax law questions and answers will be the primary feed for this system. E-mail will be examined and standard answers developed for a searchable base. This base will be used in three ways; first for assistor research and in serving customers (provides consistent and accurate answers). Second, the base will be continuously fed to electronic media for public use. Third, the FAQ’s will be fed back to appropriate revenue authority business functions to immediately improve the quality of products and services.

- An Interactive Help Desk: Under this initiative, the revenue authority will provide help desk services with “triage” capability. The revenue authority will test the capability to interact live with taxpayers on the Internet to resolve problems.

- An “expert” (artificial intelligence) system to allow taxpayers and revenue employees to lookup answers for most tax questions.
A plan to establish “touch panel” public computers for taxpayers to use in preparation of their own electronic returns. The system uses screen prompts and guides.

Planning a sub-site for major life tax events: marriage, living together, registered partner and home purchase.

Cheques/cash to electronic funds transfer
An Internet-payment service.
Electronic depositing of tax deposits.
Electronic paying of balance due returns.
A private vendor processing credit card payments over the telephone. After e-filing by computer – either from home or through a tax preparer – or by telephone, a taxpayer will be able to charge the balance due with a toll-free phone call.

A web site for electronic tax payment enrolments, payments and customer service.

**Manual responses to automated voice/mail**

- Allowing practitioners to resolve client’s cases via e-mail.
- Call centres with toll free telephone assistance – 24 hours a day, 7 days a week. The system distributes calls where capacity is available.
- An automated tax information line with recorded information on 148 tax subjects and automated refund information.
- A revenue authority home page that is used to provide information and to promote initiatives such as e-mail customer service, etc.
- E-mail newsletter type services covering agency wide topics in addition to a local newsletter component that deals with regional issues.
- Virtual communities of interest for Information Exchange Partners such as a service for tax professionals. The services will begin with CD and Internet services and will expand to become increasingly interactive, allowing for electronic exchange of information and ideas and allowing for more immediate feedback and improvement of services.
- An automatic e-mail management system to read, route and respond to e-mail inquiries.
- The use of “list servers” for the automatic registration and delivery of electronic forms publications and bulletins to electronic enrolled clients.
- An inventory of standardised tax letters that can be accessed and then personalised for specific taxpayer responses.
- A plan to allow taxpayers to secure a status report on their tax accounts via automated teller machines (ATMs).
- A plan to send tax news via e-mail.

**Reactive programs to proactive programs**

- Co-operation with private sector producers (software houses, accountancy firms, their clients) to look at encouraging Internet use, challenges to tax administration, etc.
- Software companies offering of free or very low cost federal/state tax preparation and electronic filing services over the Internet.
• Exploring additional security and privacy safeguards to help promote the use of the Internet.
• A committee of private sector stakeholders that provides input on future initiatives.
• A tax interactive web site for teens.
• Outreach programs for targeted audiences.
• Systemic issue resolution.
• An online learning lab. Under this initiative, the revenue authority will improve taxpayer education programmes, particularly for first time taxpayers and students aged 13-18 who learn about taxes in school. An online learning lab has been developed which covers, among many topics, the reasons why individuals pay taxes and how taxpayers can meet their tax obligations. Particularly important is the availability of electronic filing options and teaching electronic filing with electronic filing.
• Planning web sites specifically tailored to the young (animation, etc.) and the elderly (large format, etc.).
• Planning a business centre specifically tailored to new business start-ups.

**Segmented service to integrated/one-stop service**

• One electronic application/registration used by multiple government agencies.
• Business assistance centres. An interactive web-based service encompassing development of portals as a single, integrated means of access to different types of government information and services. Single standard presentation via Internet with appropriate authentication to enter.
• Planning a common e-business infrastructure for all government departments to facilitate taxpayer inquiries, responses and notification to multiple agencies.
• Establishment of an organisation within the revenue authority that exclusively deals with and is responsible for being the focal point of management of existing and planned programmes.
• Consolidating operations at fewer sites; replacing outdated computers.
• Public sector partnerships.
• The revenue authority working with other federal agencies and the local taxing authorities to reduce employer burden by improving customer service, establishing a harmonised wage code database, and developing a pilot for single point filing of federal and local employment returns.
• All customer service employees having mainframe access, allowing one-stop service for taxpayers. Individual notes and customer contact history can be entered.
• Central and local authorities working together to provide customers with the right services.
• A single register of business information for use by government departments, available primarily over the Internet.
• A small business CD-ROM: The revenue authority will be undertaking a number of cross-government initiatives for one-stop service starting with a cross-government CD-ROM for start-up businesses. The CD will be useful for anyone who is starting a new business and will provide information from a variety of government agencies.
**Taxpayer to customer**

- A discount of tax paid on returns filed over the Internet.
- Aggressive marketing by the revenue authority – paid advertising, broadening its trade show agenda, launching a business product marketing strategy.
- Incentives for e-filing.
- Operating more like the private sector.
- Private sector partnerships.
- Saturday walk-in assistance.
- Volunteer programmes.
- Taxpayer advocate programme.
- Citizen advocacy panels.
- Problem solving days.
- Allowing the taxpayer to check a box on the return to permit the revenue authority to contact the preparer of the return directly in the event of any questions.
- Increasing the monetary threshold required for tax deposits.
- Making available, through libraries, schools and community centers, public access to the Internet, for those taxpayers that do not have personal access.
- A corporate partnership programme: This program provides CD-ROMs of revenue authority tax products to large businesses which place the CDs on their internal networks and offer free access to their employees. Other federal and local government entities may also join the programme.
- Public and private library services: The library programme currently provides revenue authority CD-ROMs to public libraries. The revenue authority plans to add web-based and e-mail services to assist librarians in distributing tax information.
- Planning use of assisted chat sessions and “push” technology to ensure that clients using/browsing the web site can receive personalized service.
- A tax program disc for distribution to the public that calculates and estimates annual income and taxes.
- Planning a major multimedia audio/visual tax campaign to “target groups” using TV, radio, discs, videotapes, Internet, etc., in multiple languages.
The FSM did not have sufficient time to consider these findings in detail, but believes that they provide a sound starting point for the next stage of the exercise.

The Technology TAG undertook a range of work with the Consumption Tax TAG and the WP9 Sub-group on Electronic Commerce in examining the technological implications of the various collection models considered for collecting taxes on cross-border electronic commerce transactions. This work is brought together in this appendix to summarise the Technology TAG’s conclusions at this point in time.

Conclusions of the Technology TAG regarding consumption tax collection models

The Technology TAG sees the self-assessment model as impractical for business to consumer transactions.

The remaining proposals have strengths in particular areas and inherent weaknesses. For example, the registration model is strong in minimising government administration costs, but business is left with a large burden in being able to correctly identify the consumer’s jurisdiction to correctly levy a consumption tax. The costs involved in potentially registering and complying with up to 120 jurisdictions’ tax systems are also abhorrent to businesses facing this prospect. The registration model is seen as a damper on the growth of e-business. This weakness from a business perspective is seen as a strength of the tax and transfer model.

The work of the Technology TAG on the modules or activities required to calculate and collect consumption tax led to them identifying a hybrid model with elements of the collection models being appropriately combined to result in a more practical collection model. The work to develop this hybrid would involve a further analysis of the technological alternatives for successfully implementing each of the six broad activities or modules identified.

Proposed future work

Members of the Technology TAG have had some discussions around where the TAG’s work should progress in the future. They believe that there are a number of factors which should underlie future work in this area:

- There is little tax revenue at stake currently in end-to-end (B2C) online downloads.
- Technology, as existing and commercially diffused today, does not provide robust jurisdictional identification or verification methods for such downloads. Promising technologies have been identified which are likely to be deployed in the medium term.
• There is a need to keep working on these issues as a priority in order to assure a level playing field for all market participants in cross border transactions and the ability to collect revenue when such trade becomes more substantial.

• The emphasis needs to be on identifying solutions that could be deployed for cost effective compliance. TAG participants cautioned strongly against solutions that are incapable of robust verification, that are overly burdensome in terms of cost or complexity or not supported by independent commercial rationales for the collection of information.

This background and participants experiences to date led to the TAG identifying the following areas as offering potential and warranting further examination:

• Examine viable short-term solutions which may not be “technological solutions’ as such (e.g. the use of a merchant’s internal databases).

• Further study of global IPv6 numbering including examination of the potential for geographic links to be inherent to IPv6 numbers.

• Complete a catalogue of third party tax services providers to document what is currently available and to provide this information to merchants.

• Need for further study of digital certificates and what models may make sense for use by tax authorities.

• Issues related to use and recognition of digital certificates in cross border situations; roles of government and private sector in providing certification authority (CA) and registration services.

• More detailed review of the impact of wireless technologies and the impact of greater bandwidth availability.

• Ongoing monitoring to ensure that:
  – OECD directions correlate with changes in technology and commercial business models; and
  – New technologies that could be harnessed to help address the taxation challenges of electronic commerce is identified.
Appendix IV

Summary of Recommendations of the Professional Data Assessment
(Technical) Advisory Group

Set out below are the recommendations made by the PDA TAG. The FSM did not have sufficient time to consider these recommendations in detail, but believes that they provide a sound starting point for the next stage of the exercise. It also expects and encourages comments from both Government and private sector on the desirability and feasibility of the PDA TAG proposals.

Data access

There should be continued monitoring of remote access technologies by public sector and private sector auditors with a view to incorporating discussion of remote access into appropriate standards or training material.

In order to alleviate the concern that confidential data could be compromised, all relevant parties, including auditors and management, should be trained on best practices for e-commerce and web security, particularly regarding mechanisms to minimise the risks associated with accessing business data.

Businesses should be encouraged to use prudential systems for the management of encryption keys.

Internal control

In the context of small and medium sized enterprises, tax administrations should work with software developers to encourage the incorporation of internal controls in their products for use in e-commerce trading.

Tax administrations should encourage the use of new assurance technologies such as time stamping on the grounds that its adoption can give greater assurance over the integrity of data when combined with other systems controls.

Tax administrations should also engage with software developers to encourage the adoption of time stamping technologies within their software design.

Tax administrations should encourage business to adopt strong authentication measures using technologies such as PKI.

Substantive tests

In clients with good internal controls, fiscal auditors should consider placing greater reliance on the system controls and the use of less intrusive tests.

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In clients with weak internal controls, fiscal auditors should examine the use of computer assisted audit techniques where these will give reasonable audit assurance at a reduced compliance cost to the client.

**Current auditing standards and guidelines**

Tax administrations should continue to monitor new standards from standard setting bodies, best practices from the private sector and any emerging protocols.

Tax administrations should provide input, as appropriate, to standard setting bodies and other relevant parties.

**Approach to audits and auditor training and development**

Public sector and private sector auditors working in the electronic environment of e-commerce must be provided with the requisite training in order to understand that environment, to employ the correct computer-assisted audit tools and techniques, including web-based technologies and, to conduct systems audits.

Public sector and private sector auditors need to be trained in data assurance mechanisms and understand what assurances these mechanisms provide in an audit context and they must also know how to audit the relevant mechanisms.

Consideration should be given by the OECD to conducting a further survey at some future stage to assess the level of experience of auditors in the e-commerce environment.

**Desirable data elements**

The list of desirable data elements for tax invoices should be provided to the appropriate fora considering Consumption Tax issues at the OECD and elsewhere, as an aid in the furtherance of their work.

The list of elements should be issued by the OECD in the form of an information or best practice note.

The list of elements should be refined and incorporated into a de facto protocol such as XML or other protocols.

Tax administrations should approach software developers and standards bodies with a view to ensuring that the list of elements is considered in the development of appropriate systems and standards.
Chapter 4

Application of Tax Treaty Concepts to Electronic Commerce

4.1. Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on Article 5

Introduction

This section (4.1) contains the changes to the Commentary on the OECD Model Tax Convention adopted by the Committee on Fiscal Affairs on 22 December 2000 concerning the issue of the application of the current definition of permanent establishment in the context of e-commerce. It follows two previous drafts which were released for comments by Working Party No. 1 in October 1999 and March 2000.

The Committee wishes to thank the individuals, organisations and non-member countries that have sent comments on the previous drafts. These comments have helped the Working Party to draft the changes to the Commentary on Article 5, which are included in this section. The comments that were received from non-member countries lead the Committee to believe that these changes reflect interpretations that have wide support both among OECD and non-OECD countries.

The conclusions reflected in this section have been reached after a thorough analysis of the various conditions underlying the current treaty definition of permanent establishment having regard to work done over the last few years by the Working Group on Permanent Establishments. When drafting the changes included in this section, the Working Party has taken care to ensure that its interpretation of these conditions in the context of e-commerce remained fully consistent with the views of its Member countries on the application of these conditions to more traditional business operations.

The Committee wishes to stress that the changes included in this section deal exclusively with the permanent establishment definition as it currently appears in Article 5 of the OECD Model Tax Convention. The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce has been given the general
mandate “to examine how the current treaty rules for the taxation of business prof-
its apply in the context of electronic commerce and examine proposals for alterna-
tive rules”. The Committee looks forward to receiving the views of the TAG on the
more important issue of whether any changes should be made to that definition or
whether the permanent establishment concept should be abandoned. The work
of that group will assist the Committee in deciding whether changes need to be
made to the Model Tax Convention to address this broader issue.

The Committee also looks forward to receiving the views of that TAG and the
conclusions of Working Party No. 6 on the Taxation of Multinational Enterprises on
the issue of how much income should be attributed to electronic commerce oper-
ations carried on through computer equipment in circumstances where there
would be a permanent establishment.

As this section shows, the Committee has been able to reach a consensus on
the various issues concerning the application of the current definition of perma-
nent establishment in the context of e-commerce (subject to the two dissenting
views described at the end of this paragraph and below). This consensus includes
the important views that a web site cannot, in itself, constitute a permanent estab-
lishment, that a web-site hosting arrangement typically does not result in a per-
manent establishment for the enterprise that carries on business through that web
site and that an ISP will not, except in very unusual circumstances, constitute a
dependent agent of another enterprise so as to constitute a permanent establish-
ment of that enterprise. However, Spain and Portugal do not consider that physi-
cal presence is a requirement for a permanent establishment to exist in the
context of e-commerce, and therefore, they also consider that, in some circum-
stances, an enterprise carrying on business in a State through a web site could be
treated as having a permanent establishment in that State. That is why Spain and
Portugal look forward to the results of the work of the TAG on Monitoring the
Application of Existing Treaty Norms for the Taxation of Business Profits in the
Context of Electronic Commerce as regards the issue of whether changes to the
definition of permanent establishment should be made to deal with e-commerce.

As a number of commentators and Delegates have noted, it is unlikely that
much tax revenues depend on the issue of whether or not computer equipment at
a given location constitutes a permanent establishment. In many cases, the ability
to relocate computer equipment should reduce the risks that taxpayers in e-com-
merce operations be found to have permanent establishments where they did not
intend to. Also, in circumstances where a taxpayer would want to have income
attributed to a country where its computer equipment is located, that result can
be achieved through the use of a subsidiary even if no permanent establishment
is considered to exist. It is crucial, however, that taxpayers and tax authorities
know where the borderlines are and that taxpayers not be put in a position to
have a permanent establishment in a country without knowing that they have a
business presence in that country (a result that is avoided by the conclusion that a web site cannot, in itself, constitute a permanent establishment).

Since a large part of the draft released in March 2000 discussed a minority view that some human intervention was required for a permanent establishment to exist, and since many commentators have argued that this was the case, the Committee wishes to explain the position reached on that issue and reflected in the changes that have been adopted.

Having further examination of the issue, the conclusion has been reached that human intervention is not a requirement for the existence of a permanent establishment.

There is no specific reference to human intervention in paragraph 1 of Article 5 but it has been argued that the Commentary on Article 5, in particular paragraphs 2 and 10 thereof, imply that there is a requirement of human intervention for a permanent establishment to exist. The Committee concluded, however, that the Commentary does not support this view.

The relevant part of paragraph 2 reads as follows:

“The definition, therefore, contains the following conditions:

[...]

the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.”

Although electronic commerce is developing rapidly, this statement is still accurate, i.e. usually, enterprises that have fixed places of business carry on their business through personnel. This, however, does not, and was not intended to, rule out that a business may be at least partly carried on without personnel.

The same applies as regards to paragraph 10. According to the Committee, the example provided in that paragraph clearly supports the conclusion that no human intervention is required for a permanent establishment to exist. Also, the first sentence (“The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel)”) is still an accurate statement of how business operates but, again, does not rule out that a business may be at least partly carried on without personnel. Finally, the Committee believes that a requirement of human intervention could mean that, outside the e-commerce environment, important and essential business functions could be performed through fixed automated equipment located permanently at a given location without a permanent establishment being found to exist, a result that would be contrary to the object and purpose of Article 5.
The changes to the Commentary on Article 5 which appear below make it clear that, in many cases, the issue of whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis. Some countries did not like that outcome and the uncertainty that may result from it. They suggested that, in the case of e-tailers, it would have been better to simply conclude that a server cannot, by itself, constitute a permanent establishment. In order to reach a consensus, however, most of these countries have accepted the view expressed above, noting that they will take into account the need to provide a clear and certain rule in their own appreciation of what are preparatory or auxiliary activities for an e-tailer. The United Kingdom, however, has taken the view that in no circumstances do servers, of themselves or together with web sites, constitute permanent establishments of e-tailers, and it intends to make an observation to that effect when the changes to the Commentary on Article 5 are included in the Model Tax Convention.

In order to illustrate that it is possible for functions performed through computer equipment to go beyond what is preparatory or auxiliary, an example has been included in the last sentence of paragraph 42.9. It was noted during the discussion that this example is merely illustrative and should not be considered to determine the point at which the preparatory or auxiliary threshold is exceeded, since many countries consider that this could be the case even if only some of the functions described in that example are performed through the equipment.

Changes to the commentary on Article 5

Add the following heading and paragraphs 42.1 to 42.10 immediately after paragraph 42 of the Commentary on Article 5

“Electronic commerce

42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a
“place of business” as there is no “facility such as premises or, in certain instances, machinery or equipment” (see paragraph 2 above) as far as the software and data constituting that web site are concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise that operates that server.

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5 Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that
enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraphs 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

- Providing a communications link – much like a telephone line – between suppliers and customers.
- Advertising of goods or services.
- Relaying information through a mirror server for security and efficiency purposes.
- Gathering market data for the enterprise.
- Supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling
products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph."

4.2. Treaty characterisation issues

Introduction

The Technical Advisory Group (TAG) on Treaty Characterisation Issues arising from Electronic Commerce was set up by the OECD Committee on Fiscal Affairs in January 1999 with the general mandate "to examine the characterisation of various
types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary.\(^2\)

The TAG (or “Group”) met four times on 22-24 September 1999; 17-18 February 2000, 3-4 July 2000 and 7-8 November 2000. During its first two meetings, it identified a number of typical e-commerce transactions and analysed the various treaty characterisation issues that could arise from these. The result of that work was a document which described 26 categories of transactions together with the analysis and preliminary conclusions of the Group. That document was released for comments on 24 March 2000.

At its meeting of 3-4 July, the TAG continued its work on the basis of these comments. This allowed the TAG to narrow down areas of disagreement between its members, to revise its list of transactions and to draft some general conclusions on treaty characterisation issues. The results of that work were included in a document which was released for comments on 1 September 2000. That document described the various treaty characterisation issues that were identified by the Group and presented the views of the Group concerning these issues; it also included a revised analysis of the various categories of typical e-commerce transactions identified in the previous draft.

After further analysis, and having regard to the comments received, the Group, at its last meeting, was able to reach a consensus and to finalise this report to the Working Party.

This section is divided as follows:

- The next subsection includes the overall recommendation that the TAG makes to Working Party No. 1 on Tax Conventions and Related Questions (“Working Party No. 1”).
- The following subsection constitutes the main part of the report and includes a description of the various treaty characterisation issues identified by the Group, together with the conclusions of the Group on how to address each such issue and, where appropriate, suggestions for changes to the Commentaries on the Model Tax Convention.
- Appendix I to this chapter reproduces all the suggestions for changes to the Commentaries on the Model Tax Convention which are found throughout the main part of this chapter.
- Appendix II to this chapter is a revised version of the document first released on 24 March, which now includes the Group’s analysis of 28 categories of typical e-commerce transactions.\(^3\)
- Appendix III to this chapter reproduces the mandate given to the Group by the OECD Committee on Fiscal Affairs and includes the list of persons who participated in its meetings.
Recommendation to Working Party No. 1

During its work, the Group has examined characterisation issues that are relevant to the OECD Model Tax Convention as currently drafted and also some issues that relate to alternative treaty provisions not found in the Model Tax Convention. Its recommendation covers both sets of issues.

The TAG recommends to Working Party No. 1 to issue a document clarifying, along the lines of the main body of this section, how the various tax treaty characterisation issues arising from e-commerce should be solved. In doing so, and since the mandate of the TAG invited it to examine these characterisation issues “with a view to providing the necessary clarifications in the Commentary”, the Working Party is invited to take account of the suggestions for changes to the Commentary of the OECD Model Tax Convention which are included in this section (these suggestions are all reproduced in Appendix I to this chapter). The Working Party is also invited to take account of the conclusions of this section concerning various provisions which are not part of the OECD Model Tax Convention but are found in some bilateral conventions.

Treaty characterisation issues arising from e-commerce transactions

This section describes the various treaty characterisation issues that were identified by the Group in the course of its work and presents the views of the Group concerning these issues.

Throughout its work, the Group has assumed that all payments made in connection with the typical e-commerce transactions that it identified were received in the course of carrying on a business, whether or not the payers were themselves carrying on business. It follows that all these payments are capable of falling within Article 7 of the OECD Model Tax Convention, which deals with business profits. Some payments, however, may be taken out of Article 7 by the rule of paragraph 7 of Article 7, which gives priority to any other Article that expressly deals with the specific type of income concerned. One such Article is Article 12, dealing with royalties. On the basis of its analysis, the Group does not consider that any of the payments that it has examined fall within Article 21, which deals with other income.

Business profits and royalties

The definition of royalties currently found in paragraph 2 of Article 12 of the OECD Model Tax Convention reads as follows:

“The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work.
including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”

In the 1977 Double Taxation Convention, that definition also included “payments [...] for the use, or the right to use, industrial, commercial or scientific equipment” and some bilateral conventions still include this previous definition of royalties.

This section analyses classification issues arising from the possible application of various elements of these two definitions to payments made in e-commerce transactions. It also examines classification issues arising from alternative treaty provisions which deal with the provision of services or technical fees.

Business profits and payments for the use of, or the right to use, a copyright

- Analysis and conclusions

The Group found that one of the most important characterisation issues arising from e-commerce was the distinction between business profits and the part of the treaty definition of “royalties” that deals with payments for the use of, or the right to use, a copyright. Whilst differing views were originally expressed within the Group as regards this issue (as reflected in the March and September 2000 drafts for comments), further discussion in light of the comments received allowed the Group to reach the unanimous conclusions below. These are fully consistent with the views, which the Group has unanimously endorsed, that are expressed in paragraphs 14 to 14.2 of the Commentary on Article 12 as regards software payments.

Since the definition of royalties applies to “payments for” any of the various items listed in that definition, the Group has concluded that, in any given transaction, the main question to be addressed is the identification of the consideration for the payment. Under the relevant legislation of some countries, transactions which permit the customer to electronically download computer programs or other digital content may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer’s computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for treaty purposes. This would be the case, for instance, where a payment is made by a person for the downloading and the operation of a copy of a computer program. Whilst electronic downloading of the program may or may not constitute the use of a copyright by the user (as opposed to by the provider) depending on the
relevant copyright law and contractual arrangements, the essential consideration for the payment is not that possible use of a copyright.

In the case of transactions that permit the customer to electronically download digital products (such as software, images, sounds or text), the payment is made to acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquiror. This constitutes the essential consideration for the payment. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

- Suggested changes to the Commentary

Based on the following, the Group suggests that the following changes be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Add the following paragraphs 17.1 to 17.4 immediately after paragraph 17 of the Commentary on Article 12:

"17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of the consideration for the payment.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software,
images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is made to acquire data transmitted in the form of a digital signal for the acquiror's own use or enjoyment. This constitutes the essential consideration for the payment, which therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content."

Business profits and payments for know-how

- Analysis and conclusions

Whilst e-commerce transactions resulting in know-how payments are relatively rare, in some transactions, it is necessary to distinguish whether the consideration for a payment is the provision of services or the provision of know-how (i.e. information concerning industrial, commercial or scientific experience).

The Group noted that paragraph 11 of the Commentary on Article 12 refers to the following key elements to identify transactions for the provision of know-how:

- According to the ANBPPI [Association des Bureaux pour la Protection de la Propriété Industrielle], know-how is "undivulged technical information that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how
represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique”.

• “In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public.”

• “In the know-how contract “the grantor is not required to play any part himself in the application of the formula ... and ... does not guarantee the results thereof.”

• The provision of know-how must be distinguished from the “provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party”.

The paragraph also includes the following examples of payments which should not be considered to be received as consideration for the provision of know-how but rather, for the provision of services:

• Payments obtained as consideration for after-sales service.
• Payments for services rendered by a seller to the purchaser under a guarantee.
• Payments for pure technical assistance, and
• Payments for an opinion given by an engineer, an advocate or an accountant.

Applying these criteria and examples to e-commerce transactions, the Group agrees that, for instance, online advice, communications with technicians and using the trouble-shooting database, would clearly involve actual services being performed on demand rather than the provision of know-how.

The Group recognises that the distinction between payments for services rendered and payments for the supply of know-how may sometimes raise practical difficulties. It considers that the following criteria, developed in a ruling by the Australian Tax Office, may be useful in that respect:

• Under a contract for the supply of know-how:
  
  a) A “product” (i.e. knowledge, information, technique, formula, skills, process, plan, etc.) which has already been created or developed or is already in existence is transferred.

  b) The product which is the subject of the contract is transferred for use by the buyer (i.e. it is supplied); and

  c) Except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to others.
By contrast, in a contract involving the performance of services:

d) The contractor undertakes to perform services which will result in the creation, development or the bringing into existence of a product (which may or may not be know-how).

e) In the course of developing a product, the contractor would apply existing knowledge, skill and expertise – there is not a transfer (i.e. supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes; and

f) The product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. However, in the course of rendering services the contractor would, in most cases, also produce as a by-product a work (e.g. plan, design, specification, report, etc., – which could contain knowledge, etc. not otherwise known to the buyer and which may or may not be protected by patents, etc.) in which copyright would subsist. Unless specifically agreed otherwise, the contractor is the owner of such copyright and the buyer or any other person is, by law, precluded from using the property in which the copyright subsists for any purpose other than the purpose for which it was originally designed without first obtaining the approval of the contractor. This would not alter the nature of the contract which would remain one for the performance of services.

Another very important factor is the incidence of cost, i.e. both the level and the nature of the expenditure incurred by the seller:

g) In most cases involving the supply of know-how which is already in existence there would appear to be very little more which needs to be done by the supplier other than to copy existing material [...] On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure.

h) A contract for the performance of services would, depending on the nature of the services to be rendered, involve the contractor in such items of expenditure as salaries and wages to employees engaged in researching, designing, testing, drawing and other associated activities, payments to sub-contractors for the performance of similar services, etc.

These factors all point to the one main distinctive feature of know-how – that it is an asset and, as such, it is something which is already in existence and is not something brought into being in pursuance of the particular contract.5

The Group also considers that the following excerpt of the “software regulations”, which US Internal Revenue Service and Treasury issued in 1998 regarding the characterisation of income from cross-border transactions involving computer
programs, provides useful criteria to distinguish payments for services and payments for know-how as regards e-commerce transactions related to computer programs. Those regulations deal with the distinction between the provision of services (for the development or modification of the computer program) and the provision of know-how (relating to computer programming techniques) in the following words:

“Provision of services. The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described [above] is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

Provision of know-how. The provision of information with respect to a computer program will be treated as the provision of know-how... only if the information is:

1. Information relating to computer programming techniques.
2. Furnished under conditions preventing unauthorised disclosure, specifically contracted for between the parties; and
3. Considered property subject to trade secret protection.”

Example…

“i) Facts. Corp A, a US corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

ii) Analysis. This transaction contains the elements of know-how specified [above]. Therefore, this transaction will be treated as the provision of know-how.”

Suggested changes to the Commentary

The Group considers that it would be useful to provide greater guidance in the Commentary, on the basis of the above criteria and factors, on the distinction to be made between payments for the provision of know-how and payments for
the provisions of services. It therefore suggests that the following changes be
made to the Commentary on Article 12 of the OECD Model Tax Convention:

Replace paragraph 11 of the Commentary on Article 12 by the following para-
graphs 11 to 11.5 (additions to the existing text of paragraph 11 appear in bold italics):

“11. In classifying as royalties payments received as consideration for infor-
mation concerning industrial, commercial or scientific experience, paragraph 2
alludes to the concept of “know-how”. Various specialist bodies and authors
have formulated definitions of know-how which do not differ intrinsically. One
such definition, given by the “Association des Bureaux pour la Protection de la Pro-
priété Industrielle” (ANBPPI), states that “know-how is all the undivulged tech-
nical information, whether capable of being patented or not, that is necessary
for the industrial reproduction of a product or process, directly and under the
same conditions; inasmuch as it is derived from experience, know-how repre-
sents what a manufacturer cannot know from mere examination of the product
and mere knowledge of the progress of technique”.

11.1 In the know-how contract, one of the parties agrees to impart to the other,
so that he can use them for his own account, his special knowledge and experi-
ence which remain unrevealed to the public. It is recognised that the grantor is
not required to play any part himself in the application of the formulas granted
to the licensee and that he does not guarantee the result thereof.

11.2 his type of contract thus differs from contracts for the provision of ser-
vices, in which one of the parties undertakes to use the customary skills of his
calling to execute work himself for the other party. Payments made under the
latter contracts generally fall under Article 7.

11.3 The need to distinguish these two types of payments, i.e. payments for the
supply of know-how and payments for the provision of services, sometimes gives
rise to practical difficulties. The following criteria are relevant for the purpose of
making that distinction:

• Contracts for the supply of know-how concern information that already exists or
concern the supply of information after its development or creation and include
provisions concerning the confidentiality of that information.

• In the case of contracts for the provision of services, the supplier undertakes to
perform services which may require the use, by that supplier, of special
knowledge, skill or expertise but not the transfer of such special knowledge,
skill or expertise to the other party.

• In most cases involving the supply of know-how, there would generally be very
little more which needs to be done by the supplier under the contract other than
to supply existing information or reproduce existing material. On the other
hand, a contract for the performance of services would, in the majority of cases,
involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

- In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- Payments obtained as consideration for after-sales service.
- Payments for services rendered by a seller to the purchaser under a guarantee.
- Payments for pure technical assistance.
- Payments for an opinion given by an engineer, an advocate or an accountant, and

- Payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database.

11.5 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole
amount of the consider-ation the treatment applicable to the principal part.”
[Suggested changes to this last sentence are discussed below.]

Business profits and payments for the use of, or the right to use, industrial, commercial or scientific equipment

• Analysis and conclusions

As already mentioned, a number of bilateral conventions include a definition of royalties that covers “payments for the use of, or the right to use, industrial, commercial or scientific equipment” even though these words are no longer found in the definition of the current OECD Model Tax Convention. 6

Digital products

The Group examined a few transactions where the issue could arise whether the words “payments for the use of, or the right to use, industrial, commercial or scientific equipment” covered payments for time-limited use of a digital product (e.g. category 5 dealing with limited duration software and other digital information licenses).

The members of the Group all agreed that payments for such use of digital products cannot be considered as payments “for the use of, or the right to use, industrial, commercial or scientific equipment” on the basis of one or more of the following reasons:

– Because digital products cannot be considered as “equipment”, either because the word “equipment” can only apply to a tangible product (and the fact that the digital product is provided on a tangible medium would not change the fact that the object of the transaction is the acquisition of rights to use the digital content rather than rights to use the tangible medium) or because the word “equipment”, in the context of the definition of royalties, applies to property that is intended to be an accessory in an industrial, commercial or scientific process and could not therefore apply to property, such as a music or video CD, that is used in and for itself.

– Because such products cannot be viewed as “industrial, commercial or scientific”, at least when provided to the private consumer. Based on the nature of these products or the purpose of their acquisition by the users, these members believe that products such as games, music or videos cannot be considered as “industrial, commercial or scientific”; or

– Because the payments involved in that type of transaction generally cannot be considered to be “for the use, or the right to use” the product since these words do not apply to a payment made to definitively acquire a property
designed to have a short useful life, which is the case for most of these products, e.g. where someone acquires a video game CD that is programmed to become unusable after a certain period of time.

Computer equipment

The Group also examined a few transactions where it could be argued that tangible computer equipment (hardware) was being used by a customer so as to allow the relevant payment to be characterised as “payments for the use of, or the right to use, industrial, commercial or scientific equipment” (see categories 7, 8, 9, 11 and 13 in Appendix II to this chapter).

The Group examined various factors used to distinguish rental from service contracts for purposes of section 7701(e) of the US Internal Revenue Code and found these factors to be useful for purposes of determining whether payments are for “the use of, or the right to use, industrial, commercial or scientific equipment”. Once adapted to the transactions examined by the Group, these factors, which indicate a lease rather than the provision of services, can be formulated as follows:

a) The customer is in physical possession of the property.

b) The customer controls the property.

c) The customer has a significant economic or possessory interest in the property.

d) The provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.

e) The provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

f) The total payment does not substantially exceed the rental value of the computer equipment for the contract period.

This is a non-exclusive list of factors, and some of these factors may not be relevant in particular cases. All relevant facts bearing on the substance of the transaction should be taken into account when determining whether the agreement is a service contract or a lease.

Applying these factors to application service provider transactions, the Group concluded that these should generally give rise to services income as opposed to rental payments. In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which the software is loaded, provides access to many customers to the same equipment, and has the right to update and replace the software at will. The customer may not have possession or control over the software or the equipment.
will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.

Likewise, data warehousing transactions should be treated as services transactions. The vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

Provision of services

- Analysis and conclusions

Whilst the OECD Model Tax Convention does not deal separately with payments for the provision of services, the distinction between these payments and payments made as consideration for the acquisition of property is relevant for certain bilateral conventions as well as for some domestic tax law purposes. The Group therefore considered it useful to discuss the distinction between the provision of services and transactions resulting in the acquisition of property, noting that the preceding subsection already dealt with the particular question of the distinction between a rental of property and the provision of services.

The basic distinction between, on the one hand, a transaction resulting in the acquisition of property and, on the other hand, a transaction in services is whether the consideration for the payment is the acquisition of property from the provider. In this regard, a transaction resulting in the acquisition of property should be understood to include a transaction where a digital product (such as a copy of electronic data, a software program, digitised music or video images, and other forms of digital information and content), whether provided on a tangible medium or in the form of a digital signal, is acquired by a customer.

Generally speaking, if the customer owns the relevant property after the transaction, but the property was not acquired from the provider, then the transaction should be treated as a services transaction. For example, if one party engages another party to create an item of property that the first party will own from the moment of its creation, then no property will have been acquired by the first party from the other and the transaction should be characterised as the provision of services.

The Group recognised, however, that if one party acquires property from another party, the transaction should nonetheless be characterised as a services transaction to the extent that the predominant nature of the transaction is the provision of services and the acquisition of property is merely ancillary. This would be the case, for example, where the relevant property itself has little intrinsic value.
and the provider creates value through the exercise of its particular talents and skills to create a unique result for the acquiror. Online consulting or other professional services is an example of an electronic commerce transaction that typically results in services income. In these transactions, the customer usually does not acquire any form of property from the other party. If the customer does acquire property, such as a report, it most likely will have been created specifically for him and arguably was owned by the customer from the moment of its creation. If, however, the customer acquires a valuable report or other property that was not created specifically for that customer, then the transaction could give rise to income from the sale of property. For example, the sale of the same investment report or other high-value proprietary information to many customers should be treated as a sale of property rather than a service. Even if the customer obtained the report electronically by downloading it from a database of reports maintained on the vendor's server, the essential consideration would still be to acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquiror rather than to obtain a service.

Technical fees

- Analysis and conclusions

The Group discussed how various e-commerce payments would be treated under alternative treaty provisions that allow source taxation of “technical fees”.

Whilst these provisions may be drafted differently, they often include the following definition:

“The term ‘technical fees’ as used in this Article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any service of a technical, managerial or consultancy nature.”

Alternative formulations of provisions dealing with technical fees typically limit the application of these provisions to some categories of services that could fall within the scope of the definition above. For these reasons, the Group decided to restrict its analysis to that definition so as to try to clarify the limits of application of these provisions. In doing so, the Group examined separately the three different types of services referred to in the definition, i.e. technical services, managerial services and consultancy services.

Technical services

For the Group, services are of technical nature when special skills or knowledge related to a technical field are required for the provision of such services. Whilst techniques related to applied science or craftsmanship would generally correspond to such special skills or knowledge, the provision of knowledge acquired in fields
such as arts or human sciences would not. As an illustration, whilst the provisions of engineering services would be of a technical nature, the services of a psychologist would not.

The fact that technology is used in providing a service is not indicative of whether the service is of a technical nature. Similarly, the delivery of a service via technological means does not make the service technical. This is especially important in the e-commerce environment as the technology underlying the Internet is often used to provide services that are not, themselves, technical (e.g. offering online gambling services through the Internet).

In that respect, it is crucial to determine at what point the special skill or knowledge is used. Special skill or knowledge may be used in developing or creating inputs to a service business. The fee for the provision of a service will not be a technical fee, however, unless that special skill or knowledge is required when the service is provided to the customer. For example, special skill or knowledge will be required to develop software and data used in a computer game that would subsequently be used in carrying on the business of allowing consumers to play this game on the Internet for a fee. Similarly, special skill or knowledge is used to create a troubleshooting database that customers will pay to access over the Internet. In these examples, however, the relevant special skill or knowledge is not used when providing the service for which the fee is paid, i.e. allowing the consumer to play the computer game or consult the troubleshooting database.

Many categories of e-commerce transactions similarly involve the provision of the use of, or access to, data and software (see, for example, categories 7, 8, 9, 11, 13, 15, 16, 20 and 21 in Appendix II to this chapter). The service of making such data and software, or functionality of that data or software, available for a fee is not, however, a service of a technical nature. The fact that the development of the necessary data and software might itself require substantial technical skills is irrelevant as the service provided to the client is not the development of that data and software (which may well be done by someone other than the supplier) but rather the service of making the data and software available to that client. For example, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. A payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

Managerial services

The Group considers that services of a managerial nature are services rendered in performing management functions. The Group did not attempt to give a definition of management for that purpose but noted that this term should receive its normal business meaning. Thus, it would involve functions related to how a business is
run as opposed to functions involved in carrying on that business. As an illustration, Whilst the functions of hiring and training commercial agents would relate to management, the functions performed by these agents (i.e. selling) would not.

The comments in paragraphs 40 to 42 above are also relevant for the purposes of distinguishing managerial services from the service of making data and software (even if related to management), or functionality of that data or software, available for a fee. The fact that this data and software could be used by the customer in performing management functions or that the development of the necessary data and software, and the management of the business of providing it to customers, might itself require substantial management expertise is irrelevant as the service provided to the client is neither managing the client’s business, managing the supplier’s business nor developing that data and software (which may well be done by someone other than the supplier) but rather making the software and data available to that client. The mere provision of access to such data and software does not require more than having available such a database and the necessary software. A payment relating to the provision of such access would not, therefore, relate to a service of a managerial nature.

Consultancy services

For the Group, “consultancy services” refer to services constituting in the provision of advice by someone, such as a professional, who has special qualifications allowing him to do so. It was recognised that this type of services overlapped the categories of technical and managerial services to the extent that the latter types of services could well be provided by a consultant.

Mixed payments

- Analysis and conclusions

The Group identified a number of e-commerce transactions where the consideration of the payment could be considered to cover various elements (e.g. the software maintenance transactions described in category 12). It noted the principles for dealing with mixed contracts which are set out in paragraph 11 of the Commentary on Article 12.

It also noted, however, that the last sentence of the paragraph provides that “it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part” where “the other parts [...] are only of an ancillary and largely unimportant character”. The Group considers that it would be more practical, as well as more consistent with the conclusions put forward in the recently approved changes to the Commentary on Article 12, to provide that, in
such circumstances, the treatment applicable to the principal part should generally be applied to the whole consideration.

Some members of the Group took the view that, in most e-commerce transactions, the treaty classification applicable to the predominant element of the payment involved should be applied to the whole of that payment. These members noted that where as a commercial matter the transaction is regarded as a single transaction, an obligation to break down the payments involved in these transactions would impose an unreasonable compliance burden on taxpayers, especially for consumer transactions that involve relatively small amounts of money. Whilst the Group invited comments on that issue, no such comments were received. The conclusion was therefore that only the change suggested in the preceding paragraph should be recommended by the Group.

• Suggested changes to the Commentary

Based on the following, the Group suggests that the following changes be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Replace the last sentence of paragraph 11 of the Commentary on Article 12 by the following (changes to the existing text appear in strike-through and bold italics):

"If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration." Then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.

4.3. Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions (A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits)

Foreword

To date, much attention has been focused on the question of in what circumstances do electronic commerce activities, especially the operation of a server in a particular jurisdiction, lead to the recognition of the existence of permanent establishment in that jurisdiction (the threshold question) under Article 5 of the OECD Model Tax Convention. Indeed, the Committee on Fiscal Affairs has recently published a Report adding to the existing Model Commentary on Article 5 to clarify the application of the provisions of the Article in respect of web sites and
servers. The clarification will be incorporated in the next update of the Model Tax Convention.

Now that the threshold question has been settled, at least in respect of the application of the existing rules, attention turns naturally to what profits can be attributed to e-commerce activities that have passed the threshold of Article 5 so that a permanent establishment is held to exist. The allocation of the taxing rights between the jurisdiction of the enterprise and the jurisdiction of the permanent establishment are determined under Article 7 of the OECD Model Tax Convention. This discussion paper is a first attempt at exploring the interpretation and application of Article 7 to a PE carrying on retail e-commerce activities ("e-tailing").

The discussion paper has been produced by the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("Business Profits TAG"). This group was set up to assist in implementing the Ottawa Framework Conditions with a mandate to examine how the current tax treaty rules for the taxation of business profits apply in the context of electronic commerce and to consider proposals for alternative rules. This paper is a discussion draft only and does not represent a consensus view of the government or business members of the Business Profits TAG. However, the intention of releasing the discussion paper is to stimulate debate on how to attribute profit to a permanent establishment in an e-commerce context. This should assist in the ultimate development of an internationally agreed consensus on the interpretation and application of Article 7 amongst business, OECD Member and non-member Governments.

Accordingly, comments on this discussion paper are invited, and indeed, positively encouraged. Comments can be posted on the OECD’s public EDG (appl1.oecd.org/daf/taxandel.nsf or to register: www.oecd.org/daf/fa/e_com/e_rego.htm) or e-mailed to Jeffrey Owens, Head of Fiscal Affairs (daffa.contact@oecd.org) and copied to John Neighbour, Head of Transfer Pricing and Financial Transactions Unit (john.neighbour@oecd.org).

Executive summary

This discussion paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("Business Profits TAG") provides a detailed analysis of the transfer pricing issues arising in attributing profit to a permanent establishment involved in electronic commerce activities, in the context of an enterprise engaged in the retail distribution of entertainment products ("e-tailing"). The paper provides an overview of the current treaty rules for attributing profit to a permanent establishment under Article 7 of the OECD Model Tax Convention. It also refers to the on-going work of the Committee on Fiscal Affairs in this area, which is attempting to develop a common
interpretation of Article 7 that is in accordance with the articulation of the arm's length principle found in the Transfer Pricing Guidelines, and foreshadows some of issues raised in the context of this review in the Discussion Draft on the Attribution of Profits to Permanent Establishments, a discussion paper issued on 8 February 2001 by the Committee on Fiscal Affairs (CFA). That document looks at issues relating to the attribution of profits to permanent establishments in general and is not confined to permanent establishments in the e-commerce sector ("CFA general discussion draft").

This paper illustrates the various steps of the analysis that are required to attribute profit to a permanent establishment, in the context of a specific example of an enterprise distributing products over the internet through a web site hosted on a server situated in a permanent establishment in another country. Four different variations of the example are developed and analysed. The first variation is the extreme case of a stand-alone computer server performing automated functions (in particular, online processing of transactions and transmission of digitised products) without the presence of personnel in the permanent establishment. The second variation examines the case of multiple servers performing identical tasks. The third variation assumes the presence of personnel in the permanent establishment to provide online services and maintain the server. The last variation assumes that the development of the hardware and software used by the permanent establishment was entirely performed in the permanent establishment.

The paper provides an analysis of the likely outcome of the application of the arm's length principle to the four examples and identifies some issues arising under the current interpretation of Article 7 that may prevent, in certain circumstances, a profit attribution to the permanent establishment that is fully consistent with the arm's length principle. These issues are developed more fully in the CFA general discussion draft.

In summary, it is found that under the arm's length principle, the amount of profit to be attributed to the permanent establishment will be related to the nature of the functions that it performs (taking into account the assets used and risks assumed). Given the importance of intangible assets in the earning of profits from e-commerce activities, it is also be essential to determine which part of the enterprise economically "owns" or has created the intangible assets used by the permanent establishment. In the context of the stand-alone computer server (and the multiple server variation), the functional and factual analysis is likely to show that the permanent establishment is performing only routine functions and is reliant on other parts of the enterprise to provide the intangible assets necessary for it to perform most, if not all, of those functions. Accordingly, the activities of the permanent establishment are very unlikely to warrant it being attributed with a substantial share of the profit associated with the distribution activities of the enterprise conducted through the server. Further, it is suggested that the nature of
this type of server-permanent establishment, especially its lack of personnel, is likely to mean that tasks performed by the server would likely be conducted under a "contract service provider" arrangement that would leave all substantial assets and risks with the head office and attribute to the permanent establishment the profits associated with the physical operation of the computer server. Under an alternative interpretation of the arrangement, whereby the permanent establishment is considered to be instead an "independent service provider", the conclusion would be similar, given the need for the permanent establishment to recognise, in computing profit, the arm’s length value of the tangible and intangible property that it uses and that were contributed to it by other parts of the enterprise.

Where personnel are present in the permanent establishment to perform maintenance and online services tasks, the quantum of the profit attributable to the permanent establishment would be commensurate with what independent service providers would be expected to earn in a similar situation. Finally, the last variation (in-house development of server and web site) is likely to produce a more substantial attribution of profit to the permanent establishment, as it assumes sufficient development risks to be considered as the economic owner of the intangible property developed to operate the server and the web site and, therefore, is entitled to the profit associated with the exploitation of such property.

This discussion paper is limited to an analysis of an "e-tailing" situation. The implications for Article 7 of the transfer pricing issues raised by other business models could warrant further work. The paper is also limited to an analysis of transfer pricing issues and does not address issues of compliance or other administrative aspects. Finally, the paper is meant to provide a technical analysis of current rules under the OECD Model Tax Convention, and does not offer a policy evaluation of the effectiveness or appropriateness of the rules. These issues are currently being examined by the Business Profits TAG.

Views are invited on the analysis contained in this discussion paper and on areas where further work could be undertaken by the Business Profits TAG (please see the Foreword for details of where to send comments).

**Introduction**

The purpose of this discussion paper is to examine the issues surrounding the attribution of profit to a permanent establishment involved in electronic commerce transactions. In particular, the discussion paper provides a detailed analysis of the steps required to attribute, in accordance with the arm's length principle, profit to a permanent establishment that would be considered to exist under Article 5 of the OECD Model Tax Convention as a result of the use by an enterprise of a stand-alone computer server in a foreign jurisdiction in the course
of processing online retail transactions. The assumption that the operation of a computer server by an enterprise in a country can give rise to a permanent establishment in that country is based on the conclusions reached by Working Party No. 1 on Tax Conventions and Related Questions and, in particular, on the recently released additions it has proposed to the Commentary to the Model Tax Convention. The scope of this paper is limited to a technical interpretation and application of the arm's length principle to such a permanent establishment. The wider policy issue of whether the current provisions of the OECD Model Tax Convention regarding the taxation of permanent establishments are the most appropriate to deal with the issues presented by the development of electronic commerce is not discussed in this note and is another item on the work programme of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("Business Profits TAG").

The starting point for the analysis contained in this discussion paper is the current Commentary to the Business Profits Article (Article 7) of the OECD Model Tax Convention. However, the analysis also takes into account the preliminary results of a review currently on-going within the Committee on Fiscal Affairs, whose aim is to test and develop an interpretation of Article 7 that is more consistent with the interpretation of the arm's length principle in the Associated Enterprise Article (Article 9) and that takes into account the important evolution contained in the revised 1995 Transfer Pricing Guidelines. The preliminary results of the review, conducted on the basis of a "working hypothesis" that does not bind OECD Member countries, can be found in Discussion Draft on the Attribution of Profits to Permanent Establishments, released by the CFA on 8 February 2001. That document ("CFA general discussion draft") looks at issues relating to the attribution of profits to permanent establishments in general and is not confined to permanent establishments in the e-commerce sector.

The next section outlines the principles that are relevant in attributing profit to permanent establishments in general. The third section begins with a detailed example of a commercial retail operation relying on a stand-alone computer server to host its web site and process online transactions with customers. Then, a detailed analysis of the application of the arm's length principle is performed on the basis of the parameters of the example, setting out the steps that must be followed in order to attribute profit to such a permanent establishment. Considerable analysis is devoted to this first scenario. Three additional variations on the basic example are then examined in order to show how different fact patterns affect the analysis. The second variation assumes the existence of several servers in as many foreign jurisdictions performing identical tasks. The third variation assumes the presence of technical personnel in the permanent establishment. The last variation illustrates the attribution of profit when hardware and software used in the business are developed within the permanent establishment.
Several other variations could have been considered. Likewise, it is recognised that electronic commerce can occur under other forms of business models. The example examined in this discussion paper illustrates a so-called “e-tailing” operation. Other models include “B2B” (business-to-business transactions), the auction model (whereby a virtual bidding forum for purchasers and suppliers is provided) and web hosting. The principles applied in this discussion paper with regard to “e-tailing” could equally apply to other forms of e-commerce but would need to be adapted to the particular factual situation.

This discussion paper does not consider issues of compliance by taxpayers and administration by tax authorities that may be raised in the context of the example examined in the third section. These issues are to be considered as part of the wider policy analysis currently conducted by the Business Profits TAG.

**General principles for attributing profit to a permanent establishment**

The purpose of this section is to provide an overview of the rules governing the attribution of profits to permanent establishments under Article 7 of the OECD Model Tax Convention, including the latest developments on the interpretation and application of Article 7, as reflected in the CFA general discussion draft released on 8 February 2001. The description of the rules and latest developments in this section will serve as a starting point for a more thorough analysis, in the next section, of their possible application to various forms of permanent establishments involved in electronic commerce activities. Some of the challenges that may be faced in attributing profit to a permanent establishment in an electronic commerce environment are already apparent in this part. Readers are referred to the CFA general discussion draft for a more detailed analysis of the issues and explanation of the background to the review of Article 7. In brief, the CFA has noted that there is currently not a consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation of Article 7 can lead to double, or less than single taxation. The development of global trading of financial products and of electronic commerce has helped to focus attention on this unsatisfactory situation and on the need to establish a consensus position regarding the interpretation and practical application of Article 7.

As a first step in establishing a consensus position, a working hypothesis (WH) has been developed as to the preferred approach for attributing profit to a permanent establishment under Article 7. The WH has been tested by considering how it would apply in practice to attribute profit both to permanent establishments in general and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread. The CFA has released a discussion draft that contains the
results of testing the application of the WH to permanent establishments in general (Part I) and to permanent establishments of banking enterprises (Part II).

The analysis in this discussion paper is based on the WH and how it might be applied to attribute profit to a permanent establishment of an e-tailer. Differences between the results of applying the WH and of applying the existing interpretation of Article 7 are identified and discussed. It should be noted that the use of the WH in this discussion paper should not be interpreted as implying support for the adoption of the WH by any of the business or government representatives on the Business Profits TAG.

The rest of this section provides more detail on the existing interpretation of the first three paragraphs of Article 7 and on how the WH might apply to those paragraphs.

**Article 7(1) – Calculating profit to be allocated to a permanent establishment**

Article 7 of the OECD Model Tax Convention sets out the rules for allocating profits to a permanent establishment. Article 7(1) provides that only so much of the “profits of an enterprise” as are attributable to a permanent establishment in a country may be taxed in that country. The Commentary to this paragraph confirms that the profits attributable to a permanent establishment do not include profits that an enterprise may derive otherwise than through the permanent establishment. This limits the taxing rights of a host country so that profits of a non-resident enterprise that are not attributable to the permanent establishment cannot be subject to tax, for example under the “force of attraction” principle.

The OECD Model Commentary provides little additional guidance concerning how the term “profits of an enterprise” is to be interpreted; in particular, whether the profits attributable to the permanent establishment are limited by the profits of the entire enterprise. Historically, there has been a lack of consensus amongst countries on how far to take the “distinct and separate enterprise” approach of Article 7(2). Some countries put more weight on treating a permanent establishment as far as possible as if it were a separate enterprise, the “separate enterprise” approach, while others put greater weight on the fact that the permanent establishment is only a part of a single legal entity, the “single entity” approach. Between these two polar approaches, several nuances are also possible.

In order to attain its goal of achieving an international consensus on the interpretation and practical application of Article 7, the WH adopts a single interpretation (the “functionally separate entity” approach). This approach requires that the profits to be attributed to a permanent establishment are the profits that it would have earned at arm’s length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm’s length principle of Article 7(2). The phrase “profits of an enterprise” in
Article 7(1) should not therefore be interpreted as affecting the determination of the quantum of profits that can be attributed to the permanent establishment but rather as limiting the profits to “only so much of them as is attributable to that permanent establishment” and in particular as providing specific confirmation that “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment” (i.e. there should be no “force of attraction” principle).

- UN Model Convention

A number of bilateral tax treaties adopt features of the UN Model Convention. Article 7 of the UN Model Convention generally follows the principles of the corresponding Article of the OECD Model Tax Convention with respect to the attribution of profit to a permanent establishment. However, there are differences between the two models. The major difference between the two models is that the UN Model extends source country taxing rights beyond the strict attribution of profit to a permanent establishment and grants a host country the right to tax profits attributable to sales made by the non-resident enterprise in the country’s territory “of goods or merchandise of the same or similar kind as those sold through that permanent establishment”. This is the so-called “limited force of attraction” principle. This paper does not examine the implications of the application of this principle to electronic commerce transactions. Instead, it is written on the assumption that the arm’s length principle is the most appropriate principle to apply when attributing profit to a permanent establishment in the contexts of both electronic and traditional commerce.

*Article 7(2) of the OECD Model Tax Convention*

Paragraph 2 of Article 7 states the arm’s length principle in the context of permanent establishments, and is the key paragraph for attributing profits to a permanent establishment. It states that the profits to be attributed to a permanent establishment are those that it would have made if it had been a separate enterprise engaged in the same or similar activities, under the same or similar conditions, dealing with other parts of the enterprise wholly independently.

The Commentary confirms that Article 7(2) is to be considered a statement of the arm’s length principle of Article 9 in the context of permanent establishments. The OECD Transfer Pricing Guidelines (“the Guidelines”) contain detailed guidance on how to apply the arm’s length principle under Article 9 in the context of associated enterprises. The WH is based on the premise that the guidance on the application of the arm’s length principle of Article 9 given by the Guidelines should be applied to the attribution of profit to a permanent establishment using the arm’s length principle under Article 7(2). However, this guidance has to be
applied by analogy rather than directly as it is based on evaluating transactions between associated enterprises, rather than dealings within the same enterprise.

The preferred interpretation of Article 7 (2) under the WH is that a two-step analysis is required: first, a functional and factual analysis, in order to appropriately hypothesise the permanent establishment and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks; second, an analysis of the Guidelines relevant to applying the arm’s length principle to the hypothesised enterprises so undertaking functions, using assets, and assuming risks. Each of these steps is discussed below.

- First step: Determining the characteristics and functions of the hypothesised distinct and separate enterprise

Following, by analogy, the approach adopted in the Guidelines, the technique of functional analysis can be used to determine what economically significant activities are undertaken by the enterprise as a whole. The functional analysis must go on to determine which of the identified activities of the enterprise are associated with the permanent establishment, and to what extent.

The functional analysis must also take into account the assets used and risks assumed by the permanent establishment. As regards assets, the working hypothesis is to undertake a functional analysis that takes into account “assets used” (emphasis added), with no reference to legal ownership. The facts and circumstances must be examined in order to determine the extent to which the assets of the enterprise are used in the business activity carried on by the permanent establishment. To the extent that assets are used in the business activity carried on by the permanent establishment, the use of those assets should be taken into account in rewarding the functions performed by the permanent establishment. Assets of the enterprise that are not used by the permanent establishment should not be taken into account for the purposes of attributing profits to it.

Following the analysis of assets, the working hypothesis is to treat the permanent establishment as assuming certain risks, even though legally it is the enterprise as a whole that assumes those risks. Indeed, the permanent establishment should be considered as assuming any risks inherent in, or created by, the permanent establishment’s own functions (i.e. for the purpose of the permanent establishment), and any risks that relate directly to those activities. The division of risks assumed and functions performed by the head office and the permanent establishment respectively may be set out in writing, in the same manner as risks and functions may be documented contractually between separate legal entities. However, in the absence of contractual terms between the permanent establishment and the rest of the enterprise of which it is a part, determining what assumption of
risks should be attributed to the permanent establishment will have to be highly fact specific. Following, by analogy, paragraph 1.28 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be “deduced from their [the parties] conduct and the economic principles that govern relationships between independent enterprises.” This deduction may be aided by examining internal practices of the enterprise (e.g. compensation arrangements), by making a comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risks has been made.

In summary, to the extent that risks are found to have been assumed by the enterprise as a result of a function performed by the permanent establishment, the assumption of those risks should be taken into account when attributing profit to the performance of that function by the permanent establishment. If risks are found not to have been assumed by the enterprise as a result of a function performed by the permanent establishment, the assumption of those risks should not be taken into account for the purposes of attributing profits to the permanent establishment. It should be noted that this discussion of risk only relates to the assumption of risks, inherent in, or created by, the performance of a function.

- Second step: Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis

The WH provides for the choice and application of methods described in the Guidelines to be applicable when determining the profits to be attributed to a permanent establishment based upon its functions performed (taking into account assets used and risks assumed). The permanent establishment should obtain an arm’s length return for its functions, taking into account the assets used and risks assumed, in the same manner as would a comparable independent enterprise.

A functional analysis of the permanent establishment will already have been accomplished in the process of constructing the hypothesised “distinct and separate” enterprise under the first step of the analysis. Additionally, the working hypothesis is to undertake a comparison of dealings between the permanent establishment and the enterprise of which it is a part, with transactions between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the permanent establishment context means either that there are no differences materially affecting the measure used to attribute profit to the permanent establishment, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences.

An important question is whether inter-branch dealings have taken place and so should be recognised for the purposes of attributing profit. In the associated
enterprise situation it will usually be self-evident that a transaction has occurred, e.g., the transaction will have legal consequences other than for tax purposes. However, a dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is often inferred solely for the purpose of determining an arm's length attribution of profit. Consequently, it will be necessary at the outset to determine whether any dealing exists before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm's length attribution of profit.

Under the WH, a "dealing" will be recognised, for the purpose of attributing profit, where it relates to a real and identifiable event (e.g., the physical transfer of stock in trade, the provision of services, the use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.). A functional analysis should be used to determine whether such an event has occurred and should be taken into account as an inter-branch dealing of economic significance. This will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the "dealing". In transactions between independent enterprises, the determination of the transfer of risks, responsibilities and benefits would normally require an analysis of the contractual terms of the transaction, following the guidance on contractual terms found in paragraphs 1.28 and 1.29 of the Guidelines. This guidance should be applied by analogy in the permanent establishment context.

Once the above threshold has been passed and a dealing recognised as existing, the WH applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. The guidance is applied not to transactions but to the dealings between the permanent establishment and the other parts of the enterprise. So the examination of a dealing should be based on the dealing actually undertaken by the permanent establishment and the other part of the enterprise as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.37, tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a permanent establishment and so "should not disregard the actual dealings or substitute other dealings for them."

Where the permanent establishment has dealings with other parts of the enterprise, those dealings are an important factor to be considered and will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the permanent establishment and the other parts of the enterprise, taking into account assets used and risks assumed. Such inter-branch dealings should have the same effect on the attribution of profits between the permanent establishment and other parts of the enterprise, as would comparable transactions between independent enterprises. However, the inter-branch dealings
are postulated **solely** for the purpose of attributing the appropriate amount of profit to the permanent establishment.

The comparability analysis might determine that there has been a provision of goods, services or assets, etc. between one part of the enterprise and another, that is comparable to a provision of goods, services or assets, etc. between independent enterprises. Accordingly, the part of the enterprise making such a “provision” should receive the return which an independent enterprise would have received for making a comparable “provision” in a transaction at arm’s length. Another outcome of the comparability analysis might be that the permanent establishment and the other part of the enterprise dealing with it are found to be acting, under all the facts and circumstances, in a comparable manner to economic co-participants in an activity corresponding theoretically to a cost contribution arrangement (CCA). If the permanent establishment and the rest of the enterprise are found to be economic co-participants in such an activity, then the dealings would result in the attribution of profits in a manner similar to transactions between associated enterprises in a CCA. The comparability analysis may result in other outcomes and these should be equally susceptible to analysis, by analogy, with the guidance contained in the Guidelines.

**Article 7 (3) of the OECD Model Tax Convention**

Historically, some countries interpreted Article 7(3) as mandating an allocation of costs (without any profit element). However, most Member countries, including those that interpret Article 7(3) as **requiring** modifications to the arm’s length principle, believe that it would be preferable if Article 7(3) did not result in modifications to the arm’s length principle of Article 7(2). Accordingly, the working hypothesis is that the role of Article 7(3) should be just to ensure that the expenses associated with a permanent establishment’s activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the permanent establishment’s jurisdiction, or is not incurred exclusively for the permanent establishment.

**Special considerations in attributing profit to a permanent establishment in an electronic commerce environment**

**Server creates a permanent establishment**

This section is developed on the basis of a hypothetical example with a basic scenario and a number of variations. The example focuses only on the computer server as a tool to support a retail distribution function. It is assumed, under the proposed additions to the Commentary to Article 5 of the Model Tax Convention, that the server constitutes a permanent establishment of the enterprise so that
the jurisdiction of the permanent establishment has a right to tax the profits of the non-resident enterprise attributable to that permanent establishment.

• Variation 1: Single server

Starco Inc., a hypothetical corporation resident in country A, is an online distributor of music and video products worldwide. Starco purchases the right to distribute music and full-length movies from producers in several countries and makes various types of products available at the retail level to consumers over the World Wide Web through its well-known web site.

Starco's web site, much like a catalogue, displays the entire range of Starco's products and allows visitors to purchase its products on line. Consumers have the choice to order a physical copy of the product they wish to purchase (available on various supports, such as CD, DVD, VHS cassettes, etc.) or to download a digitised version of the product on line from its server to the consumer's computer, once the payment is confirmed. Most of Starco's products are available in digitised form.

Starco hosts its web site on a single server in country B. The server was installed toward the end of 1998 and has been operational since 1 January 1999, the beginning of Starco's financial year. The web site became well-known as a result of an aggressive worldwide publicity campaign conducted by Starco prior to and around the time it was launched. No personnel attended the server throughout the 1999 financial year and the server performed as expected. The server is a powerful computer fitted with software programmed to:

i) Display the various pages of Starco's web site.

ii) Process orders placed by customers for the purchase of physical products.

iii) Process orders placed by customers for the purchase of digitised products.

iv) Hold a digitised copy of all available products.

v) Transmit digitised products on line to the computer of customers.

Here is how a typical transaction takes place:

1. The customer considers the list of products available on the web site and selects the products that he/she wishes to purchase and the mode of delivery – physical support or digitised transmission.

2. The customer fills in an order form with all the required information, and provides a credit card number as the means of payment for the products to be purchased.

3. The customer sends the order on line.

4. The customer receives, on line, within two minutes, confirmation that his/her order has been received and that the credit card company has accepted the transaction. Where a physical product was ordered, the
message includes an estimate of the delay before delivery by mail. Where a digitised product was ordered, downloading of the product may commence after the customer received the purchase confirmation. Where technical problems occur, the consumer may contact Starco either via a toll-free telephone number or e-mail.

Here is how the server operates in the course of this typical transaction:

1. The order is received by the server in country B. The server is programmed to contact by phone the credit card company of the customer in order to secure immediately payment for the product purchased. Once the transaction is accepted by the credit card company, payment is made by it to a Starco bank account in country A. Where the payment is made as directed, the server moves on to the next step. If the payment is, for whatever reason, not authorised, notice is sent to the customer that the transaction cannot be completed.

2. The next step depends on the form of the product ordered. If a physical product was ordered, the server sends a notice to the customer informing him/her of the delay before the product is delivered by mail. At the same time, a message is sent to the computer of Starco's central warehouse in country A, requesting that the products selected by the customer be delivered at the address provided in the order. In most occasions, the products to be delivered can be drawn directly from the warehouse's extensive inventory. However, it may also be required, in order to fulfil the customer's order, to purchase products from its suppliers.

3. If a digitised product was ordered, the server provides permission to the customer to download a copy of the product immediately. Downloading entails sending on line a copy of digitised product ordered, which sits in a digitised format on the server. The customer may perform the downloading once. When the downloading is successfully completed, the server sends notice that the transaction is completed. If the downloading is interrupted before completion, the customer may resume downloading until it is successfully completed. The server provides a menu of troubleshooting options to handle the most common problems encountered by customers during the downloading process.

On the basis of the interpretation of Article 5 recently issued by the Committee on Fiscal Affairs, it is assumed, under the fact pattern described above, that Starco's server in country B constitutes, for tax purposes, a permanent establishment of Starco.

General considerations

The analysis below is concerned with attributing profit to the permanent establishment for the 1999 financial year. The attribution of profit to a permanent
establishment begins with a functional analysis, which establishes the role of the permanent establishment in the enterprise and informs the next step, which requires one to hypothesise the attributes of the permanent establishment as a separate and distinct enterprise as well as the nature of the “dealings” between the permanent establishment and the rest of the enterprise, in order to apply the appropriate transfer pricing method to attribute profit to the permanent establishment.

First step: Determining the conditions of the hypothesised distinct and separate enterprise

Functions performed

The functional analysis will show that the permanent establishment performs the following functions autonomously:

- The establishment of an internet connection between the server and any person with a computer, a modem and an internet browser through an interface created by the joint operation of the permanent establishment’s hardware and software, the web site;
- Presentation of Starco, of Starco’s products, of instructions for visitors to enter into a commercial transaction with Starco, of phone numbers to handle any inquiries about products or about online transactions.
- Processing of orders submitted by customers on line, immediate validation of payments provided by customers with credit card companies, immediate approval or refusal of orders on line, processing of instructions to Starco for the subsequent physical delivery of products, performance of online transmission of digitised products, provision of online trouble-shooting.

Assets used

The functional and factual analysis will show that the permanent establishment requires assets, in the form of both hardware and software to undertake the above functions. The permanent establishment of Starco in country B consists of both hardware and software located in an office space rented by Starco. The hardware, a physical asset, is a powerful computer with the latest communication devices capable of handling a large volume of traffic. The software, which is intangible property either acquired or developed by Starco, consists of the sums of all the programs required to ensure that: i) the computer can be operational autonomously; ii) the computer can be linked via communication lines with one or more Starco’s computers in other locations, including Starco’s head office and warehouse in country A; iii) the computer can be linked via modem lines (or similar means of communication) with any person seeking to access Starco’s web site; iv) the computer can maintain Starco’s web site and v) the computer can perform operations relating to the processing of commercial transactions with customers, including seeking and
obtaining authorisation from the financial institution for the payment to be made. “Software”, therefore, is given a wide meaning in the following discussion and is not limited to commercial software widely available on the market (for example, a computer's operating system), but encompasses the product resulting from the development work necessary for the creation and all aspects of the operation of Starco’s web site. Such development work is specific to the needs of Starco and results in the creation of “custom” software. The cost of such development work (whether incurred internally or under contract with outside experts) is expected to represent the bulk of the cost of the software installed in the permanent establishment.

Hardware and software do not, on their own, ensure that commercial activities occur on a web site. The permanent establishment also makes use of Starco’s other intangible assets. The most obvious of these assets is the marketing intangible associated with the enterprise. The main component of this intangible is the enterprise’s own brand name, which will attract potential customers on the web site and, therefore, result in commercial transactions occurring through the permanent establishment. Another intangible (an “e-commerce marketing intangible”) may be directly related to the operation of the web site. For example, is it laid out clearly, is it fun to use, does it carry interviews with “hot” groups or musicians, does it manage the purchases of its supplies and process customer orders quickly and efficiently. Both these intangibles are directly relevant to the success of a commercial web site.

It is not sufficient, for purposes of attributing profit to Starco’s permanent establishment, to determine which intangible assets are used by it. One needs to determine which part of the enterprise is entitled to the benefits associated with the use of the intangibles by the permanent establishment. The reward associated with an intangible property does not necessarily accrue to the part of the enterprise making use of it, but rather to the part of the enterprise that developed or otherwise contributed the intangible.

- Risks assumed

Having determined the functions performed and assets (including intangible property) “used” by the permanent establishment, one also needs to determine the risks assumed respectively by the permanent establishment and the rest of the enterprise.

Legally, these risks are borne by the enterprise as a whole. The challenge, for the purpose of attributing profit to the permanent establishment, is to determine which risks, if any, should be attributed to the permanent establishment as opposed to the rest of Starco. Under the WH, the functional and factual analysis will determine the extent to which the permanent establishment should be considered to assume any risks inherent in or created by its own functions or that
relate directly to those functions. The rest of this sub-section looks at the various types of risk inherent in the business of Starco.

**Credit risk**

The extent of the credit risk assumed by Starco will depend on how transactions are processed. In the vast majority of cases, payment will likely be made with a credit card. Where Starco seeks some form of corroboration (e.g., a confirmation number) from the issuer of the credit card before proceeding with the transaction, payment for the transaction will be effectively guaranteed. In such cases, credit risk is probably negligible. However, where such validation is not performed systematically, for example where single payments to Starco are of a low monetary value, Starco would assume the credit risk in respect of these transactions.

Under the WH, the associated credit risk would be treated as assumed by the part of the enterprise carrying out the function leading to the creation of that risk. This raises the question of which part of Starco carries out that function. Is it the permanent establishment because it accepts the customer’s order or is it the head office because it has provided the software that enables the permanent establishment to accept that order? In short, can risk be assumed by the actions of a computer or is human intervention required? The WH links the assumption of risk with the carrying out of functions and so would be indifferent to whether the function leading to the assumption of risk was carried out with, or without, human intervention. Views on this issue would be particularly welcome.

**Market risks**

The cost of holding physical inventory depends on the nature of the arrangements between Starco and its suppliers. If the arrangements allow Starco to return unsold inventory after a given period of time, then the market risk is mostly borne by Starco’s suppliers – Starco’s share of the risk would be commensurate with the transactions costs that may be involved in returning unsold inventory. If no such possibility exists, all of the market risk is borne by Starco. The extent of this market risk, in turn, depends on the nature of the consideration paid by Starco for the intangible property element of the products it acquires from suppliers. Let us assume that for both digital and physical products, a payment is made to suppliers each time a product is purchased by a customer. Market risks include the transactional costs associated with the possibility of having to replace a defective product – the cost of the defective product itself would not ordinarily be borne by Starco as arrangements with suppliers may provide for the replacement of such products at no charge.

In the case of digitised products, the cost of the physical support is irrelevant. The server is able to provide a digitised version of each product, and to transfer
that product to the customer each time a transaction is entered into with a customer online.

Therefore, under a per-unit payment arrangement, Starco’s market risk is limited to the cost of the physical support of the products acquired from suppliers, since royalties are payable only when products are sold on the retail market. The cost of the marginal physical support is infinitesimal in the case of digitised products (assuming that the business is successful). Therefore, the risk borne by Starco of having to replace a defective digitised product amounts to the extra royalty that may become payable (depending on the nature of the arrangement with Starco’s suppliers) when the customer is allowed to download again the product.

Conversely, Starco’s credit risk is the sum of both the cost of the physical support and the payment made in connection with the delivery of a product for which the proceeds of transactions may later prove to be non-existent where the customer made a fraudulent use of a credit card or where there was no corroboration of the transaction by the credit card company. In the case of a digitised transmission, the cost is limited to the royalty payable by Starco.

**Technological risks**

The foregoing also has implications for determining which part of the enterprise bears the technological risks associated with the operation of the server in country B. Two broad categories of technological risks can be distinguished. The first category encompasses risks that directly affect the volume of business of the enterprises, for example, where the malfunctioning of the hardware or software in the server results in the loss of business for the permanent establishment. The second category includes other risks that result from the performance of routine automated functions, for example, where the server is used by hackers to spread defamatory material about one of the artists featured on the site, or where a customer’s credit card number is obtained from the site and used fraudulently. Arguably, the activities of the permanent establishment create this second category of risks and so the permanent establishment should be treated as assuming this category of risk.

For the permanent establishment to be considered to solely assume the first category of risk, the economic position of the head office should be unaffected by the realisation of the risks – for example, as in the case where perishable goods are transferred to a permanent establishment and the permanent establishment assumes the entire inventory risk. It is arguable that this is not the case for Starco’s permanent establishment, as loss of business by the permanent establishment due to the permanent establishment’s own making is, in fact, a revenue loss for the head office, given the nature of the “inventory” held by the permanent establishment – digitised products on a hard drive are not “inventory” and the permanent
establishment does not have any inventory of physical products. On the other hand, it may be argued that functions of the permanent establishment are such that it does expose the enterprise to at least limited market risk – if it fails then the enterprise may forego current revenues and, possibly, because of the premium put on instant availability of the latest fashionable releases, future customers. Because the permanent establishment is the source of such risk, it may be appropriate to allocate limited market risk to the permanent establishment. In other circumstances, where the permanent establishment is able, for example through sophisticated software, to perform a function comparable to that of a full function distributor, the sharing of risk may be different.

- Implications of the functional analysis

In order to appropriately hypothesise the permanent establishment as a distinct and separate enterprise, for example as the equivalent of a retail outlet or a service provider, it is necessary to consider the result of the functional and factual analysis and to perform a comparison with the functions usually associated with such enterprises, including the division of risks inherent to such functions. The functions ordinarily associated with a retail outlet include: decision-making regarding the ordering of inventory and the level of inventory to be held; negotiations regarding terms with suppliers; decisions on product pricing, marketing and promotion; establishing contacts with customers; concluding contracts with customers; the physical distribution of goods; credit control, including decisions on credit arrangements for customers; the management of incoming funds; accounting functions such as cash flow control. A functional analysis must include determining the extent to which these functions are carried out in Starco's permanent establishment.

It is likely that a functional analysis of Starco will reveal that the head office in country A and not the permanent establishment in country B carries out many of these functions exclusively. The lack of human or artificial intelligence in the permanent establishment precludes any ability to bargain, make key decisions or carry out many of these elements of a normal sales or distribution function. There are also likely to be conceptual difficulties in regarding digital information on the permanent establishment's server as "inventory", which could be the implied conclusion if the permanent establishment was considered to be akin to an independent retail outlet. Therefore, while the permanent establishment can be considered to carry out routine (autonomous) aspects of a sales function, it cannot be regarded as having all the attributes of a conventional retail outlet nor to carry out the various functions that give rise to the substantive market and credit risks. As a result, it would not be consistent with the factual and functional analysis to assume that the permanent establishment has notionally "acquired" digital inventory from the head office. The same conclusion could be reached for the market risks associated with the sale of physical products. They clearly arise from, and are...
associated with, the functions carried out by Starco's head office. The factual and functional analysis would show that the permanent establishment could not be considered to notionally hold title to physical products sold through its server. Indeed, the sales functions of the permanent establishment do not include the actual handling of physical products obtained from suppliers and shipped to purchasers (the actual shipping is performed by the head office), which is a core function of most conventional retail outlets. The situation is less clear-cut with credit and technological risks, as these appear to be more associated with the routine functions of accepting and handling customer transactions that are performed by the permanent establishment.

The foregoing suggests that, in the context of this example, the permanent establishment's functions are closer to that of a service provider.

However, within such a characterisation, more than one type of arrangement is possible, essentially depending on the sharing of risk between the service provider and the beneficiary of such services. The issue is whether the permanent establishment can be said to bear the full technological risk associated with the operation of its server. In a similar arrangement between arm's length parties, the purchaser of the service would not be expected to reward a service supplier incapable, for a given period of time, of providing the service, which it undertook to provide. On the other hand, the provider of the service would not be expected to fully compensate the purchaser for lost transactions.

One possibility is that the permanent establishment is acting as the equivalent of an independent service provider. Under this model, the permanent establishment is considered to have acquired at arm's length prices the hardware and software necessary for the provision of services and, crucially, it assumes the risks usually associated with the operation of such an enterprise.

However, it is also possible that the permanent establishment is acting like a “contract service provider”. Under this model, Starco's head office is considered to retain control (“economic ownership”) of all the property (tangible and intangible) transferred to the permanent establishment. This means that the risks associated with the use of such assets are also considered to remain with the head office. The only risk for the permanent establishment is that it might not be compensated adequately for the services that it has performed.

Between independent enterprises, an analysis of the contractual terms would assist considerably in determining how the responsibilities, risks and benefits of a service arrangement are to be divided between the parties and consequently whether the arrangement is that of a contract service provider or as an independent service provider. As noted in the section regarding Article 7(2) above, the WH applies the guidance on this matter in the Guidelines (paragraph 1.28) by analogy and by reference to the conduct of the parties and the economic principles that
govern relationships between independent enterprises. Following the guidance in
the WH should enable a determination to be made as to whether the permanent
establishment is acting as a contract service provider or as an independent service
provider.

- Conclusions

The result of the functional and factual analysis, and in particular the determi-
nation of risks assumed by the permanent establishment, will determine the true
nature of the operations of the permanent establishment. For a permanent estab-
lishment carrying out e-tailing activities, the analysis may reveal that the perma-
nent establishment is performing functions, using assets and assuming risks akin
to those performed by a retail outlet, i.e. the purchasing and distributing of prod-
ucts for a profit. Or it may reveal that the functions performed, assets used and
risks assumed by the permanent establishment are similar to those of a service
provider, providing services\textsuperscript{14} for and on behalf another part of the enterprise

However, it would appear that under the fact pattern of this example, the factual
and functional analysis is unlikely to show that the permanent establishment is per-
forming many of the functions, or assuming many of the risks, of an independent retail
outlet. The lack of personnel at the permanent establishment under this fact pattern
makes it hard to envisage the permanent establishment assuming anything but the
most routine risks that are directly related to the automated functions it performs. The
functions it performs are more akin to sales support functions or to back office func-
tions in a global trading business. The “service provider” model is therefore likely to
be the most useful tool for analysing this type of server-permanent establishment and
for finding comparables under the second step of the analysis described below. In the
case of Starco, the limited functionality of the permanent establishment means one
could credibly characterise the arrangement as one similar to that of a “contract
service provider”, whereby the permanent establishment is mandated to provide
services to the head office using tangible and intangible property provided by, and
remaining under the control and responsibility of, the head office.

On the basis of these findings, the proper attributes of the permanent estab-
lishment and the nature of the “dealings” that it is assumed to have with the rest
of the enterprise can be established for purposes of applying the principles of
Article 7 of the Model Tax Convention.

Second step: Determining the profits of the hypothesised distinct and separate enterprise

Because the permanent establishment of Starco in country B does not have a
distinct legal personality, transactions entered into by a customer on its web site
hosted on its server in country B are legally entered into with all of Starco. However,
the legal aspect of the transaction is of little relevance to the task of attributing
profit to the permanent establishment. The question to be answered is what profit the permanent establishment would earn, in similar circumstances, if it were dealing at arm's length with the rest of Starco, under the relevant business model. Because of the lack of legal personality of the permanent establishment, it cannot enter into legally enforceable transactions with the rest of Starco, because an enterprise cannot transact with itself. However, in order to provide an answer to the above question, one is required to establish whether “dealings” occurred between the permanent establishment and the rest of the enterprise and to determine the true nature of such “dealings”, in order to be able to apply the arm's length principle, as if a transaction had occurred between two distinct and separate enterprises.

The response to the above question will differ according to whether the relevant dealings of the permanent establishment can best be compared to transactions undertaken by a “retail outlet”, an “independent service provider” or a “contract service provider”. In the case of the particular fact pattern examined in this note, the analysis of the previous section suggested that the functions performed, assets used and risks assumed by the permanent establishment were unlikely to be comparable to those of a “retail outlet”, although the conclusion may differ in different circumstances. The rest of the section will therefore focus on comparing the dealings undertaken by the permanent establishment with the two variants of the “service provider” model.

• “Contract service provider” model

Under this model, a functional and comparability analysis is likely to find that there have been few dealings between the permanent establishment and the head office. In the pre-commercial exploitation phase, property (hardware and software) was transferred from the head office to the permanent establishment. As noted in the section regarding Article 7(2) above, a dealing will be recognised where it results in an economically significant transfer of risks and responsibilities between the parties. Any such transfer would, in the absence of contractual terms, have to be deduced from the conduct of the parties and the economic principles that govern relationships between independent enterprises. Once again, the limited nature of the functions that can be performed by the permanent establishment due to its lack of personnel, leads to the provisional conclusion that the analysis is unlikely to show the head office as notionally disposing of such property for tax purposes but rather as retaining control and “economic ownership” of such valuable property. Therefore, it is not considered that a “dealing” is likely to have taken place between both parts of the enterprise at that time. During the commercial exploitation stage, the permanent establishment performs services for the benefit of Starco and, therefore, the functional and comparability analysis is thought likely to characterise dealings as a notional service contract between the head office and the permanent
establishment, where the head office retains most of the responsibilities, risks and benefits of the service arrangement. Such an arrangement gives rise to a dealing in respect of which an arm's length consideration must be established.

- “Independent service provider” model

Under this model, the functional and comparability analyses are likely to recognise a number of dealings that take place between the different parts of the enterprise.

As under the previously examined model, a transfer of tangible and intangible assets occurred prior to the commercial exploitation phase of the web site hosted in the permanent establishment. Where the permanent establishment is considered to perform functions, use assets and assume risks in a manner comparable to a full service provider, these transfers give rise to “dealings”, in that the permanent establishment is considered to notionally acquire assets, or the right to use assets, as the case may be, much like would be the case if the permanent establishment were an independent enterprise. In a conventional situation where such transfers occur, the permanent establishment would compute its profit so as to recognise an arm's length compensation for the head office in consideration for the provision of such property. This is so because the head office originally acquired the hardware and the digitised products and developed the software contributed to the permanent establishment and arm's length parties would seek remuneration for the transfer of such property.

The next paragraphs consider closely the particular issues arising from the transfer to the permanent establishment of each category of property.

Software

A question may arise as to the exact nature of the right acquired by the permanent establishment when software was transferred to it from the head office. The functional and factual analysis is unlikely to show that the head office has relinquished any significant rights associated with the software, other than the right to use the software, given the limited capacity of a permanent establishment that lacks personnel. The enterprise is likely to make continuing use of the software in head office, in other permanent establishments or in subsidiaries it controls. Moreover, the permanent establishment has clearly not acquired the right to resell or modify the software, given the nature of the activity of the permanent establishment (and a fortiori because of the lack of human or artificial intelligence at the location of the permanent establishment). Therefore, the appropriate analysis of the nature of this dealing is to consider that the permanent establishment has notionally acquired a right to use the software. In computing its profit, the
permanent establishment would consequently deduct an amount that represents what arm’s length parties would pay for the acquisition of such a right.

Marketing intangibles

A question arises as to whether a similar analysis should apply in the case of the marketing intangible (for example, the brand name) used on the web site hosted on the permanent establishment’s server. Whereas it would be appropriate to assume that the permanent establishment had acquired the notional right to use Starco’s marketing intangible if it had been viewed as the equivalent of a retail outlet, it is not apparent that such an assumption remains suitable where the permanent establishment is considered to be the equivalent of a provider of services to the rest of Starco. This is because it is arguably the head office that is considered to exploit the marketing intangible – comparable independent service providers would not need to acquire a marketing intangible for purposes of providing services to Starco, and Starco would not need to cede the right to use it if it dealt with an arm’s length service provider. Moreover, it is not clear how the service provider could exploit or benefit from the marketing intangible. Should a dealing be recognised, an independent enterprise utilising a marketing intangible (or benefiting from other organisational expertise) developed by another enterprise would, under the arm’s length principle, be expected to compensate the latter for the use of such an intangible and, therefore, an arm’s length charge in an equivalent amount should be deducted in computing the profit of the permanent establishment. Views on the appropriate treatment of marketing intangible in the context of this example and more generally are welcome.

A subsidiary issue, assuming the existence of a dealing for marketing intangibles, is whether the activities of permanent establishment could ever be such as to increase the value of a marketing intangible provided by the head office and, therefore, entitle the permanent establishment to some of the profits associated with the use of such an intangible (to the same extent observed between associated enterprises). Views are invited on this issue, in particular in the context of this example.

A question also arises as to which part of the enterprise would be the economic owner of any “e-commerce marketing intangible”, related to the web site. Similar issues might arise for other marketing intangibles: for example where the permanent establishment collects customer information, does it mean that the permanent establishment is treated as the economic “owner” of the resulting marketing intangible, a customer list? If the permanent establishment is treated as the sole economic “owner” of these intangibles then no dealings need to be recognised in relation to them, unless other parts of the enterprise start to exploit them.
Similar issues arise in relation to digitised products on the permanent establishment's server. If such property is considered to remain under the economic ownership of the head office (as would likely be the case for a service provider), there would be no dealings to take into account.

Application of Article 7 in the case of intangible property

The above discussion suggests that where the existence of dealings in respect of software, marketing intangible or other intangibles needs to be recognised, consideration for such dealings needs to be determined under the arm's length principle. However, Article 7 of the Model Tax Convention does not presently permit such an outcome with respect to software and marketing intangible. While the Commentary clearly mandates a mark-up in accordance with the arm's length principle where stock in trade is being transferred from one part of an enterprise to another, such is not the case with regard to other types of property, in particular intangibles. There is no explicit authority in the current Commentary to assess the transfer of economic value (other than for inventory) from the head office to the permanent establishment at market value under the arm's length principle. Consider the current Model Tax Convention Commentary on intangible property:

“In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g. payments of royalties or cost sharing arrangements) cannot be applied in respect of the relation between parts of the same enterprise. Indeed, it may be extremely difficult to allocate “ownership” of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances, it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty.”

This implies that such transfers are valued at cost. In our example, this produces a somewhat perverse result, as it amounts to treating the new permanent establishment as the effective economic “owner” of the software and of other relevant intangibles that were created before it came into existence. In that sense, the permanent establishment is getting a “free ride” on the back of the efforts and expertise of the head office.
The problem with this approach is that the market value of software or of other intangibles may not bear much relation to the cost of creating it. This is a particular problem with intellectual property such as software, which is based fairly directly on ideas and that does not necessarily require the presence of a large infrastructure to create. Also the original cost may have been depreciated before the permanent establishment came into existence so that there are no costs of the enterprise to attribute to the permanent establishment.

The undesirable consequences of the rather outdated approach of the current Commentary can be seen by supposing that Starco sets up an identical server performing identical functions in Country Z but that it forms a subsidiary to own and operate the server. If the market value of the intangible is substantially greater than the costs of creating it, then the subsidiary in Country Z will, under the arm’s length principle, have to pay far more to Starco for the continuing right to use the intangible than the permanent establishment in Country B will have to pay in order to reimburse Starco for its share of the historical costs of creating that intangible. Of course, the situation would be the reverse if the market value of the intangible was less than the historical costs of creating it.

In either case, a different tax result is obtained simply by virtue of whether the same economic function is performed through a subsidiary or through a permanent establishment. This does not seem sensible tax policy and points to a limitation to the current Commentary to Article 7. While it is true that such a situation is not unique to electronic commerce, such differences of result between a permanent establishment and a subsidiary are likely to be greater and more frequent in the e-commerce context because of the prevalence of intangibles, especially those based on ideas. These issues are discussed in greater detail in the CFA general discussion draft, and the Committee on Fiscal Affairs is actively considering the issues relating to the attribution of profit to permanent establishments. Views from the public are invited on these important issues.

Finally, the allocation of costs (for example pursuant to a cost contribution arrangement) may, indeed, be appropriate where the permanent establishment is in existence at the time of the development of the intangible and the enterprise intends to have the permanent establishment make use of the intangible, when and if developed.

Hardware

Finally, the facts and circumstances (including any internal documentation) regarding the transfer of the hardware to the permanent establishment must be examined in order to determine the character of such a transfer (“dealing”) and especially the division of the risks and responsibilities of ownership between the parties. Under the WH, the determination must be made by making a full examination...
of the facts and circumstances surrounding the change in use, including the subsequent conduct of the parties and any relevant documentation. The intent of the enterprise in effecting this change of use, as documented and as corroborated by its conduct, will be relevant in determining the nature of the dealing. Once the full facts and circumstances have been established, the nature of the inter-branch dealing (sale, lease or licence) would be determined by reference to the nature of comparable transactions between independent enterprises. In this context, it may be relevant to establish whether the enterprise itself owns the assets, leases it or rents it from an independent supplier and to know what independent parties would do in similar circumstances. While the documentation of the arrangement will assist in the determination, if the conduct of the parties is inconsistent with this documentation, consideration must be given to the actual conduct of the permanent establishment and the rest of the enterprise in order to establish the true nature of the arrangement. One result of this examination could be to characterise the transfer as a lease arrangement between the head office and the permanent establishment, in which case a notional arm's length lease payment would be deductible in computing the profit of the permanent establishment. Another possible result would be to characterise the dealing as an outright sale, i.e. that the head office has disposed of the hardware and that the permanent establishment has acquired it at its fair market value. In such a case, capital cost allowance in accordance with the depreciation system of country B would be deducted in computing the permanent establishment's profit. The issue of how to account for the transfer of tangible property between two parts of a single enterprise is discussed in details in Part I of the CFA general discussion draft, in which the wider issue of attribution of profit to permanent establishments is examined. The question here is whether the above guidance has much relevance to a fact pattern such as this, given the lack of personnel of the permanent establishment, so making any analysis of the intention of the parties is only relevant from the head office perspective.

In the commercial exploitation stage, a dealing assumed to take place under the “independent service provider” model between the permanent establishment and the head office in the form of a service contract notionally concluded between both parties, whereby the permanent establishment is considered to have performed functions on behalf, and for the benefit of the head office. These include hosting a web site, handling transactions with customers and channelling proceeds of transactions to Starco. The value of the fee payable pursuant to this notional contract is to be determined under the arm’s length principle.

Therefore, under the “independent service provider” model, the setting up of a server by Starco in country B can be characterised as an initial provision of tangible and intangible property to the permanent establishment in order to enable the permanent establishment to provide a service to the rest of the enterprise. Having established the attributes of the permanent establishment and the nature
of its “dealings” with the rest of the enterprise, one can now apply a traditional transfer pricing analysis on such “dealings” in order to determine the arm’s length compensation for each dealing. This will determine the quantum of profit attributable to the permanent establishment.

Application of transfer pricing methods

- “Contract service provider” model

Under this model, the only arm’s length charge to be determined relates to the provision of services to the head office. Remuneration between independent enterprises for such services would take the form of a fee, which reflects the value of the functions performed by it and the relatively risk-less nature of the arrangement from its point of view.

The starting point for the analysis would be to examine if there were comparable transactions undertaken by arm’s length contract service providers such that a comparable uncontrolled price (CUP) could be applied. The transactions would have to be comparable in terms of the functions performed, assets used and risks (indeed lack of risks) assumed. Views on the likely availability of CUPs are welcome. Where the CUP method cannot be applied reliably, it may be possible to apply a cost plus method to determine an arm’s length reward for such a permanent establishment. The costs to be taken into account would be the direct and indirect costs incurred in the permanent establishment in the course of providing the service (rent, insurance, electricity, communication lines, etc.), but would not take into account any capital costs associated with tangible and intangible assets, on the basis that the head office is assumed to retain economic “ownership” of such property. An arm’s length profit margin could be found by considering the mark up charged in similar arrangements entered into by independent enterprises. Other transfer pricing methods found in the Guidelines may also be applied where the comparability standard in Chapter 1 can be satisfied.

- “Independent service provider” model

In this model, arm’s length charges must be established for “dealings” assumed to take place between the permanent establishment and the rest of the enterprise before and during the commercial exploitation stage. Dealings for the former include the provision of the hardware and of intangible property in the form of software by the head office to the permanent establishment.

Application of the arm’s length principle requires one to find comparable products and services traded in comparable transactions between independent parties, or at least comparable functions performed by independent parties.

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Finding a CUP for both the hardware and the software (to the extent authorised under the Model Tax Convention, as discussed previously) may be possible. However, establishing the arm's length compensation for the transfer of the right to use the software may not be a straightforward exercise, because of the difficulty of finding products that are sufficiently comparable. Where no exact CUP can be found, one could attempt to find the arm’s length price for software used for comparable functions.

The costs of the permanent establishment are not limited to the arm’s length charge to be recognised in consideration for the use of both tangible and intangible property. Expenses are incurred in the permanent establishment in the form of payment for the use of the premises, the cost of electricity and communication lines, the payment of insurance premiums, etc. Unlike conventional situations, such payments are not actually made out of actual revenue earned by the permanent establishment but are presumably paid by the head office. An argument can be had over whether these costs are the costs of the permanent establishment or costs of the head office incurred for the purpose of the permanent establishment, which must be recognised, pursuant to Article 7(3) of the Model Tax Convention, in computing the permanent establishment’s profits. In practice, this is an issue of little consequence since, in either case, such cost should reduce the taxable profit of the permanent establishment.

During the commercial exploitation stage, one must establish an arm’s length compensation for the service provided to the head office by the permanent establishment. It may be that independent enterprises, making use of similar hardware and software are in the business of providing similar web hosting services to other enterprises. If such comparable enterprises can be found, a CUP for a similar type of transaction would be the best estimation of an arm’s length price. If a CUP is not available, a cost-plus charge for the provision of similar services would be appropriate. Internet service suppliers would be an obvious source of either CUP or comparable gross margins for similar service arrangements, provided adjustments are made to take into account any differences between the services provided by an internet service provider and the permanent establishment. Care would also need to be exercised to ensure that the cost base from which the gross margin is derived is similar to that used for the permanent establishment. Unlike the determination made in the “contract service provider” model, the cost base to be used for purposes of applying the cost plus method would take into account the notional expenses associated with the transfer to and use by the permanent establishment of the tangible and intangible property contributed by the head office.

The use of a profit method, especially a transaction net margin method (TNMM) should not be overlooked where it is not possible to apply traditional transaction methods reliably. A net margin analysis over costs may be possible.
The above analysis of the “independent service provider” model shows that one needs to posit several intra-company dealings that raise complex valuation issues under the arm’s length principle. Furthermore, the arm’s length character of such estimates is in doubt under the current interpretation of Article 7. This suggests that this model may not represent the most appropriate or practical model to apply to the fact pattern provided in this section.16 However, it is not denied that it may be appropriate in different circumstances.

**Conclusion**

While it is difficult, in abstract, to determine how significant the quantum of profit attributed to Starco’s permanent establishment would be, a number of observations can be offered.

Under the “independent service provider” model, the profit margin of the permanent establishment is computed as the difference between the arm’s length compensation that can be charged on the market for the service provided to the head office and the arm’s length charge that must be recognised for the use of the tangible and intangible property contributed by the head office. Such a calculation is not necessarily indicative of the profit margin that would be earned by an independent enterprise whose business is to provide such services to third parties, given that such an enterprise would likely own the hardware and develop the software itself (see Variation 4). The profit margin of such an independent enterprise would be mostly attributable to the value added associated with the development of software and the renting of either the hardware or of space on a server. It is probably fair to say that the profit accruing to a typical internet service provider would exceed the profit accruing to the permanent establishment in this variation of the example. An internet service provider will typically host the software developed or acquired by its customer but use its own software (which it has developed or acquired itself) in order to provide a portal into the internet. In this variation of the example, the head office has provided the permanent establishment with all software, including that needed to establish a portal into the Internet.

Ultimately, the profit generated by the permanent establishment comes from two main sources. The first source stems from the on-going operation of a package of hardware and software that makes up the server and supports a web site. If the compensation for the transfer of this package from the head office to the permanent establishment were done on arm’s length terms, substantially all of the profit associated with the exploitation of such assets would effectively accrue to the head office. The second source relates to the exploitation of marketing intangibles, including “e-commerce marketing intangibles”. Again, substantially all of the profits associated with the exploitation of such assets would accrue to the head office provided that the intangibles are “owned” by the head office. This would
appear to be the case for marketing intangibles such as the brand but may be less clear cut for “e-commerce marketing intangibles” which are more closely related to the operations of the web site.

This outcome is explicitly achieved under the “contract service provider” model, whereby the profit of the permanent establishment will likely be determined by reference to a cost plus calculation performed on the basis of the direct operating costs incurred in the permanent establishment. Therefore, the computation of the compensation attributable to the permanent establishment specifically ignores the value of the tangible and intangible property used by it, which de facto attributes the reward for such property to the head office. 17

Therefore, for this example, the application of the functional and factual analyses described in the guidance on the arm’s length principle of Article 9 found in the Guidelines would, in all likelihood, leave the permanent establishment with a quantum of profit that is insignificant relative to either the value of transactions processed through the permanent establishment or the arm’s length cost of securing the use of the hardware and software required to ensure the continuous operation of the server without human intervention. An independent enterprise providing the same software and hardware to the permanent establishment would insist on an arm’s length reward for the exploitation of both types of property. Under this fact pattern, the permanent establishment is only performing low-level automated functions that make up only a small proportion of the functions necessary to act as a full function retail outlet/distributor or as a full function service provider. The level of profit earned is likely to be commensurately low and be very significantly less than that earned by full function retail outlet/distributors or full function service providers.

Given these observations, the question to be answered is whether the existing international tax policy rules for taxing business profits (Articles 7 and 9 of the OECD Model Tax Convention) allow this result. The guidance on the application of that Article found in the Guidelines applies the arm’s length principle of Article 9 without restriction and in a manner based on economic reality. However, although Article 7 contains a provision similar to the arm’s length principle of Article 9 [Article 7(2)], the Model Commentary appears to restrict the application of that principle in a number of ways (see previous remarks on the transfer of software and marketing intangible). More details on this issue can be found in the CFA general discussion draft released on 8 February 2001. Views on this issue are welcome.

The prohibition of a deduction in computing the profits of the permanent establishment for an amount equivalent to the market value for using software or intangible property developed by the head office, if mandated under the current interpretation of Article 7, would lead to an over-attribution of profit to the permanent establishment, where the market value exceeds the allocation of costs
related to the intangible property in accordance with the current interpretation of Article 7. When undertaking a comparability analysis with transactions between independent enterprises (CUP method), the permanent establishment would be treated as having the right to use the software and the marketing intangible and so the arm's length price would have to reflect the use of such property. Similarly, when making a comparison with gross margins earned by independent enterprises (cost plus or resale price methods), the arm's length gross margin earned by the permanent establishment would reflect the use of the intangible.

However, it would seem to follow from the above prohibition that, although the permanent establishment would obtain the same price or gross margin as the independents (based on use of the software and marketing intangible), it would be able to earn a higher net profit as it would not have to recognise, in computing its profit for tax purposes, the full market value for using such property (assuming that the market value is greater than historic costs of developing it). In such cases, the permanent establishment would be a "free-rider" as it would be rewarded for functions and activities it had not carried out and that it could never have carried out given its lack of either human or artificial intelligence. In cases where the market value of the intangible is lower than historic costs of developing it, the permanent establishment would earn less profit due to factors outside its control (inefficiency of the head office R&D function).

Another issue that arises is whether the above problems occur when, in last resort situations, profit methods are used such that a net, rather than a gross margin are compared. The comparable net margin will have been computed by deducting operating expenses (including any payments made for the use of intangible property) from the gross margins. To be consistent with the current interpretation of Article 7, would it be necessary to add back any payments for the use of intangible property to arrive at the comparable net margin?

In conclusion, it is questionable whether, under the "independent service provider" model, the current rules for Article 7 are capable of producing a result that leads to an attribution of profit that is fully consistent with the arm's length principle as articulated in the Guidelines (when applied to permanent establishments by analogy). To the extent that they are not, results would differ depending on whether the particular economic function is carried out through a subsidiary or through a permanent establishment. Arguably, such a result is not desirable on tax policy grounds and so the Model Commentary on Article 7 would need to be changed. As described in the section above on Article 7(2) above, a preferable approach might be to apply the arm's length principle of Article 7 in a manner as similar as possible to the guidance on the application of the arm's length principle of Article 9 found in the Guidelines. Views are invited on this important issue in the context of a permanent establishment undertaking e-commerce activities.

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Variation 2: Multiple servers

The facts are the same as in the previous example, except for the following modifications:

Starco's web page is hosted on four different servers located in country B (Americas), country C (Western Europe), country D (Eastern Europe and Asia) and Country E (Southern Hemisphere). When a person attempts to connect to Starco's web site, the person is connected to a given server according to a predetermined procedure, programmed on and managed by the server located in country B, that takes into account the geographical proximity of the person and the traffic on each server. Once a connection has been established between a would-be customer and a given server, all aspects of the transactions are performed on the same server.18

The benefits, from Starco's point of view, of relying on multiple servers include: speeding up the customer's access to, and interaction with, the web site; providing extra security for both the enterprise and its clients; and reducing the risks associated with technology breakdowns.

The main relevant difference, from a tax point of view, between this example and the previous example is that the functions that were performed exclusively by Starco's server in country B are now duplicated by several servers. However, the range of functions performed by any one server in respect of a transaction (from the time that the prospective customer establishes communication with Starco's web site until the customer receives delivery of products) remains the same. But the volume of transactions will now be shared among servers in different countries. The existence of several servers performing identical functions contributes to reducing the risks associated with the operation of any given server.

The principles developed in the previous section on Variation 1 remain applicable to this example, although the administrative and compliance issues may be more difficult. The "contract service provider" model, under which profit will likely be attributed to the permanent establishment on the basis of the cost plus method, may be the model that best suits the facts and circumstances. Alternatively, the "independent service provider" model may be contemplated. The functional and factual analysis would determine whether and to what extent the de facto pooling of risks among several servers would affect the quantum of reward attributable to each permanent establishment. Of course, the more difficult transfer pricing issues occurring between the head office and the permanent establishment under this model, such as the determination of the proper charge for the right to use the software and marketing intangible, would be increased four-fold.

This example assumes that all the steps of commercial transactions are performed by a single server, once the particular server has been selected. Therefore, no transfer pricing issue arises in connection with "dealings" between two or more
server because no such “dealings” take place. On the other hand, if one had assumed that the billing of the transaction took place in a server while electronic delivery of a digitised product occurred from another server, one would have had to consider how to allocate the remuneration associated with each step among the different permanent establishments.

**Server is part of an existing permanent establishment**

Two variations from the initial example are examined briefly where personnel are present in the permanent establishment in country B and are involved in attending the operation of the server. In the first variation, the personnel have installed hardware specified by the head office and software created by the head office in country A. In the second variation, all of the programming and software development is assumed to have taken place within the permanent establishment in country B and on-going improvements to the web site are performed in the permanent establishment.

- **Variation 3: Technical support staff in permanent establishment**

The facts relating to Starco’s operations and the characteristics of the server in country B are the same as in the first variation. However, personnel are present in country B to perform the following tasks: ensure the maintenance of the server, perform repairs to the hardware and address any problems affecting the operation of the web site. The personnel are also responsible for handling trouble-shooting with customers or web site visitors worldwide experiencing difficulties with the web site, in particular in connection with online transactions. Finally, the personnel provide after-sales services and support to customers. Interactions with customers or would-be customers either occur on line or, exceptionally, on the telephone.

**General considerations**

This example moves away from the extreme situation where a combination of tangible and intangible assets can, on their own, constitute a permanent establishment and presents a situation more commonly found in commercial arrangements. One peculiarity remains: contacts between the permanent establishment and customers remain virtual, as they occur on line, as opposed to face to face. However, this is not a critical consideration in the following analysis.

**Functional analysis and conditions of the hypothesised distinct and separate enterprise**

The presence of personnel in the permanent establishment to maintain the continuous operation of the server and to provide technical support to online customers changes the nature of the functions performed by the respective parts of
the enterprise and adds additional functions to the existing routine automated functions already performed by the permanent establishment. Whereas the additional functions were performed by personnel situated in Starco's head office in previous examples, they are now functions performed within the permanent establishment.

A functional and factual analysis would also reveal that personnel in the permanent establishment are required to make use of both tangible assets (for example, computers) and intangible assets (for example, software) over and above those required by the permanent establishment posited in Variation 1 in order to provide technical services to customers. In both cases, such assets will either have been provided by the enterprise or acquired by personnel of the permanent establishment from third parties. Depending on the nature of the arrangement between the head office and the permanent establishment, the existence of "dealings" between the head office and the permanent establishment may need to be recognised in order to account for the use of the assets of the enterprise by the permanent establishment.

An important consideration to take into account is that the services provided by personnel of the permanent establishment to customers are not separately charged to them. The cost of the provision of services by Starco is internalised in the prices it charges customers for its products. Therefore, any incremental provision of services does not directly increase Starco's revenue – although it may indirectly contribute to increase its market share by gaining a reputation as an efficient e-business because of the service support originating from the permanent establishment and thereby lead to the creation of an e-commerce marketing intangible.

Likewise, the incremental provision of services does not increase Starco's costs, since personnel are basically on stand-by, available at any time to deal with customer's queries.

Given the nature of the operation of the permanent establishment, and in the light of the analysis of the situation described in the previous section on Variation 1, it is unlikely that the functional and comparability analyses would characterise the permanent establishment as undertaking functions, using assets and assuming risks comparable to those of a "retail outlet". Therefore, the following focuses on the two variants of the "service provider" model as being the most likely outcomes of the functional and comparability analyses. Views on whether the retail outlet is an unlikely outcome are particularly invited.

Under this model, the functions performed by the server remain a service provided by the permanent establishment to the rest of the enterprise. The additional functions, the provision of services to Starco's customers, represent services either provided to the rest of the enterprise or provided to third parties on behalf of the
enterprise. The permanent establishment cannot be said to bear significant risk from the provision of such services (except the small risk arising from the fact that the extra arm's length remuneration received for performing additional services may not cover the extra costs of performing those services). As under the previous model, the head office bears the full market risk associated with the possible loss of business due to a failure to help would-be customers. The revenues of the permanent establishment associated with the provision of online services to customers would not be a function of the outcome of performing particular services, but would be structured as a fee for the continuous availability of the service.

As under the first two examples, the functional and factual analysis could reveal that the nature of the arrangement is one similar to that of a “contract service provider”. In such cases, the only dealing that needs to be taken into account is the remuneration of the permanent establishment for the services it provides to, and on behalf of, the rest of the enterprise. However, the same analysis could also reveal that the permanent establishment is better characterised as an “independent service provider”, fully equipped to provide the services sought by Starco and seeking to cover both capital and operating costs and earn a profit. In such cases, as explained earlier, dealings would need to be recognised with respect to the transfer of tangible and intangible property to the permanent establishment, as well as for the provision of services by it. Comments on the above conclusions would be welcome.

Application of transfer pricing methods

This portion of the analysis is similar to that found in the previous section on Variation 1. However, under this version of the “contract service provider” model, the remuneration for the permanent establishment would be more substantial than under the first two variations, owing to the additional functions performed within the permanent establishment. Where a cost plus method is applied, the cost base by reference to which a cost plus calculation would be performed would reflect the additional direct and indirect costs incurred in the permanent establishment (principally employee compensation). Similarly, the applicable arm’s length margin would reflect the different nature and functions of the permanent establishment.

Under the “independent service provider” model, a CUP, if available, would be the best estimation of an arm's length price and should first be sought, assuming that one can determine the market price for services of an identical nature (or of a sufficiently similar nature to allow for adjustments to make it sufficiently comparable) provided on the market by independent suppliers. Where a CUP is not available, a service fee determined on a cost plus basis, based on the gross mark-up associated with the provision of similar services, would be appropriate.
Alternatively, the application of TNMM could be considered if it does not prove possible to apply with sufficient reliability one of the traditional transaction methods. The permanent establishment would also, under this model, be attributed a more significant quantum of profit than under the first two variations, given the additional functions performed therein.

- Variation 4: Web site fully developed in permanent establishment

The facts relating to Starco’s operations and the characteristics of the server in country B are the same as in Variation 1. However, the history of the creation of the web site differs. It is assumed that the server was set up in 1997 and that personnel in country B performed throughout 1997 and 1998 further developments to the software, gradually upgrading the configuration of the web site to its present form. Significant development costs were incurred during that time within the permanent establishment in country B.

General considerations

There is a fundamental difference between this example and the previous ones. In the previous examples, the earnings associated with the development of the software required to create an operational server and a web site in a remote location were clearly attributable to Starco’s head office, where all development efforts took place and development costs were incurred.

This example assumes (arguably somewhat unrealistically) that the full development efforts and costs toward the development of the server and the web site were expended in country B, for purposes of subsequently exploiting the server and hosting the web site so developed.19 Consequently, under the WH the permanent establishment is treated as the economic “owner” of the intangibles. It should be noted that the WH looks to a number of factors, not just where the developments took place, in order to determine which part of the enterprise is the economic “owner” of an intangible. See the CFA general discussion draft for further details. The determination of the economic “owner” of the intangible property impacts significantly on the allocation of earnings attributable to the creation of such property within the enterprise under the arm’s length principle.

Functional analysis and conditions of the hypothesised distinct and separate enterprise

Unlike the previous example, tangible and intangible assets (except for the marketing intangible) are not transferred from the head office to the permanent establishment. Starco sets up a completely new operation in country B (presumably because of favourable external factors such as proximity of similar businesses, the presence of a fully-trained workforce or attractive tax incentives) and capitalises it with the financial resources required to develop the hardware and
software necessary to launch and operate a commercial web site for the benefit of Starco.

A functional and factual analysis is likely to reveal that the permanent establishment is in the business of providing services related to Starco's e-tailing activities. The activities and functions that the permanent establishment carries out in the commercial exploitation phase are unchanged in comparison with Variation 3. The key difference is that the permanent establishment can be considered, for tax purposes, to utilise software over which it has economic ownership in order to carry out those functions and this situation should be reflected in the attribution of profit.

The development phase leading to the creation of a web site entails the development of intangible property, akin to a research and development project. Following the guidance in the section on Article 7(2), on determining the divisions of responsibilities, risk and benefits of a transaction in the absence of contractual terms, the financial risk associated with this development of the software was incurred in the permanent establishment. Because the permanent establishment is considered to be the economic "owner" of the web site, it follows that the economic benefit derived from the commercial exploitation of the web site should accrue to the permanent establishment. That is, the permanent establishment would be considered, under the separate enterprise fiction required by Article 7 of the Model Tax Convention, to be the economic owner of the software that supports the web site. This can be contrasted to the example in Variation 1 where the permanent establishment could not be considered to be the economic owner of these intangibles. In that example, the profit margin of the permanent establishment was computed either on a cost plus basis or as the difference between a) the arm's length compensation for the service provided to the head office and b) the arm's length charge payable for the use of the tangible and intangible property contributed by the head office. In the present variation of the example, the latter element would be nil (no dealings would need to be taken into account) or at least much reduced so that the compensation to the permanent establishment comprise a), net of the costs of development of the software incurred by the permanent establishment.

The permanent establishment can be seen to derive profit from the exploitation of tangible and intangible property that it notionally "owns", in an economic sense. Unlike the issue raised in the discussion under Variation 1 regarding the internal transfer of software, there is no doubt that this framework of analysis is consistent with Article 7 and its current interpretation found in the OECD Model Commentary. Therefore, the profit of the permanent establishment should be the reward that a separate independent entity exploiting the same "package" of assets would be expected to earn. However, similar problems with Article 7 would arise where the permanent establishment makes its intangible property available

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to other parts of Starco, for example where new server/web sites are set up in other jurisdictions.

A situation in between those described under Variation 1 and this section, whereby some of the development work towards the creation of, say, software, would be undertaken at head office and some subsequent development would take place within the permanent establishment, could also be imagined. The basic analysis developed in both sections would remain applicable: an appropriate proportion of the profit directly associated with the commercial exploitation of that software would be attributed to the head office and another would be attributable to the permanent establishment. The appropriate proportion would reflect the relative value of the contribution made by the permanent establishment and by the head office towards the development of the software.

Application of transfer pricing methods

The best estimate of the profit to be attributed to the permanent establishment would be obtained from the service fee that similar operations conducted by independent enterprises would charge for a similar service (a CUP). It may be possible, for this purpose, to find operations with similar characteristics, or with a sufficient degree of comparability to permit relevant adjustments to be made. It is useful to compare this with the service typically provided by an internet service provider. In this variation it is probably fair to say that the reward to the permanent establishment would exceed that expected to be earned by a typical internet service provider. The latter will typically host the software developed or acquired by its customer but use its own software (which it has developed or acquired itself) in order to provide a portal into the internet. In this variation the permanent establishment does more than this: it develops the software that the "customer" has on its server as well as provides a portal into the internet. Nevertheless, an internet service provider may provide a reasonable comparable in this case provided that sufficiently reliable adjustments can be made to compensate for functional differences.

Where a CUP for the service fee is not available, other transfer pricing methods authorised by the Guidelines would have to be applied. These may include profit methods that require the difficult task of arriving at an arm’s length valuation of the return on the intangible property used in Starco’s business.

Conclusions

This discussion paper has provided a detailed analysis of the issues surrounding the attribution of profit to different types of permanent establishments involved in the “e-tailing” business of an enterprise. It is recognised that electronic commerce is not limited to “e-tailing” and that other types of business
models ("B2B", auctioning) exist. It would have been beyond the scope of this discussion paper to analyse the tax implications of all types of business models. However, the general principles developed in this paper, in particular in the case where the permanent establishment operates autonomously without the presence of personnel, is capable of application to other business models. However, these principles may need to be adapted to the particular factual situation.

The foregoing analysis, intended to determine how, and to what extent, one would attribute profit to a permanent establishment involved, with or without the assistance of personnel, in electronic commerce activities, has resulted in the following provisional findings based on the WH:

- Where, as in Variations 1 and 2, a permanent establishment consists only of a server supporting a web site through which commercial transactions and transmission of digitised products take place, the bulk of the benefit generated by the permanent establishment derives from the exploitation of hardware and software used by the permanent establishment and from marketing intangibles. Under a "contract service provider" arrangement, economic ownership and most risks associated with the property and the marketing intangibles is likely to remain with the head office. Under an "independent service provider" arrangement, where the head office transferred such a package of assets to the permanent establishment, an arm's length charge in consideration for such transfer would attribute substantially all of the profits directly associated with such a package to the head office, thereby leaving comparatively little profit to the permanent establishment, in relation to the value of the commercial activities carried on through it. The computer server in the permanent establishment is only performing low-level automated support functions that make up only a small proportion of the functions necessary to act as a full function retail outlet/distributor or as a full function service provider. The level of profit earned is likely to be commensurately low and be very significantly less than that earned by full function retail outlet/distributors or full function service providers. However, issues do arise as to whether some of the return related to the use of "e-commerce marketing intangibles" and the assumption of credit risk and technology risks, would be attributed to the permanent establishment on the basis that they are related to the operation of the web site itself and to the functions performed by the permanent establishment.

- Where, as in Variation 3, personnel are present in the permanent establishment to ensure the continuous operation of the web site and provide technical support to customers and would-be customers, the permanent establishment should be expected to be attributed the profit associated with such service functions, in accordance with the arm's length principle. However, the profit
directly associated with the exploitation of the hardware and software created 
by the enterprise and from marketing intangibles would continue to be largely 
attributed to the head office, as under the previous examples.

• Finally, where, as in Variation 4, the hardware and software is entirely 
developed and constructed by personnel of the permanent establish-
ment such that the permanent establishment is treated as the economic 
owner of the intangible property, the profit directly associated with the 
commercial operation of such assets is attributable, under the principles of 
Article 7 and the arm’s length principle, to the permanent establishment. 
Where the software is developed partially by head office and partially by 
the permanent establishment, the relevant proportion, determined under 
the arm’s length principle, of the profit directly associated with the com-
mercial exploitation of that software is attributable to the permanent establish-
ment. Such a proportion would reflect the relative value of the contribution 
made by the permanent establishment and by the head office.

The analysis of the first variation has demonstrated the difficulty of develop-
ing a factual and functional analysis in the extreme case where a computer server 
is considered to constitute a permanent establishment and to apply the arm’s 
length principle. In particular, it can be difficult to determine which part of the 
enterprise should be treated as the economic “owner” of “e-commerce marketing 
intangibles” that are related to the operations of the web site itself. It may also be 
difficult to apply the arm’s length principle to “dealings” involving the transfer of 
intangible property between two parts of an enterprise, as valuation for this type 
of property, in particular finding suitable comparable transactions, can be chal-
lenging. Further, one of the key, and most difficult determination that has to be 
made in the permanent establishment context relates to the assumption of risks 
and the allocation of risks assumed by the enterprise as a whole to its various 
parts. The approach generally taken under the WH is to apply the approach taken 
for associated enterprises, i.e. the concept of contractual terms, by analogy to the 
relationships between, say, the permanent establishment and head office. This 
requires an analysis of the conduct of the parties and of the economic relation-
ships that generally govern the relationships between independent enterprises. 
Where the permanent establishment lacks personnel, it is difficult to apply this 
approach. One possibility might be to say that it is not really possible for the per-
manent establishment to assume risks except those that arise as a direct result of 
the functions it performs. For example, where the permanent establishment 
accepts and settles customer transactions, it could be viewed as assuming the 
credit risk associated with such transactions.

Issues similar to those described in this discussion paper would arise in the 
situation where the server is owned and operated by a subsidiary of Starco, such 
that the paradigm moves from Article 7 to Article 9 of the OECD Model Tax
Convention. Indeed, the conclusions reached above are based more on an analysis of the arm's length principle of Article 9 (as elaborated by the Guidelines) than on the Commentary to Article 7. The conclusions may therefore not always be consistent with the current interpretation of Article 7 of the Model Tax Convention.

However, as already noted, the current interpretation of Article 7 does not appear to produce a result that is consistent with the arm's length principle as developed in the Guidelines where "dealings" involving intangible property must be taken into account in attributing profit to the permanent establishment. Further, the result will differ depending on whether the particular economic function is carried out through a subsidiary or though a permanent establishment. Such a result is not desirable on tax policy grounds and may require the Model Commentary on Article 7 to be changed. A preferable approach would be to apply the arm's length principle of Article 7 in a manner as similar as possible to the guidance on the application of the arm's length principle of Article 9 found in the Guidelines. The extent to which this approach is desirable and, if so, how it might best be achieved, is under active consideration by the Committee on Fiscal Affairs.

This discussion paper does not pretend to offer the definitive answer to the question of the attribution of profit to the type of permanent establishments examined therein. The purpose of this draft discussion paper is to elicit a discussion of the relevant issues and to invite interested parties to share their views on this important subject for consideration by the Business Profit TAG and by the Committee on Fiscal Affairs.

4.4. Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie Breaker Rule (A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits)\textsuperscript{23}

Introduction

The purpose of this section (4.4) is to identify possible limitations we are likely to face with the application of the "place of effective management" tie breaker rule in the current and future environment of electronic commerce and technology and to identify possible solutions.

This section is broadly divided into four parts. The first part of the paper provides a brief background to taxing principles, double taxation and the role of the residence tie-breaker. The second part looks at the guidance that is available on how the "place of effective management" may be determined in a traditional environment. It attempts to draw together, from a number of different sources, the list of key factors for determining a "place of effective management". The third part of this section (4.4) considers how these key factors may apply in a modern,
technologically advanced environment. Finally, the paper will identify possible options to overcome the tie-breakers limitations. In doing so, some specific issues are identified for further consideration, and comments are sought on these options and issues.

**Taxing principles and double taxation**

There are two main principles under which countries tax income – source and residency.

Income derived by a person may be taxed by a country because of a connection between the country and the generation of the income (source jurisdiction). For example, a business is carried on in the country, real property is located in the country, or an employee works in that country. Countries assert source jurisdiction to tax income on the basis that the income is generated from economic activity within the country.

Countries may also tax income (wherever derived) because the person earning the income is a resident of that country (residence jurisdiction). A country’s justification for residence tax may be seen to rest on the need to finance its public goods and social infrastructure, and the nexus between the consumption of such public goods and social infrastructure by persons who are residents having an over-all capacity to pay.

Most countries tax income on both a source and residence basis. That is, a resident person is usually taxed on income from both domestic and foreign sources, whilst non-residents are only taxed on domestic source income.

Most instances of double taxation will arise as a result of residence-source jurisdictional conflicts. However, double taxation can also arise from residence-residence conflicts where both Contracting States treat a person as a “resident” for tax purposes under their domestic law (with the result that the person is fully liable to tax in both States).

The main focus of Double Tax Conventions is to avoid such double taxation which, if not addressed, may impede cross border flows of trade, investment and capital.

**Resolving residence-residence conflicts**

The OECD Model Tax Convention deals with residence-residence conflicts through tie-breaker rules in Article 4 which allocate residence of the “dual resident” person to one of those States, so that person is treated as a resident solely of that State for the purposes of the Convention. In the case of an individual, the tie-breaker rules look at various indicia of personal attachment to a State with a
view to determining to which State “it is felt to be natural that the right to tax devolves”.21

In the case of companies and other bodies of persons, a tie-breaker rule based on personal attachment is clearly not appropriate. The Commentary also rejects a tie-breaker based on purely formal criteria such as registration. In giving preference to the State where the entity is “actually managed”,22 it would seem that the intention is to select a criterion which reflects where the main management decisions are taken.

Paragraph 3 of Article 4 of the OECD Model Tax Convention states that a non-individual:

“... shall be deemed to be a resident only of the State in which its place of effective management is situated.” [Highlight added]

How do you determine a “place of effective management” in a traditional environment?

The meaning of the term “place of effective management” is not defined in Article 4 of the OECD Model Tax Convention. However, the following new paragraph 24 in the Commentary on Article 4 which was included in the 2000 Update to the Model, offers some guidance on the meaning of this term.

“24. … The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the enterprise’s business are in substance made. The place of effective management will ordinarily be where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the enterprise as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An enterprise may have more than one place of management, but it can have only one place of effective management at any one time.”

The new paragraph reinforces the point that the determination of a place of effective management is a question of fact.

The term “place of effective management” is also used in Article 8 (Shipping, Inland Waterways Transport and Air Transport) of the OECD Model Tax Convention as the key criterion for determining the allocation of taxing rights over income derived from the operation of ships or aircraft in international traffic. The term is also used under Article 13(3), 15(3) and 22(3) for allocating taxing rights to capital gains or dependent personal services income from shipping, inland waterways and air transport.

However, the term “place of effective management” is not defined in any of the Articles mentioned above. Nor is any further guidance given on its meaning.
In the absence of any specific definition of “place of effective management”, many commentators have been influenced by concepts used in domestic tax law residence rules, such as “central management and control” and “place of management”, when considering the meaning of the term “place of effective management”.

Guidance from “Central Management and Control” (CM&C)

CM&C is one of the residence tests adopted in a number of different countries for non-individuals. For example, under Section 6(1) of Australia’s Income Tax Assessment Act 1936, a company is a resident of Australia if:

- It is incorporated in Australia; or
- It carries on business in Australia and is centrally managed and controlled in Australia; or
- It carries on business in Australia and its voting power is controlled by shareholders resident in Australia.

Understanding the factors which determine a place of CM&C may provide assistance in determining a place of effective management.

In Australia, the expression “centrally managed and controlled” is not defined in the domestic tax legislation. However, there are a number of court cases which provide some guidance on how the place of CM&C is to be determined.

According to a number of court decisions, while determining a place of CM&C is a question of fact, it ordinarily coincides with the place where the directors of the company exercise their power and authority (which will generally be where they meet). A leading case establishing this is De Beers Consolidated Gold Mines (1906) AC 455. In that case a company registered in South Africa worked diamond mines, had its Head Office and held its general meetings of shareholders all in South Africa. Its Directors held meetings both in South Africa and in the United Kingdom, but the Directors’ meetings held in the United Kingdom were found to be those where real control of the company was exercised. Accordingly the company was found to be UK resident.

In a number of Canadian cases, the courts, relying on the statement of the Lord Chancellor in the De Beers case, have found that the place of CM&C was where the company “really keeps house and does business”. Some of the factors taken into account in determining this place include:

- Place of incorporation.
- Place of residence of shareholders and directors.
- Where the business operations take place.
- Where financial dealings of the company occurred; and
- Where the seal and minute books of the company were kept.
However, this general rule is by no means conclusive. The courts have also taken certain other factors into account when determining the place of CM&C. In *North Australian Pastoral Co Ltd v FCT* (1946) 71 CLR 623, the taxpayer company was regarded as a resident of the Northern Territory where the actual business operations were located, notwithstanding that the directors meetings were held in another State. This conclusion was reached based on the fact that:

- The company's whole undertakings, being, incorporation, registered office, public office and full books of account were located in Northern Territory.
- The directors met in Brisbane, Queensland, as a matter of convenience.
- The manager of the property in the Territory took the responsibility for the success or failure of the venture; and
- Visits to the property by the directors and consultation with the manager were acknowledged to be of importance in reaching policy decisions.

However, in *Malayan Shipping Co Ltd v FC of T* (1946) 71 CLR 156, the court held that the company was a resident of Australia because the managing director exercised from Australia complete management and control over the business operations of the company, notwithstanding that the trading operations were conducted abroad.

In certain exceptional circumstances, the place where a controlling shareholder (such as a parent company) makes its decisions may be relevant in determining where the central management and control is located. In *Unit Construction Co Ltd v Bullock (Inspector of Taxes)* (1959) 3 ALL ER 831, three wholly owned subsidiary companies were incorporated in Kenya. By their articles of association, powers of management were vested in the directors who were located in Kenya and who could not validly hold meetings in the United Kingdom. However, these management powers were not in fact exercised by the local directors who stood aside in all matters of real importance, so that it was the board of directors of the parent company in the United Kingdom which effectively made all the decisions. This resulted in the subsidiaries being held to be UK residents.

**Guidance from “place of management”**

Place of management is another residence test adopted by a number of treaty countries to determine residence of non-individuals. Some countries, e.g. Switzerland, use the concept of “place of effective management” in their domestic law.

In Swiss practice, a distinction is drawn between the place of effective management and merely administrative management or decision making by executive bodies (e.g. Where the decisions of a board of directors are limited to control of the company and to basic decisions). Although there are no court decisions on the meaning of the term “place of effective management”, it would be expected that
the same interpretation would apply to the term as used in Swiss treaties and its
domestic law.

In describing the meaning of “place of effective management”, Professor
Vogel suggests that it is similar to that of “place of management” used under the
German domestic law.

According to the German case law, a place of management is regarded as the
place where the management’s important policies are actually made. Vogel states
that “what is decisive is not the place where the management directives take
effect, but rather the place where they are given.” It is the centre of top level
management, i.e. the place at which the person authorised to represent the com-
pany carries on his business managing activities. If a controlling shareholder does
in fact manage the conduct of the company’s business, then that shareholder may
be regarded as being in charge of the top level management, and the place where
those decisions are made would appear to be the centre of management. How-
ever, Vogel indicates that a place from which a business is merely supervised
would not qualify.

Vogel also states that, under German law, if the place of management cannot
be determined by the application of these criteria, the top manager’s place of re-
sidence may determine the residence of the company.

The analysis in this subsection is based on the experience of a limited num-
ber of countries. Comments are particularly invited on the experience in other
countries which use the central management and control or place of management
concept, or other similar concepts which may provide guidance on the meaning of
place of effective management.

Summary of key factors in determining a place of effective management

A place of effective management will generally be where key management
and commercial decisions necessary for the conduct of a business are in sub-
stance made and given. This will ordinarily be where the directors meet to make
decisions relating to the management of the company, but the determination of a
place of effective management is a question of fact and other relevant factors
taken into account by the courts have included:

- Where the centre of top level management is located.
- Where the business operations are actually conducted.
- Legal factors such as the place of incorporation, the location of the regis-
tered office, public officer, etc.
- Where controlling shareholders make key management and commercial
decisions in relation to the company; and
- Where the directors reside.
It should be noted, while the guidance from *Central Management and Control* and the *Place of Management* indicates the place of effective management will ordinarily lie with the directors, in certain circumstances these strategic decisions and powers may be exercised by others. For example, the guidance provided in paragraph 24 of the Commentary on Article 4, makes it clear that the relevant consideration is where the high level decision making occurs. If this function is performed by persons other than the Board of Directors, then the relevant consideration is the place where those other people make their decisions.

In the past, in an environment where the most senior manager or managers tended to operate from and meet in a single location such as a head office, determination of the place where key management and commercial decisions were made was not too difficult. The place where the top level management activities occurred would mainly coincide with the place where the company was incorporated and had its registered office, where the business activities were conducted and where the directors or senior managers resided. It was therefore, as the Commentary states “rare in practice for a company, etc. to be subject to tax as a resident in more than one State”. 31

However, the communications and technological revolution is fundamentally changing the way people run their business. Due to sophisticated telecommunication technology and fast, efficient and relatively cheap transportation, it is no longer necessary for a person or a group of persons to be physically located or meet in any one particular place to run a business. This increased mobility and functional decentralisation may have a significant impact on the incidence of dual resident companies, and the application of the place of effective management tie-breaker rules.

**Limitations in a modern, technologically advanced environment**

In a modern environment, the application of the above factors may not result in a clear determination of which State should be given preference as the State of residence, or may result in an outcome which does not appear to accord with the policy intentions of the provision.

**Place of effective management in multi-jurisdictions**

Given that the “place of effective management” is one of substance over form, in theory, it should always produce results which reflect the true policy intention of the tie breaker rule.

However, the availability of advanced and evolving communications technology such as videoconferencing or electronic discussion group applications via the Internet means that it is no longer necessary for a group of persons to be physically located or meet in one place to hold discussions and make decisions. In a
modern environment, application of the traditional approach can produce results which do not reflect the intention of the tie-breaker rule. This is illustrated below.

If senior managers adopt conferencing through the Internet, for example, as a key medium for making management and commercial decisions and those managers are located throughout the world, it may be difficult to determine a place of effective management. In such cases, a place of management might be regarded as existing in each jurisdiction where a manager is located at the time of making decisions, but it may be difficult (if not impossible) to point to any particular location as being the one place of effective management.

German case law suggests that the residence of a company may be determined by the residence of the top manager, in cases where the place of management cannot be determined. It may be that this approach could be extended to companies managed by a board of directors or senior executives. However, increasingly, it is likely that situations will arise where those people are not all residents of one country.

How does one determine, for example, a place of effective management when half of the directors reside in Country A, while the other half reside in Country B? This scenario may become more prevalent in the future as more companies list on multiple stock exchanges and if the recent announcement of a proposed globally tradable stock eventuates.\(^3\)

Although the use of technology may increase the number of cases where a place of effective management may exist simultaneously in multiple jurisdictions, this possibility has also been recognised in traditional business operations. See for example, Lord Radcliffe's statement in *Bullock v The Unit Construction Co Ltd* 38 TC at page 739, ...individual cases have not always so arranged themselves as to make it possible to identify any one country as the seat of central management and control at all. Though such instances must be rare, the management and control may be divided or even, at any rate in theory, peripatetic.

**Mobility**

Increasing numbers of enterprises conducting transnational businesses, combined with rapid improvement in global transportation systems, are also likely to have an impact on the place of effective management concept. In particular, there may be an increased incidence of mobile places of effective management.

It is not too difficult, for example, to envisage a situation where the managing director of a company who is responsible for the management of that company is constantly on the move. In some extreme cases, that person may consistently be making the decisions while flying over the ocean or while visiting various sites in different jurisdictions where his business is conducted.
Similarly, a board of directors may arrange to meet in different places throughout the year. For example, the board of a multinational enterprise may agree to meet at the offices of the enterprise around the globe on a rotational basis. This can also lead to an enterprise having a mobile place of effective management.

**Anomalies**

In the traditional environment a situation can arise where the company is treated as a resident for tax purposes under the domestic law of both Contracting States, but the place of effective management is in a third State. This may occur for example where increased use of modern technology may cause this to become a practical issue.

**Options to resolve the limitations**

It is generally accepted that there is a need to deal with residence-residence conflicts and most tax treaties achieve this through a residence tie-breaker to avoid the impost of double taxation. As a way of evaluating the options discussed we should do so on the understanding that to be an effective tie-breaker provision for treaty purposes the rule must operate to assign residence to only one of the Contracting States.

**Place of effective management in multi-jurisdictions**

As noted above, the characteristics of effective management may exist in a number of jurisdictions and it may be said to exist simultaneously in more than one jurisdiction without a specific single jurisdiction being dominant. Thus to the extent that the place of effective management test fails to provide a clear allocation of residence to one country, albeit in a limited number of cases, it may be seen to be an ineffective rule.

In order to achieve a tie-breaker rule that will produce a single territory result in all cases, the following options may be considered:

A) Replace the place of effective management concept.

B) Refine the place of effective management test.

C) Establish a hierarchy of tests, as in the individual tie-breaker so that if one test does not provide an outcome, the next test will apply; or

D) A combination of B and C above.

Another alternative is to deny dual resident companies the benefits under the Convention. Although this option does not address the issue of residence-residence...
conflicts resulting in double taxation, it does act as a deterrent to treaty abuse by dual resident companies.

A) Replace the place of effective management concept

Various options have been raised as a possible alternative tie-breaker, such as:

a) place of incorporation or, in the case of an unincorporated association, place where corporate law applies to the establishment of the enterprise;
b) place where the directors/shareholders reside; and
c) the place where economic nexus is strongest.

i) Place of incorporation or, in the case of an unincorporated association, place where corporate law applies to the enterprise

While the place of incorporation test has the advantage of being easily understood, has minimal administration and compliance costs in many cases, there are nevertheless arguments against its adoption as a tie-breaker test.

In today's environment the act of incorporating an enterprise or establishing an incorporated association is relatively simple. In fact, many jurisdictions allow online incorporation or establishment. As a result it is possible that the only tie an enterprise may have to the jurisdiction in which it is incorporated or established is a formal tie. For example, Company Z incorporated in Country A, may have its entire management, business operations and assets located in Country B. For this reason the place of incorporation was rejected as a tie-breaker test in paragraph 22 of the Commentary on Article 4.

"22. It would not be an adequate solution to attach importance to a purely formal criterion like registration..."

Another issue. Suppose Company Z incorporated in Country A, divides its entire management, business operations and assets between Country B and C. If a treaty exists between Countries B and C, who both claim the company as a resident, a tie-breaker based purely on incorporation will not deliver a result between Country B and Country C. Therefore the underlying policy intent will not be realised and double taxation may result.

Similarly, the place of incorporation test may not be reflective of changes to an enterprise's circumstances over time. For example, Company Z incorporated in Country A and having its seat of management, operations and assets in that country may over time migrate these to another country. In such cases, the economic and business links to Country A may be reduced to a minimum, but under a tie-breaker rule based on place of incorporation, residence taxing rights would be allocated solely to that country. This would not seem to be a correct policy outcome.
Furthermore, as the process of incorporation is a formal one, it is possible at some later time to change the place of incorporation to another country using a number of methods. While this may not be widespread, especially where there may be capital gains tax implications, it is relatively easy to change residence by creating a new entity and transferring the business to it or by re-registering in another country.

Finally, in some jurisdictions it may be possible for a company to be incorporated in more than one country, which would have the effect of rendering such a tie-breaker ineffective.

Using the place of incorporation or establishment as a tie-breaker for companies would produce a result similar to looking to where an individual was born as opposed to where they live. Transposing this scenario of changing the place of incorporation to that of an individual would be to recognise place of birth as the sole residency test.

**ii) Place where the directors/shareholders reside**

As noted above, a test relying solely on where the directors/senior managers or shareholders reside will not always give a clear result. Even a test relying on where the majority of shareholders or directors/senior managers reside may not always result in certainty and may give rise to extreme results where the shareholders are not natural persons.

**iii) Where the economic nexus is strongest**

The economic connection to a State may be characterised by the extent that land, labour, capital and enterprise (the factors of production) are used by the company in deriving its profits. Using those characteristics the tie-breaker would serve to determine to which State, the company has its strongest ties and to deem the company to be a resident solely of that State.

While on the surface it may appear that such an option is more aligned to source taxation rationale, it also may have some links to the underlying rationale for residence taxation. It could be argued that if the State provides certain facilities and infrastructure for its residents, those who benefit most from such facilities and infrastructure ought to contribute to the State via residence-based taxes. So if a company uses the legal infrastructure, consumes or uses the facilities etc in that State, there is a case that it ought to be treated as a resident. If it does so in more than one State, then a tie-breaker rule based on economic nexus would require a determination (as with individuals) of where its ties/consumption are stronger. However, it could also be argued that the use by a company of the facilities and infrastructure of a State is a rationale that supports source, rather than residence, taxation. Nevertheless, the concept of economic nexus could still be
used as a tie-breaker even if it is not used as a basis for residence taxation. It should be noted that such a concept being used in a residence tie-breaker is not unprecedented. For example, the individual tie-breaker uses “centre of vital interests” as a determining factor in deeming residence.

It may be that this option warrants further consideration on the appropriateness of such a test to confer residence. If so, the consideration should be given as to what characterises economic connection to a State. Consideration should also be given to whether such a test may be overly difficult to apply as it could involve subjective comparisons. It also may discriminate against multinational enterprises resident in small countries.

B) Refine the place of effective management test

In refining the existing place of effective management test, two options have been suggested. Either, making a determination on the basis of predominant factors or giving a weighting to various factors.

The construction of paragraph 24 of the 2000 Commentary presupposes that the determination is on the basis of the following predominant factors; where the key management and commercial decisions are made in substance; where the most senior person or group of persons makes its decisions and where the actions to be taken by the enterprise as a whole are determined. It may be that, for the majority of cases involving the company residence tie-breaker, these three factors readily deliver a decision which reflects the underlying policy intent. This may be considered the norm.

However, where analysis of these predominant factors does not produce a single place of effective management, it may be necessary to consider other additional factors, as is suggested in paragraph 24 of the Commentary where it states that “however, no definitive rule can be given and all the relevant facts and circumstances must be examined to determine the place of effective management”. Other facts which may be considered in association with the dominant factors could include:

- Location of and functions performed at the headquarters.
- Information on where central management and control of the company is to be located contained within company formation documents (articles of association etc).
- Place of incorporation or registration.
- Relative importance of the functions performed within the two States; and
- Where the majority of directors reside.

Comments are invited as to whether this would be a useful addition to the Commentary, and if so, what weighting should be given to the various factors and whether there are other factors which should be taken into account.
Addressing mobility

Article 4 does not offer guidance on this type of situation. However, Article 8 of the OECD Model Convention deals with one example of a mobile place of effective management. Paragraph 3 of Article 8 states:

“3. If the place of effective management ... is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.”

In effect, the provision recognises that a place of effective management which is located on board a ship will be mobile, and to overcome this problem, operates to deem the place of effective management to be in the jurisdiction with which the shipping enterprise has its closest links.

It may be possible to devise a similar provision to deal with other situations where the place of effective management is mobile, e.g. where a single board of directors meets in different locations. It will not however address situations where a place of effective management could be said to exist simultaneously in multiple jurisdictions, for example, where directors from different countries conduct meetings by way of video-conferencing.

C) Establish a hierarchy of tests, as in the individual

Article 4 paragraph 2 of the Model Convention establishes a hierarchical approach for the individual residency tie-breaker. A similar approach may provide assistance in applying the corporate tie-breaker.

However, further consideration of a hierarchy of tests approach may be warranted. If we assume that an analysis of the predominant factors, (i.e. where the key management and commercial decisions are made in substance; where the most senior person or group of persons makes its decisions and where the actions to be taken by the enterprise as a whole are determined) will in general produce a correct result, then this may form the first level of the hierarchy as it would, in general, yield a result reflecting the policy intent in most cases.

The level or levels below would therefore deal with determinations regarded as the exceptions. A possible structure for such a hierarchy may be:

- Place of effective management.
- Place of incorporation.
- Economic nexus; and
- Mutual agreement.
Comments are invited on this approach, including whether such a test would limit our ability to deal with the tie-breaker situations considered to be the “exceptions” as a hierarchical approach will make the test rigid.

D) A combination of options B and C

A number of different options have been identified above and while some of these may prove to be an ineffective option in isolation they may be effective when combined with others. Therefore further consideration should be given to identify possible combinations resulting in an effective tie-breaker test.

Deny dual resident companies the benefits under the Convention

A number of countries have lodged reservations to Article 4 to deny dual resident companies the benefits under the Convention in certain circumstances. While the individual countries’ reasons for such reservations may differ, such an option may be seen to encourage the controller or controllers of a dual resident company to take appropriate measures to prevent dual residence.

However, as noted earlier, company dual or indeed multiple residency may occur due to conflicting residency rules. For example, incorporation/central management and control conflict. Under such an option, the corporate may be subjected to double taxation on its income even though there may be sound commercial reasons for their central management and control structuring.

Where to from here

In the majority of cases, the place of effective management tie-breaker test will provide the right result. However, the tie-breaker must be capable of effective application in all cases where dual residency arises.

Of the options put forward to date for the replacement of the current test, only the place of incorporation provides certainty (except in those rare cases where dual incorporation may arise). However, that test does not always give the right policy outcome as there may be little or no business/economic link and may be manipulated easily.

Further specification of factors giving rise to the place of effective management may assist. In response the paper identifies the following options for further consideration:

- “Where the economic nexus is strongest”:
  Expansion of the 2000 Commentary to identify a further range of factors that may be relevant in determining the place of effective management.
• In dealing with mobility of POEM explore a similar approach as in paragraph 3 of Article 8 which states; “If the place of effective management ... is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.”

• Establishing a hierarchy of tests; and

• Using a combination of options, such as those presented to develop an effective test.

Comments are invited on those options, and whether other alternatives not addressed in this paper should be considered. Comments can be posted on the OECD’s public EDG (appli1.oecd.org/daf/taxandel.nsf and/or to register to participate in the EDG: www.oecd.org/daf/ia/e_com/e_rego.htm) or e-mailed to Jeffrey Owens, Head of Fiscal Affairs (daffa.contact@oecd.org) and copied to Jacques Sasseville, Head of Tax Treaty Unit (jacques.sasseville@oecd.org).
Notes

1. Working Party No. 1 on Tax Conventions and Related Questions is a subsidiary body of the OECD Committee on Fiscal Affairs and is responsible for drafting changes to the OECD Model Tax Convention.

2. The detailed mandate and composition of the Treaty Characterisation TAG appear in Appendix III to this chapter.

3. The Treaty Characterisation TAG did not attempt to cover all categories of current and future e-commerce transactions. Instead, it sought to identify the principles to be applied in analysing the various treaty characterisation issues so that they can be applied to the existing and emerging transactions as required.

4. The same result would apply regardless of whether the payment was made as regards the downloading of one specific product or in the form of a subscription fee for the right to access a web site where that digital product may be downloaded.


6. Paragraph 9 of the Commentary on Article 12 indicates that these words were deleted from the definition of royalties in order to exclude income from … leasing [of such equipment] from the definition of royalties and, consequently, to remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits…”

7. See, for example, the provision of the India-United States tax convention dealing with “included services”.

8. In February 2001, this section (4.3) was released to the public for a period of public comment (through June 2001). It is therefore not a final text and should not be cited from or referred to as such.


12. Software is, for the purpose of this section (4.3), referred to as “intangible” property, notwithstanding the broader issue of how it is characterised under the Model Tax Convention or domestic law. While the software may or may not be intellectual property of the enterprise (depending, for example, on whether the software was acquired on the market
or developed by the enterprise), this paper avoids making the distinction. Of course, such a distinction can potentially be material to the determination of the arm’s length compensation associated with a transaction involving such property.

13. One could imagine a situation where the server PE had software that researched the latest consumer trends, ordered material from suppliers based on that research and on the basis of the lowest possible cost. The question arises as to whether, in such a situation, the functional and factual analysis could show that the permanent establishment was actually assuming some market risk.

14. The “service provider” model should not be confused with the approach that consists of treating transactions in digitised products as “services” for purposes of value added taxes. This model is only meant to imply that the revenues of the permanent establishment are in the form of a fee for services performed for the benefit of the head office. The issue of the characterisation of transactions in digitised products occurring between Starco and customers is not relevant to the issue of the attribution of income to the permanent establishment and, therefore, is not considered further in this discussion paper.

15. Paragraph 17.4 of the Commentary to the OECD Model Tax Convention.

16. The reader may be left wondering why so much of the analysis is devoted to approaches that may not prove to be practical or appropriate in the circumstances. There are two answers to this question: first, this paper is meant to illustrate the thought process that takes place while performing a functional and factual analysis where the outcome cannot necessarily be anticipated at the outset. Second, whereas the discussion in this note is based on a specific and simple example and, consequently, could allow one to perform precise analysis leading to specific conclusions, reliance on such a specific example is also, by definition, limiting in nature, because one cannot necessarily infer that the analysis and conclusions are of general application. This is why it is useful to identify in this paper the different directions that may be adopted in the course of performing a functional and factual analysis when the fact pattern is different and more complex.

17. The server-permanent establishment is peculiar as, unlike more conventional situations, both types of property are not used as input in a human process creating value added – the mere autonomous operation of both types of property creates the value added. For example, where a manufacturing intangible developed by an enterprise is contributed to either a permanent establishment or a subsidiary of the enterprise for commercial exploitation, the resulting value created by the manufacturing function using the intangible is the sum of the value added attributable to the pure manufacturing function and the value added associated with the exploitation of the intangible. Manufacturing absent the intangible would not create the same value and the value could only be extracted by the intangible where it is used in a manufacturing function. In the case of the computer server, the exploitation of the combination of the hardware and software is essentially a passive function, in that no other significant factors of productions need be involved. A possible exception is the use of the information gathering function to create marketing intangibles such as customer lists and e-commerce marketing intangibles. The value of these intangibles will depend respectively on the nature of the information obtained and the operation of the web site. Both of these are a function of the complexity of the relevant software.

18. Another variation, where different aspects of a transaction are performed by different servers, could also be examined. However, such an assumption raises the threshold
issue of whether performance of certain activities and not others would still qualify any of the particular servers as a permanent establishments under Article 5 of the Model Tax Convention.

19. In other words, the development was undertaken with the intention of providing a long-term benefit for the PE itself and was not developed on behalf of, or for the benefit of, other parts of Starco.

20. In February 2001, this section (4.4) was released to the public for a period of public comment (through June 2001). It is therefore not a final text and should not be cited from or referred to as such.


22. Paragraph 22 of the Commentary on Article 4 of the Model Tax Convention.


25. For example, Australia, Ireland and the United Kingdom.


28. For example, Germany and the Netherlands.

29. See Vogel, K., *Double Taxation Conventions*, 3rd edition, Kluwer Law International, page 262 in which he states “The German domestic term place of management’ is very similar to the treaty term place of effective management’, and even more so because the former term is interpreted by the courts to refer to the factual conditions”.

30. Supra at page 262.

31. Paragraph 21 of the Commentary on Article 4 of the Model Tax Convention.

32. See [www.computershare.com](http://www.computershare.com).

33. See the reservations lodged by Canada, Mexico and the United States for details.
Appendix I

Suggestions for Changes to the Commentary to the OECD Model Tax Convention

[Changes to the existing text of the Commentary appear in bold italics for additions and strikethrough for deletions.]

Replace paragraph 11 of the Commentary on Article 12 by the following paragraphs 11 to 11.5:

Replace the last sentence of paragraph 11 of the Commentary on Article 12 by the following (changes to the existing text appear in strike-through and bold italics):

"11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of “know-how”. Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the “Association des Bureaux pour la Protection de la Propriété Industrielle” (ANBPPI), states that “know-how” is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7.

11.3 The need to distinguish these two types of payments, i.e., payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- Contracts for the supply of know-how concern information that already exists or concern the supply of information after its development or creation and include provisions concerning the confidentiality of that information.

- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.

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In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- Payments obtained as consideration for after-sales service.
- Payments for services rendered by a seller to the purchaser under a guarantee.
- Payments for pure technical assistance.
- Payments for an opinion given by an engineer, an advocate or an accountant, and
- Payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database.

11.5 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration. Then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part."

Add the following paragraphs 17.1 to 17.4 immediately after paragraph 17 of the Commentary on Article 12:

"17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of the consideration for the payment."
17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is made to acquire data transmitted in the form of a digital signal for the acquirer's own use or enjoyment. This constitutes the essential consideration for the payment, which therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purpose of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content."
Appendix II

Analysis of Various Categories of Typical E-commerce Transactions

This appendix is an updated version of the draft released by the Treaty Characterisation TAG (or "Group") on 24 March 2000 and first revised on 1 September 2000. This last version reflects the conclusions reached by the Group on the various characterisation issues identified in the second section of Chapter 4.2.

Category 1: Electronic order processing of tangible products

Definition

The customer selects an item from an online catalogue of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The product is physically delivered to the customer by a common carrier.

Analysis and conclusions

Whilst the Group considers that category of transaction as a useful starting point, it does not see it as raising any treaty characterization issue. In this type of transaction, the payment made by the customer constitutes consideration that clearly falls within Article 7 (Business Profits) rather than Article 12 (Royalties), because it does not involve a use of copyright.

Category 2: Electronic ordering and downloading of digital products

Definition

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded onto the customer’s hard disk or other non-temporary media.

Analysis and conclusions

The Group found that this category of transaction raised the fundamental characterisation issue discussed earlier, i.e. the distinction between business profits and the part of the treaty definition of “royalties” dealing with payments for the use of, or the right to use, a copyright. It concluded that in the case of transactions that permit the customer to electronically download digitised products (such as software, images, sounds or text) for the customer’s own use or enjoyment, the payment is made to acquire data transmitted in the form of a digital signal. Since this constitutes the essential consideration for the payment, that
payment cannot be considered as royalties as a payment made for the use or the right to use a copyright so as to constitute a royalty. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the use of a copyright under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

Category 3: Electronic ordering and downloading of digital products for purposes of commercial exploitation of the copyright

Definition

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded into the customer's hard disk or other non-temporary media. The customer acquires the right to commercially exploit the copyright in the digital product (e.g. a book publisher acquires a copyrighted picture to be included on the cover of a book that it is producing).

Analysis and conclusions

The Group considered it useful to refer to this category of transaction in order to illustrate a case where all its members agree that the payment qualifies as a royalty. Indeed, in that case, the payment is made as consideration for the right to use the copyright in the digital product. In the example given, that use takes the form of the reproduction and sale, for commercial purpose, of the copyrighted picture.

Category 4: Updates and add-ons

Definition

The provider of software or other digital product agrees to provide the customer with updates and add-ons to the digital product. There is no agreement to produce updates or add-ons specifically for a given customer.

Analysis and conclusions

The Group agrees that this category of transaction should be treated:

- Like the transactions described in category 1 above if the updates and adds-on are delivered on a tangible medium.
- Like the transactions described in category 2 above if the updates and adds-on are delivered electronically.

Since both categories 1 and 2 would give rise to payments falling under Article 7, payments made by the customer in this category of transaction should therefore be treated similarly.
Category 5: Limited duration software and other digital information licenses

Definition

The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are deleted or become unusable upon termination of the license.

Analysis and conclusions

The Group unanimously concluded that, under the OECD Model as currently worded, that transaction should be treated exactly as transactions falling under categories 1 or 2 so that the payment to the commercial provider of the limited duration digital product would fall under Article 7 (Business Profits).

Also, if a particular convention includes a definition of royalties that covers “payments for the use of, or the right to use, industrial, commercial or scientific equipment”, the Group concluded that such payments cannot be considered as payments “for the use of, or the right to use, industrial, commercial or scientific equipment” for the reasons set out in the third section of Chapter 4.2.

Category 6: Single-use software or other digital product

Definition

The customer receives the right to use software or other digital products one time. The product may be either downloaded or used remotely (e.g. use of software stored on a remote server). The customer does not receive the right to make copies of the digital product other than as required to use the digital product for its intended use.

Analysis and conclusions

Whilst some members view this type of transaction as contracts for services and others view them as being similar to the transactions referred to in categories 2 and 5, the Group unanimously agreed that payments made in these transactions fall under Article 7 as business profits.

Category 7: Application hosting – separate license

Definition

A user has a perpetual license to use a software product. The user enters into a contract with a host entity whereby the host entity loads the software copy on servers owned and operated by the host. The host provides technical support to protect against failures of the system. The user can access, execute and operate the software application remotely. The application is executed either at a customer’s computer after it is downloaded into RAM or remotely on the host’s server. This type of arrangement could apply, for example, for financial management, inventory control, human resource management or other enterprise resource management software applications.
Analysis and conclusions

The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to business profits falling under Article 7.

Where, however, a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment", the issue arises whether these words can be applied to all or part of the payments arising from these transactions.

As discussed in the third section of Chapter 4.2, the Group concluded that these transactions should generally give rise to services income as opposed to rental payments. In a typical transaction, the vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

The Group also discussed whether payments arising in this type of transaction could be treated as payments for services of a "technical nature" under alternative treaty provisions that allow source taxation of "technical fees". To the extent that main service being provided is merely that of storing the data and software of customers, this service is akin to mere warehousing and the performance of that function does not require the direct exercise of any special technical skill or knowledge.

Category 8: Application hosting – bundled contract

Definition

For a single, bundled fee, the user enters into a contract whereby the provider, who is also the copyright owner, allows access to one or more software applications, hosts the software applications on a server owned and operated by the host, and provides technical support for the hardware and software. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. The contract is renewable annually for an additional fee.

Analysis and conclusions

The Group agrees that, under the current wording of the OECD Model, there would be no need to separate the payment described in this example as all of it would constitute business profits falling under Article 7.

Pursuant to the existing paragraph 11 of the Commentary on Article 12, however, the need to separate the payment into various components could arise when applying bilateral conventions that include the alternative provisions referred to in the previous category (see the third section of Chapter 4.2). This would be the case to the extent that part of the payment relates to the provision of technical support for the software that would constitute services of a technical nature. In that case, that part would be treated differently from the parts relating to allowing access to one or more software applications and hosting such software applications as such functions do not require the application of special skills or knowledge (they essentially require owning the relevant equipment and software rights that are made available).
Category 9: Application Service Provider (“ASP”)

Definition
The provider obtains a license to use a software application in the provider’s business of being an application service provider. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. For example, the software might automate sourcing, ordering, payment, and delivery of goods or services used in the customer’s business, such as office supplies or travel arrangements. The provider does not provide the goods or services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider’s server, and does not have possession or control of a software copy.

Analysis and conclusions
As regards the payment made by the customer, the Group agrees that the issues arising are similar to those discussed under the preceding category.

Category 10: ASP license fees

Definition
In the example above, the ASP pays the provider of the software application a fee which is a percentage of the revenue collected from customers. The contract is for a one year term.

Analysis and conclusions
The Group agrees that this type of transaction, being essentially for the provision of a software product to be used in the business of the transferee, falls within Article 7. The Group acknowledged that the fact that the ASP’s customer will have access to the software copy hosted on servers owned and operated by the provider may technically involve the ASP displaying to the customers some copyrighted information (e.g. forms for data input). The Group agreed, however, that if providing such access constituted the use of a copyright right by the ASP (for example a display or other right), such use of copyright would be such a minimal part of the consideration for the payment made by the ASP to the software provider that it should not be relevant for the treaty characterisation of that payment.

Category 11: Web site hosting

Definition
The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content on the site. The provider is compensated by a fee based on the passage of time.

Analysis and conclusions
The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to business profits falling under Article 7. The Group also notes that where
a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of "technical fees", this type of transaction would not give rise to these two types of income under the circumstances and for the reasons presented under category 7, which deals with application hosting.

Category 12: Software maintenance

Definition

Software maintenance contracts typically bundle software updates together with technical support. A single annual fee is charged for both updates and technical support. In most cases, the principal object of the contract is the software updates.

Analysis and conclusions

The Group concluded that the remarks expressed in the third section of Chapter 4.2 as regards mixed contracts, which refer to the principles set out in paragraph 11 of the Commentary on Article 12, apply to such transactions. Where, under those principles, part of the payment is regarded to be for the provision of technical support, the issues described in category 14 below as regards alternative treaty provisions that allow source taxation of "technical fees" will arise.

Category 13: Data warehousing

Definition

The customer stores its computer data on computer servers owned and operated by the provider. The customer can access, upload, retrieve and manipulate data remotely. No software is licensed to the customer under this transaction. An example would be a retailer who stores its inventory records on the provider's hardware and persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock.

Analysis and conclusions

The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to business profits falling under Article 7. The Group also notes that where a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of "technical fees", this type of transaction would not give rise to these two types of income under the circumstances and for the reasons presented under category 7, which deals with application hosting.

Category 14: Customer support over a computer network

Definition

The provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support can take the form of online technical documentation, a trouble-shooting database, and communications (e.g. by e-mail) with human technicians.
Analysis and conclusions

The Group agreed that, based on this description and under the wording of the OECD Model Convention, the payment arising in this type of transaction would fall within Article 7. In reaching its conclusion, the Group discussed the extent to which the payment could be considered as a payment for “information concerning industrial, commercial or scientific experience” (know-how) so as to constitute royalties.

Based on paragraphs in the third section of Chapter 4.2 and, in particular, the factors listed, the Group agrees that online advice, communications with technicians and using the trouble-shooting database, would clearly involve actual services being performed on demand rather than the provision of know-how.

Whilst the provision of technical documentation could, depending on the circumstances, constitute the provision of know-how, this would require that the information be “undivulged technical information” as described in paragraph 11 of the Commentary on Article 12. Also, as mentioned in the same paragraph, know-how “is necessary for the industrial reproduction of a product or process”. To the extent that know-how must be technical information relating to industrial reproduction of a product or process, the Group considers that information that merely relates to the operation or use of products as opposed to their development or production would not fall under the definition of know-how.

The Group notes that the remarks in the third section of Chapter 4.2, which deals with mixed contracts, would be relevant if the contract were considered to cover the provision of both services and know-how.

The Group finally discussed how the payment arising in this type of transaction would be treated under alternative treaty provisions that allow source taxation of “technical fees”.

Whilst the provision of online advice through communications with technicians may require the application of special skill and knowledge and might therefore constitute services of a technical nature, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. The part of the payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

Category 15: Data retrieval

Definition

The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.

Analysis and conclusions

All members of the Group consider that the payment arising from this type of transaction would fall under Article 7. Some of them reach that conclusion because, given that the principal value of such a database would be the ability to search and extract the documents, these members view the contract as a contract for services. Others consider that, in this transaction, the customer pays in order to ultimately obtain the data that he will search for. They therefore view the transaction as being similar to those described in category 2 and will accordingly treat the payment as business profits.
The Group also addressed the issue of whether these could be considered as services "of a technical nature" under the alternative provisions on technical fees previously referred to. The Group agreed that providing a client with the use of search and retrieval software and with access to a database does not involve the exercise of special skill or knowledge when the software and database is delivered to the client. The fact that the development of the necessary software and database would itself require substantial technical skills was found to be irrelevant as the service provided to the client was not the development of the software and database (which may well be done by someone other than the supplier) but rather making the completed software and database available to that client.

**Category 16: Delivery of exclusive or other high-value data**

**Definition**

As in the previous example, the provider makes a repository of information available to customers. In this case, however, the data is of greater value to the customer than the means of finding and retrieving it. The provider adds significant value in terms of content (e.g., by adding analysis of raw data) but the resulting product is not prepared for a specific customer and no obligation to keep its contents confidential is imposed on customers. Examples of such products might include special industry or investment reports. Such reports are either sent electronically to subscribers or are made available for purchase and download from an online catalogue or index.

**Analysis and conclusions**

The Group agrees that these transactions involve the same characterization issues as those described in the previous category. It therefore believes that the payment arising from this type of transaction would fall under Article 7 and is not a technical fee for the same reason.

**Category 17: Advertising**

**Definition**

Advertisers pay to have their advertisements disseminated to users of a given web site. So-called "banner ads" are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser. Advertising rates are most commonly specified in terms of a cost per thousand "impressions" (number of times the ad is displayed to a user), though rates might also be based on the number of "click-throughs" (number of times the ad is clicked by a user).

**Analysis and conclusions**

All members of the Group agreed that the payments arising from these transactions would constitute business profits falling under Article 7 rather than royalties, even under alternative definitions of royalties that cover payments "for the use, or the right to use, industrial, commercial or scientific equipment".

**Category 18: Electronic access to professional advice (e.g., consultancy)**

**Definition**

A consultant, lawyer, doctor or other professional service provider advises customers through e-mail, video conferencing, or other remote means of communication.
Analysis and conclusions

Again, all members of the Group agreed that the payments arising from these transactions would constitute business profits falling under Article 7 rather than royalties. As already stated, the provision of on-demand advice is a service and not the supply of know-how.

As these transactions involve the provision of technical, managerial or consultancy services, the Group also addressed the issue of whether these could be considered as services “of a technical nature” under the alternative provisions on technical fees that have been previously referred to. The Group concluded that to the extent that the services were rendered by someone acting as a consultant, they would constitute services of a consultancy nature so as to fall within the definition quoted in the third section of Chapter 4.2.

Category 19: Technical information

Definition

The customer is provided with undivulged technical information concerning a product or process (e.g. narrative description and diagrams of a secret manufacturing process).

Analysis and conclusions

The Group agrees that payments arising from this category of transactions constitute royalties as they are made for the supply of know-how, i.e. “for information concerning industrial, commercial or scientific experience.”

Category 20: Information delivery

Definition

The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. The principal value to customers is the convenience of receiving widely available information in a custom-packaged format tailored to their specific needs.

Analysis and conclusions

The Group agrees that this type of transaction raises basically the same issues as those described under category 15 above. The members of the Group therefore consider that the payments arising from these transactions constitute business profits falling under Article 7 and are not technical fees for the same reason.

Category 21: Access to an interactive web site

Definition

The provider makes available to subscribers a web site featuring digital content, including information, music, video, games, and activities (whether or not developed or owned by the provider). Subscribers pay a fixed periodic fee for access to the site. The principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or services from the site.
Analysis and conclusions

The Group agrees that the subscription fee paid in this type of transactions would constitute a payment for services. As that payment is mainly for the interaction with the site for purposes of the personal enjoyment of the user and not for the provision of any service of a technical, managerial or consultancy nature, it would not, under the previously quoted definition of "technical fees", fall under the alternative provisions covering these types of payments. The Group also agreed any payment to the owner of the copyright in the digital content that would be made by the provider for the right to display that content to its subscribers would constitute royalties.

Category 22: Online shopping portals

Definition

A web site operator hosts electronic catalogues of multiple merchants on its computer servers. Users of the web site can select products from these catalogues and place orders online. The web site operator has no contractual relationship with shoppers. It merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. The merchants pay the web site operator a commission equal to a percentage of the orders placed through the site.

Analysis and conclusions

The Group agrees that these payments are revenues from advertising or similar services that constitute business profits falling under Article 7.

Category 23: Online auctions

Definition

The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.

Analysis and conclusions

The Group agrees that these payments are revenues similar to those of an auction house and constitute business profits falling under Article 7.

Category 24: Sales referral programs

Definition

An online provider pays a sales commission to the operator of a web site that refers sales leads to the provider. The web site operator will list one or more of the provider’s products on the operator’s web site. If a user clicks on one of these products, the user will retrieve a web page from the provider’s site from which the product can be purchased. When the link on the operator’s web page is used, the provider can identify the source of the sales lead and will pay the operator a percentage commission if the user buys the product.
**Analysis and conclusions**

The Group agrees that these payments constitute business profits falling under Article 7.

**Category 25: Content acquisition transactions**

**Definition**

A web site operator pays various content providers for news stories, information, and other online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new content specifically for the web site.

**Analysis and conclusions**

The Group agrees that the two alternatives described above need to be distinguished. Where the site operator pays a content provider for the right to display copyrighted material, the payment would fall under the definition of royalties to the extent that the public display of the content constitutes a right covered by the copyright of the owner of the content. Where, however, the operator pays for the creation of new content and, as a result of the relevant contractual arrangements, becomes the owner of the copyright in the content so created, the payment cannot be for royalties and falls under Article 7.

**Category 26: Streamed (real time) web-based broadcasting**

**Definition**

The user accesses a content database of copyrighted audio and/or visual material. The broadcaster receive subscription or advertising revenues.

**Analysis and conclusions**

The Group agrees that the subscription or advertising fees that would be received in these transactions would constitute business profits falling under Article 7.

**Category 27: Carriage fees**

**Definition**

A content provider pays a particular web site or network operator in order to have its content displayed by the web site or network operator.

**Analysis and conclusions**

The Group agrees that in that type of transactions, the web site or network operator is providing a commercial service for a fee and its income should be characterised as business profits under Article 7. In these transactions, unlike in those described in category 25, it is the owner of the copyrighted material who makes the payment, which makes it clear that Article 12 is not applicable.
Category 28: Subscription to a web site allowing the downloading of digital products

Definition

The provider makes available to subscribers a web site featuring copyrighted digital content (e.g. music). Subscribers pay a fixed periodic fee for access to the site. Unlike category 21, the principal value of the site to subscribers is the possibility to download these digital products.

Analysis and conclusions

The Group agrees that the subscription fee paid in this type of transaction would fall under Article 7. As explained above, transactions that permit the customer to electronically download digitised products (i.e. music in this case) for the customer’s own use or enjoyment do not give rise to royalties. The Group also agreed that this category of transaction is closer to category 2 than to category 21 since the essential consideration for the payment is not the temporary interaction with the site but, rather, the acquisition of the music data transmitted in the form of a digital signal.
Appendix III

Mandate and Composition of the Treaty Characterisation TAG

[The following is the mandate that the TAG received by the Committee on Fiscal Affairs.]

General mandate

The general mandate for the TAG on Treaty Characterisation of Electronic Commerce Payments is as follows:

“To examine the characterisation of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary.”

Specific mandate

The work of the TAG on Treaty Characterisation of Electronic Commerce Payments will involve primarily, but not exclusively, a consideration of the application of the definition of royalties in the context of electronic commerce.

It has already been decided to seek comments from interested parties on how the principles that underlie the proposed changes to the Commentary on software payments may be relevant in considering how that definition applies in the case of electronic commerce transactions involving digitised contents. The first responsibility of the TAG will therefore be to examine these comments and to make appropriate suggestions.

In the course of its work, the TAG will be invited to examine and provide comments on the distinction that can be drawn between various types of payments in determining whether a particular electronic commerce payment, e.g. a payment made for electronically searching a computer database and downloading a document from it, is made for the sale or lease of property, or for the provision of a service or as a royalty. In particular:

a) The TAG is invited to identify different types of electronic commerce transactions and the particular characteristics of such transactions which might enable distinctions to be drawn between payments for services and income from sales or leasing of property.

b) The TAG is invited to identify characteristics of electronic commerce transactions which might enable distinctions to be drawn between business profits and royalties and, in particular, the circumstances, if any, in which electronic commerce payments may be considered to be payments for use of copyright or use of know-how.

c) The TAG is invited to comment on whether there are reasons for preferring one characterisation to another.
d) The TAG is invited to identify the circumstances in which electronic commerce transactions can be considered to give rise to payments for industrial, commercial or scientific equipment.

Composition of the TAG

The following persons have participated in the activities of the TAG and have attended one or more of its meetings: It should be noted that this Chapter 4.2 reflects the personal views of the TAG participants at the time it was prepared. These views should not, therefore, be attributed to any government, business or organisation for which these participants work.

AUSTRALIA
Ms. Ariane Pickering (Co-Chair of the TAG) Ms. HK Holdaway
Australian Taxation Office Australian Taxation Office

CHILE
Ms. Liselott Kana (Co-Chair of the TAG)
Ministry of Finance

CHINA
Mr. Wang Yukang
Ministry of Finance

GERMANY
Mr. Helmut Krabbe Mr. Martin Kreienbaum
Federal Ministry of Finance Federal Ministry of Finance

INDIA
Mr. Vijay Mathur
Ministry of Finance

ISRAEL
Mr. Yehoshua Sherman (Mr. Sherman left the Israel Income Tax and Property Tax Commission before the report was completed) Ms. Frida Israeli
Israel Income Tax and property Tax Commission Israel Income Tax and Property Tax Commission
Mr. Yuval Cohen
Israel Income Tax and Property Tax Commission

JAPAN
Mr. Hiroyuki Iguchi Mr. Isao Watanabe
Ministry of Finance Ministry of Finance
Mr. Akihiko Yoshida Mr. Katsumi Shinagawa
Ministry of Finance Ministry of Finance

NORWAY
Mr. Gjert Melsom
Ministry of Finance

UNITED KINGDOM
Mr. Mike Waters
Inland Revenue

UNITED STATES
Mr. Michael Mundaca
Department of Treasury

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While representatives of the Government of Israel participated in the work of the Group, these representatives wish to indicate that they do not necessarily support some of the conclusions reached by the Group, especially as regards the meaning of the words “payments for the use, or the right to use, industrial, commercial or scientific equipment”.

BUSINESS

Mr. Gary Sprague (Co-Chair of the TAG)
Baker and McKenzie
United States

Mr. Frank Steimel
SIEMENS
Germany

Mr. Yasushi Ogasawara
NTT Data
Japan

Mr. David Fuller
REED ELSEVIER plc
United Kingdom

Mr. Charles Fontaine
REED ELSEVIER Inc.
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Ms. Anne Buettner
WALT DISNEY Co.
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Ms. Carol Felepchuk
IBM Canada Ltd.
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Mr. Mark E. Nebergall
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Mr. M. Onodera
NTT Data
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Mr. Mark Williams
WALT DISNEY Co.
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Part II

INPUT FROM THE TECHNICAL ADVISORY GROUPS (TAGs)
When originally set up in early 1999 the Technical Advisory Groups (TAGs) were given a two-year mandate to allow them time for a consideration of a range of tax policy and tax practice issues. The involvement of non-OECD economies and the private sector was designed to ensure that the types of policy and administrative solutions being developed were both compatible with current and emerging business models and, as far as reasonably possible, globally applicable. It was recognised at the outset that the business participants had a key role to play, bringing to the debate valuable business and technological knowledge and expertise. Further, it was also recognised that given the global nature of e-commerce, participation of non-member economies in the process was vital.

Five TAGs were created:

- The Consumption Tax TAG focused on advising on the practical implementation of the Ottawa principle of taxation in the place of consumption. The TAG brought valuable business perspectives to the debate on alternative collection mechanism options, and on how indirect taxation systems might be streamlined and simplified in the context of e-commerce.

- The work of the Treaty Characterisation TAG involved primarily a consideration of the application of the definition of royalties in the context of e-commerce.

- The Business Profits TAG examined how the current tax treaty rules for the taxation of business profits apply in the context of e-commerce and proposals for alternative rules.

- The Professional Data Assessment TAG focused upon an examination of the feasibility and practicality of developing internationally compatible information and record-keeping requirements and tax collection arrangements.

- The Technology TAG provided, in the main, expert technological input into the work of the other TAGs.
All of the TAGs provided valuable input into the wider OECD-led process. The non-member and business input into the policy development process proved very important in helping to identify more soundly-based and widely acceptable policy positions. The CFA is committed to continuing the TAG process (see Chapter 6).

This chapter sets out the main findings and/or conclusions and recommendations of each of the five TAGs. The summary reports here are supplemented in all cases (except that of the Treaty Characterisation TAG) by full reports with supported annexes which are available electronically via the OECD’s web site at www.oecd.org/daf/fa: “Public Release of OECD Reports”.

**5.1. Main findings/conclusions of the Consumption Tax Technical Advisory Group (TAG)**

**Overview and background**

*Composition of the Consumption Tax TAG*

The members of the Consumption Tax Technical Advisory Group (CT TAG) were drawn from countries with a broad geographical spread and the government representatives included non-OECD members. The business members were drawn from a wide range of industries. The role of the CT TAG was to work through its mandate, so supporting the work of Working Party No. 9 on Consumption Taxes (WP9) in fleshing out the consumption tax aspects of the Taxation Framework Conditions endorsed at the Ottawa Ministerial meeting held in October 1998 (the “Ottawa Framework”).  

*Working methods*

From an early stage, it was agreed by both the business and government members of the CT TAG (and by the Working Party No. 9 Sub-group on Electronic Commerce – “Sub-group”) that the TAG could best support the process as a whole (particularly in advising the Sub-group) if it functioned predominantly as a mechanism for identifying business concerns and priorities. In practice, this approach facilitated an iterative dialogue (involving both the exchange of papers, and joint meetings) between the TAG (broadly representing a business perspective) and the Sub-group. In this mode, the TAG was able more readily to offer responses to papers from the Sub-group, as well as generate its own ideas, which directly reflected business thinking. The Sub-group found this a productive way to get feedback and input from the TAG, and has reflected such input in the WP9 Report to the Committee on Fiscal Affairs (CFA) (identifying clearly business concerns, priorities, points of agreement, and differences).
Given this working method, the terms of this report inevitably focus on the papers which were produced by the business members, and which reflect, principally although by no means exclusively, their perspective. In many instances the process has helpfully identified a good deal of common ground between business and government (as identified below, and in the WP9 Report to the CFA).

Progress of work

The CT TAG met on five occasions between April 1999 and October 2000. The early meetings were spent in getting acquainted and focusing on the tasks necessary to fulfill the mandate. With the agreement and support of the government members, the business members set themselves various tasks, in the form of drafting papers, and divided into “mini-groups” to achieve this. The tasks evolved over the period but four main issues were studied and papers on these were presented to the full CT TAG and then to the Sub-group. The CT TAG was invited on three occasions to meet with the Sub-group to review and debate the papers and issues concerned. These invitations and the open-minded approach which lay behind them were welcomed by the business members, and the free debate generated was regarded as very constructive. The issues identified through the working process of the CT TAG are described more fully below and have been reflected by the Sub-group at various points in the Report it has prepared on behalf of WP9 for submission to the CFA (the “WP9 Report”). The business members of the CT TAG note this point and are encouraged that their contribution to the process is viewed as constructive and helpful.

Issues covered and recommendations

Place of consumption

The Ottawa Framework states as a broad principle that taxation should take place in the jurisdiction where consumption takes place. In its deliberations, the entire CT TAG noted early on that it would not be possible to identify or trace every individual event of consumption and that it would be necessary to identify a less precise, but more practical and workable test by which to identify which country’s consumption tax is due on a particular transaction. The business members came to the conclusion, later supported by the government members, that the most practical solution is to look at the customer’s permanent address or usual place of residence. This conclusion is reflected in the WP9 Report. This led to consideration of what constitutes adequate verification of usual place of residence. Government members expressed concern that it would be difficult to accept customer-provided information without a means of verification. Business members felt strongly that companies should be able to rely on the best information available.
at the time of a transaction, noting that verification requirements that delayed completion of a transaction or resulted in substantial costs unrelated to the normal course of business would undermine the growth of e-commerce and be inconsistent with the principles adopted at Ottawa.

Business members suggested that the quality of information available at the time of a transaction is expected to evolve over time. In the short term, businesses might have to rely on such factors as customer attestation, credit card billing address as provided by the customer, the language of the digitised goods or services being delivered, or the target market for digitised goods or services. In the longer term, much more robust verification options may be available, including options that enable the identification of the income tax residence of the purchaser.

Given that the Ottawa Taxation Framework is intended to prevent tax issues being a barrier to the growth of electronic commerce, it is hoped that a practical approach will be adopted with real-time verification being sought by governments only when the mechanisms exist for this to be done. The TAG welcomes the recognition in the WP9 Report.

**Tax collection options**

How consumption tax is collected on electronic commerce is clearly a key issue, and both the business members of the CT TAG and the government members of the Sub-group spent considerable time working on this topic. Both groups acknowledged that there is no “easy” solution to be found, at least for business-to-consumer (B2C) online transactions. It was agreed as common ground that a “self-assessment” or “reverse charge” mechanism is a logical way for tax on business-to-business (B2B) transactions to be collected. With respect to B2C transactions, the following models and potentially relevant technological developments were examined, and the key points are noted under each point:

a) **Consumer self-assessment, both business and non-business**

The CT TAG agreed that self-assessment for business customers is a simple, highly desirable mechanism for taxing business-to-business transactions. With respect to private customer transactions, it was agreed that consumer self-assessment is not likely to be an effective tax compliance mechanism in the near term. However, the business members recommended that the self-assessment model continue to be reviewed in light of emerging technologies and changing business models. Due to technological changes driven by other factors (such as privacy, fraud and piracy prevention) consumer self-assessment might in the future become a viable means of collecting consumption tax, and an open mind should be kept as to its potential feasibility.
b) Registration of non-resident suppliers

The CT TAG agreed that for this model international co-operation would be necessary to make compliance by vendors enforceable. Until such mechanisms are available, the business members pointed out, registration and compliance procedures should be as straightforward and simple as possible – see also the Simplified Interim Approach (SIA), (see the SIA section below). In particular, expensive and cumbersome fiscal representative procedures should not be enforced. The business members also noted that, in time, a registration model might be combined with “trusted third party” models which are in course of development. Options should be kept open for vendors to use such models in due course.

c) Tax at source and transfer

The CT TAG agreed that the tax at source and transfer model would entail an extremely high level of international co-operation between tax authorities, and as such might not only be unrealistic in the near term but difficult to achieve in the long term. The most significant limitation of this discussion is that it focuses on a relatively narrow way in which this type of approach may work and, thus, may prematurely conclude that there is little potential here.

d) Withholding by third parties (such as financial institutions)

In response to the publication of the Technology TAG paper, a number of financial services companies – (particularly credit card companies) have submitted papers to the OECD, identifying a number of significant issues and concerns. The Consumption Tax TAG welcomes this information, and to the extent points discussed below are contrary to points made in these submissions, it would defer to those other papers. The TAG agrees with the Technology TAG’s conclusion that the suggested framework is unrealistic.

Summary of current consumption tax barriers to the development of electronic commerce

The business members noted the principles stated in the Ottawa Framework that taxes applied to e-commerce should be efficient, certain and simple. However, in practice, consumption tax rules as they apply to conventional business do not have these characteristics, and it was thought by the business members that complexities in existing rules may be a barrier to both conventional and electronic commerce. A small group of CT TAG members therefore drafted a paper concerning these barriers and offered some general recommendations for simplification. The business members of the TAG welcome the recognition in the WP9 Report of the
important role of simplification, and encourage governments to address selected urgent issues such as electronic invoicing and reporting, simplification of representation procedures, more efficient payment and refund procedures, as a priority.

**Simplified interim approach (SIA)**

Given the difficulties of identifying a workable collection option (see section above), the business members put forward, firstly by presentation and secondly on paper, the suggestion of a simplified tax compliance system which would hopefully encourage vendors not established in a particular country to collect and remit tax. This was seen as an interim measure, operating only until one or more of the collection options described above, or a new option, developed into a feasible system. The potential value of this approach is recognised in the WP9 Report, and business members of the TAG strongly recommend that governments give this idea further detailed consideration.

The SIA focuses on the need to simplify all aspects of VAT tax compliance for non-established sellers, including registration, identification of turnover and calculation of tax, electronic submission of returns and audit processes. Access to relevant information and provision of information regarding changes should be made available online.

The entire thrust of the SIA is that VAT compliance should be so simple that non-established vendors would be encouraged to register.

**Next steps and future work**

As noted above, the members of the CT TAG consider that the TAG process has been helpful and constructive in advancing the work identified in the Ottawa Framework. It is hoped that the TAG will be retained as a mechanism for incorporating joint government and business input into the important process of finalising the policy of how consumption taxes should be applied to electronic commerce. In this respect the CT TAG has identified possible further work areas as follows:

**Place of consumption**

Work to expand and refine the list of “proxies” which may be used to identify the permanent address or usual place of residence of a customer. It is possible that this work may benefit from being carried out in conjunction with Technology TAG members.

**Work to assess potential tax collection options being developed**

The CT TAG should continue to assess all forthcoming developments in this area.
Current consumption tax barriers

Further work between government and business members to develop the suggestions for simplification and to focus on those which have the most potential benefit for business and the maximum possibility of being adopted globally.

Simplified interim approach

Further work to expand and develop the initial ideas into a comprehensive model.

Conclusions

The CT TAG agrees with the conclusions in the WP9 Report as follows:

A. Guidelines on the definition of the place of consumption

i) That the application of the Taxation Framework Conditions to international trade in services and intangible property can best be achieved by: (1) defining the principle of taxation in the place of consumption more clearly, and (2) identifying collection mechanisms that can support the practical operation of that principle.

ii) That this principle should be expressed in the form of OECD “Guidelines on the Definition of the Place of Consumption for Consumption Taxation of Cross-Border Services and Intangible Property”.

iii) That such Guidelines should define the place of consumption:

   a) For business-to-business (B2B) transactions, by reference to the jurisdiction in which the recipient has located its business presence; and

   b) For business-to-consumer (B2C) transactions, by reference to the recipient’s usual jurisdiction of residence. And that further work is required on appropriate means of verifying the latter.

B. Recommendations on collection mechanism options

iv) That the most viable collection mechanisms to support the practical application of such Guidelines lie:

   a) In a reverse charge or a self-assessment mechanism for B2B transactions; and

   b) In the short term (pending adoption of technology-facilitated options), in some form of registration-based mechanism for B2C transactions with specific efforts being made to promote simplified approaches to registration of non-resident suppliers.
That in the medium term, particularly in the context of collection mechanisms for B2C transactions, technology-based options offer genuine potential and merit more detailed examination in active co-operation with business.

C. Related issues

vi) That the growth in cross-border e-commerce presents new international challenges for indirect tax authorities, and so underlines the need for substantially greater levels of international administrative co-operation.

vii) That the dialogue with the business community and non-members, as part of the post-Ottawa process should continue as part of ongoing work on selected issues.

That simplification has important role to play in addressing business concerns, minimising compliance costs and reducing administrative costs, and that further work is necessary to assess and progress various ideas and options.

Business members' summary comments

The business members feel strongly that simpler solutions lead to higher levels of compliance, and that future requirements should leverage the development of commercial business models. E-commerce models are evolving, suggesting that business and governments should work together to review opportunities to use new developments to increase the effectiveness and robustness of tax collection mechanisms. Business members feel they have a helpful role to play in this process.

5.2. Main findings/conclusions of the Technology Technical Advisory Group (TAG)

Introduction

The Technology Technical Advisory Group (TAG) undertook a range of work with the Consumption Tax and Professional Data Assessment (PDA) TAGs and the Working Party No. 9 Sub-Group on Electronic Commerce ("WP9 Sub-group") in examining the technological implications of the various collection models considered for collecting consumption taxes on cross-border electronic commerce transactions and the reliability of indicator systems and trails for audit purposes. This work is brought together in this section to summarise the Technology TAG's conclusions to date. Where appropriate, each subsection sets forth suggestions of where continued work is required. As a further mandate, the TAG looks to continuing work in resolving the issues presented by the various technologies, most of which are quickly evolving as is all the technology underlying electronic commerce.
Annexes to the full Report by the Technology TAG\textsuperscript{16} provide a range of supporting detail to this executive summary of the main findings and conclusions of the TAG.

**Scope**

The mandate of the Technology TAG developed into that of a responsive expert group providing contextual information regarding the applicability of technological solutions to issues of audit, tracking and collection. Beyond applicability, the Technology TAG provided estimates of reliability and evaluated solutions based on the practicability of implementation. Implementation issues included factors such as cost, efficacy and commercial reasonableness.

Generally speaking, the tax collection issues which the Technology TAG was asked to address implicitly contain four fundamental assumptions:

- First, the electronic transaction type which is the most susceptible to tax avoidance and requires a tax collection solution is that of “virtual products”\textsuperscript{17} sold from businesses to consumers.
- Second, the primary means by which consumers will access the Internet for the purchase of “virtual products” will be via computers or interactive TVs and, over time, through mobile devices,\textsuperscript{18} but most virtual products are not suited to being downloaded by current mobile phones.
- Third, although this section deals primarily with VAT and similar consumption taxes, any system which is designed must necessarily consider alternative systems such as the sales/use tax system in the United States.
- Lastly, the dominant issue for consumption taxes is cross-border transactions.\textsuperscript{19}

**Collection model options**

While this section considers the four primary models that have been advanced for the collection of consumption taxes on cross-border e-commerce transactions, the Technology TAG would like to stress that they do not see these models as mutually exclusive from a technological perspective. It is important to ensure that any first steps towards implementation of a collection model be consistent with the development of a longer-term solution. This is a necessary step to minimise business compliance costs and allow easy administration by revenue authorities.

The Technology TAG also advocates the implementation of the ultimately agreed model on a smaller scale such as the sale of virtual products from businesses to consumers as a viable short-term starting point. Clear signals from government in relation to the preferred long-term solution would also facilitate businesses working with government without the distraction of dealing with short-term proposals.
The Technology TAG also highlights the fact that end-to-end virtual transactions are currently a very small part of e-commerce. These issues are primarily dealt with in this section because of the context of the questions put to the TAG. The TAG also recognises the potential for significant growth in this area and that the complexity of the inherent issues coupled with the pace of technological innovation and maturing of business models will require more intense study to develop appropriate solutions in advance of such growth.

**Relevant technologies**

Successfully implementing a viable consumption tax collection model will require harnessing of the same technologies that businesses are adopting for their electronic commerce initiatives. Inherent in this is the need to link collection mechanisms with the underlying business models to maximise the return on the necessary investment for both business and government.

**Shared technological elements**

The Technology TAG has noted a number of shared technological elements common to many of the tax collection/administration models it has investigated. From a technological perspective, the TAG found it useful to consider the models from the perspective of the broad activities or modules represented in Figure 1.

![Figure 1. Shared technological elements](source: Technology TAG, 2000.)

The primary differences between the proposed collection models are then limited to how this logical model would be physically implemented (for example, who would have responsibilities for different activities).
Jurisdictional verification

The module which has presented the greatest challenges for the Technology TAG is the jurisdictional identification module. Common to all models, the challenge is to provide merchants with a mechanism which, *inter alia*, allows the jurisdiction of the consumer to be verified. This information is essential if the Ottawa Taxation Framework Condition to the effect that taxation should be in the jurisdiction of the consumer is to be implemented.

The “Technology Primer for Identity of Parties and Classification” which is available in the full Report by the Technology TAG discusses the potential technologies and their strengths and limitations. The primary findings of the Technology TAG in relation to the identification of a consumer's jurisdiction are:

1. The simplest form of jurisdictional identification is to accept a consumer’s self-declaration of jurisdiction. The financial incentive for a consumer to incorrectly declare a jurisdiction in order to avoid consumption taxes means that this solution, while technologically simple to implement, has major limitations from a government perspective, increasing the scope for revenue risk. Some form of verification of the consumer’s self-declaration will be necessary if a degree of reliability acceptable to revenue authorities is to be obtained.

2. In conjunction with payment system providers, an examination was undertaken of the potential for using credit card numbers, credit card billing addresses or other information inherent to credit cards to verify a consumer’s jurisdiction. While the TAG is continuing the dialogue with the credit card companies, the Technology TAG’s conclusion is that the credit card business processes do not provide a workable verification methodology. In addition, the directions of the payment system providers’ business models mean that the current verification limitations will become greater over time. It is therefore unlikely that revenue authorities’ jurisdictional verification needs will be met through these avenues unless a (currently non-apparent) strong business rationale can be identified to provide a suitable return for the payment system providers.

3. Internet Protocol (IP) addresses offer potential in that they are an essential part of every access point to the Internet. IP traces have some limitations (such as a single Internet portal for AOL users and corporate aggregators, the use of anonymisers, plans for IPv4 to be replaced with IPv621, and potential for spoofing) such that the costs of implementation may not be worthwhile.22 Given today’s technology, the limited improvement in location technology offered by IP traces appears to be the best available, but there is a significant reluctance on the part of business to undertake implementation of such systems because of concerns of the
lack of commercial necessity, limited utility, almost assured obsolescence of IPv4 traceware in the near to medium term, costs of implementation and potential for disruption of service in cases of unclear results. Lastly, while inquiries have uncovered that IPv6 does not currently include a predictable geographic component, further work needs to be done to better understand the potential for jurisdictional identification. IPv6 tracing technology will need to be monitored as it develops. Governments need to be aware that the pseudo-geographic link between IP number and jurisdiction can potentially be significantly strengthened. However, this will become harder and costlier to accomplish once full, rather than trial, deployment of IPv6 begins. Research on this must be a priority, as IPv6 deployment is expected within the next two years.

4. Technology-based options utilising digital certificates, alone or in conjunction with trusted third parties, could offer genuine potential in the medium to long term. This requires an uptake by consumers and a change in existing business-to-consumer (B2C) models. However commercial deployments are now under way and businesses are beginning to invest in consumer solutions. More detailed examination of this potential, and how best governments might support and utilise it, is an important field of further work.

5. The Technology TAG understand and agree on the need to find a practical short-term solution to meet the needs of government without negatively impacting the ability of business to engage in online commerce or imposing unreasonable burdens of compliance. It is possible that viable short-term solutions may not be technological solutions (e.g. the use of a merchant’s internal databases). Progressing viable short-term solutions should be one of the first items of work for the Technology TAG once it reconvenes.

6. Any solution must also encompass the increasing consumer sensitivity and industry responsiveness to concerns about privacy and data protection. Many commercial systems are being designed on a more need-to-know and permission-marketing-based information architecture. There is thus a significant reluctance on the part of business to collect more information than that needed for commercial purposes. This trend is also impacting future developments in payment systems.

The Technology TAG suggests that the whole area of jurisdictional verification needs further work. To be done properly, this work may eventually require a dedicated team of experts. The TAG stresses the need to complete further basic research before settling on any collection model or method that requires technological deployment. The policy and practice are symbiotic and need to be developed.
concurrently. Resolving policy independently of understanding the required technology may lead to policy that cannot be practically implemented.

These limitations also lead the Technology TAG to caution regarding moves away from place of consumption as the principle for imposing consumption taxes on digital products. Moves by the WP9 Sub-group towards using place of residence as the basis for taxation may limit the options for technological verification in the future. With the major exception of digital certificates, technology may be, as or more likely to, be able to determine a consumer’s location (i.e. place of consumption) in the longer term rather than his or her place of residence. The Technology TAG therefore advocates that flexibility remain in the longer term defining of “place of consumption”.

The collection models

The Technology TAG’s conclusions in relation to each of the four primary consumption tax collection models identified in further detail in Annex II to the full Report by the Technology TAG are set out below. As discussed above, the Technology TAG examined the collection model from the perspective of a logical model detailing the broad activities or modules required for a successful implementation. The Technology TAG has also commented below on the “Simplified Interim Approach” advocated by the Consumption Tax TAG.

While a version of the tax at source and transfer/trusted-third-party models is the Technology TAG’s favoured model of those initially considered, it would advocate that future discussions concentrate on determining how each of the above six modules could best be implemented to achieve the goal of a successful consumption tax collection model. The most efficient and effective long-term solution must successfully address all six of these elements.

The self-assessment option

Self-assessment is seen as a viable option for business-to-business (B2B) transactions. No technology issues have been identified.

While there is little cost to a pure self-assessment deployment there are significant government concerns in relation to the reliability of the resultant data. The technology costs and the low likelihood of a successful commercial deployment or a reliable verification system result in a recommendation that this option is the least practicable for B2C transactions from a technology perspective. The view of the Technology TAG is that a self-assessment model that government agencies would find reliable creates almost insurmountable problems to implement from a technology standpoint. Limitations in current registration options, consumer identity verification issues and difficulties in verifying many small
payments from many sources combine to make a model which cannot be robustly implemented with the currently available technology.

The registration option

The major technology issues posed by this model are the identification of the consumption tax status of the customer; verifying the jurisdiction of the consumer, identifying non-resident suppliers and developing systems capable of compliance once those factors are established.\textsuperscript{12}

Technology appears to be capable of providing solutions to the first two issues in the medium term. The resolution of these issues is also required for the collection models discussed below. While solutions are advanced for the identification of non-resident suppliers, it is unlikely that the taxation net will ever be completely robust.

The Technology TAG sees the imposition of significant compliance costs on non-resident suppliers, especially those making supplies in multiple jurisdictions or making nominal supplies, as an important drawback of this model. The provision of easily accessible information on the Web or an enhanced system to provide a goods classification and calculation routine on the Web is advanced as a possible technological solution to improve the implementation of this model. (These solutions are also important components of the following collection models.) In looking at simplification of compliance and sharing of burdens, suggestions were made relating to globalising applications, simplifying rates and calculation and having burdens of compliance equitably shared where appropriate.

The tax-at-source and transfer option

Current technology would enable an implementation of the tax-at-source and transfer model. In fact, commercial providers already offer products which, between them, exhibit all the characteristics of the model. The major technological limitation at this point deals with verifying consumers’ jurisdiction, as discussed above. The model is flexible enough to benefit from future improvements in technology and the adoption of new technologies by business and consumers.

The main work required to implement this model is in attaining government agreement for the collection, transfer and remittance of consumption tax revenues. Technologies should also be considered that could mitigate possible increases in costs of tax administration.

The trusted-third-party/clearinghouse option

From a Technology TAG viewpoint, the trusted third party (TTP) model is, in large part, identical to the tax-at-source and transfer model. The difference is that
A trusted third party, and not a local revenue authority, is charged with collecting the tax.

The model raises the issues of achieving efficiency in implementation and examining how the costs and benefits of a consumption tax model could be shared between the parties involved in either the transaction or the collection of the resultant taxation revenue.

Combining the tax-at-source and transfer/trusted-third-party models

The strengths and weaknesses of these two models in some ways counteract each other. An alternative approach may be a hybrid one that incorporates parts of both the tax-at-source and transfer and the clearinghouse models. Such a hybrid approach is attractive from a technology perspective.

The Consumption Tax TAG’s simplified interim approach

The Simplified Interim Approach (SIA) advocated by the Consumption Tax TAG provides a number of suggestions to overcome many of the current issues associated with collecting consumption taxes on cross-border transactions. From the Technology TAG’s perspective, SIA provides an integrated non-technological solution to the current consumption tax challenges. The Technology TAG has a great degree of empathy with the issues raised and advise that there is no technological impediment to this interim solution. The Technology TAG does, however, suggest that all possible efforts at simplification be undertaken and that a uniform user interface and forms set be developed to help facilitate implementation and use and to lower compliance burdens. Lastly, consideration of government-maintained online tax tables, which are uniform in format, might also facilitate the development of online look-up systems for real-time tax calculation in cross-border transactions. More specific comments are set forth in the conclusions below.

Collection model conclusions

The Technology TAG sees the self-assessment model as impractical for B2C transactions.

The remaining proposals have strengths in particular elements but also have inherent weaknesses. For example, the registration model is strong in minimising government administration costs but leaves business with the large burden of having to correctly identify the consumer’s jurisdiction to correctly levy a consumption tax. The costs involved in potentially registering and complying with up to 120 jurisdictions’ tax systems are abhorrent to businesses facing this prospect. The registration model is seen as a damper on the growth of e-business. This weakness from a business perspective is a strength of the tax-and-transfer model.

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This leads to the concept of examining elements of the collection models to result in a stronger model. Such an analysis would involve determination of the technological alternatives for successfully implementing each of the six broad activities or modules shown in Figure 1.

To the extent that the Consumption Tax TAG and WP9 Sub-group have recommended examining registration models as a near-term solution, the Technology TAG would emphasise the following factors that may minimise compliance burdens:

- Develop standardised global procedures (e.g. forms, registration methods, etc.) and web access.
- Engage in simplification to the greatest extent possible.
- Explore ways to share compliance burdens, including by developing hybrid approaches.
- Understand the current limitations of technology to provide identification and verification.
- Work with business to explore technological improvements in identification and verification that have independent commercial utility to assure business investment and deployment; and
- Ensure that any interim registration options lead towards a more palatable collection model for the medium term.

Issues related to the work of the Professional Data Assessment TAG

Many issues which were considered for the PDA TAG revolved around the issues of verifying the location of the identity of parties to the transaction, where the parties were, when the transaction took place and the information inherent to or contained within the transaction. Since the PDA TAG looks at these transactions after the fact, major issues were also raised as to the reliability of the records and systems which established the who, what, when and where of the transactions. While end-to-end virtual transactions were recognised to be the most problematic, concerns were raised about verifying electronic records of transactions. Since, under this section we will only discuss those issues which are significantly different from those raised in the Technology TAG's evaluation of the collection models, the focus will be on when a transaction occurred and the reliability of records of the transaction. By way of analysis context, the Technology TAG points out that when reviewing the above factors, the TAG also looked at issues of commercial reasonableness, costs of implementation and retention and comparison to non-virtual equivalents.

The PDA TAG highlighted two ways in which factors could be established. The first was to show that the record itself was worthy of credibility and contained sufficient information to establish the information in question. The second was to
establish that systems, accounting methods and audit procedures were in place that were sufficient to provide evidence in the credibility of these systems. It was recognised that the latter case would be more applicable to larger businesses which hired or had on staff professional accounting experts who had reviewed systems and practices. In light of the greater concern with the smaller, unaudited practitioners, the Technology TAG’s attention was focused on those cases.

**Establishing when a transaction occurs**

The PDA TAG stated, in relation to consumption taxes, that it was necessary to establish the day when a transaction occurred. The two major technologies reviewed to establish transaction time were third-party time-stamping and document storage service providers and time-stamp technologies (third party or system clock) included in e-commerce systems. While revenue auditors showed a preference for third-party service providers that would both time-stamp and archive documents, it was acknowledged that there was no reasonable commercial purpose for such service and the costs were prohibitive for the vast majority of online transactions.

Electronic commerce systems integrate order entries into databases. Databases provide relative data entries keyed off the system clock. These systems can be supplemented by references to external time stamping services. There were, however, no commercial reasons for such services for the vast majority of Internet consumer transactions and there were concerns from revenue auditors that systems clocks and electronic records may be subject to alteration. In light of the presumed lack of programming sophistication by most SMEs it was considered that the greatest risk to alteration arose where third parties created programs designed to hide transactions or otherwise interfere with the proper functioning of the back end e-commerce systems.

Annex XIX to the full Report by the Technology TAG discusses the technology aspects of electronic record integrity in more detail.

**Need for training**

There were concerns that there might be unreasonable expectations as to the ability of e-commerce systems to improve on the reliability of current paper-based and computerised accounting systems. These expectations resulted from the lack of training on e-commerce systems for auditors coupled with the lack of system models to compare. In a paper-based system, fraud is mostly discovered not by forensic analysis, but either by visible proof of changes or lack of congruity to established expectations derived from reviews of similarly situated businesses. In the case of electronic systems and transactions there is a need for auditors to
understand the electronic traces which are left on systems as well as comparative models for Internet-based businesses.

Lastly, in tandem with work related to digital signatures, technologies for authentication and verification should be explored in relation to document reliability.

Proposed future work

Members of the Technology TAG have had some discussions around where the TAG’s work should progress in the future. The Technology TAG believes that there are a number of factors which should underlie future work in this area:

- There is little tax revenue at stake currently in end-to-end online downloads.
- Technology, as commercially diffused today, does not provide robust identification or verification methods for such downloads, although promising technologies were likely to be deployed in the middle term.
- There is a need to keep working on these issues as a priority in order to assure a level playing field for all market participants in cross-border transactions and the ability to collect revenue when such trade becomes more substantial.
- The emphasis needs to be on identifying solutions that could be deployed for effective compliance. The Technology TAG strongly cautions against solutions that are incapable of compliance verification, overly burdensome in terms of cost or complexity, or not supported by independent commercial rationales for collection of information.

This background and the Technology TAG’s experiences to date led it to identify the following areas as offering potential and warranting further examination:

- Examine viable short-term solutions which may not be technological solutions (e.g., the use of a merchant’s internal databases).
- Continue study of global IPv6 numbering, including examination of the potential for geographic links to be inherent to IPv6 numbers.
- Complete a catalogue of third-party tax-services providers to document what is currently available and to provide information to merchants.
- Continue study of digital signatures and what models may make sense for use by revenue authorities.
- Examine issues related to use and recognition of digital signatures in cross-border situations; and roles of government and private sector in providing certification/registration authority services.
- Undertake a more detailed review of the impact of wireless technologies and of greater bandwidth availability.
• Continue monitoring to ensure that OECD directions correlate with changes in technology and commercial business models; and
• Identify new technology that could be harnessed to help address the taxation challenges of electronic commerce.

5.3. Main findings/conclusions of the Professional Data Assessment Technical Advisory Group (TAG)

Introduction and structure of report

This section synthesises the results of more than 18 months’ work by the representatives of both business and government who worked together on a range of issues drawn from the mandate of the Professional Data Assessment Technical Advisory Group (PDA TAG). It concentrates on the key findings of the TAG, some of which have been condensed. These findings are set in a contextual narrative which has been designed to convey the deliberations of the representatives of the TAG with a minimum of technical language. Arising from its deliberations, the TAG has made 18 recommendations, and these are found in the “Conclusions” subsection.

During the course of its 18-month life, the TAG has produced detailed papers on, or achieved outputs, in relation to the following:

a) Conducted an analysis of the audit risks associated with electronic commerce trading, highlighting either extensions to traditional audit risks or new risks arising.

b) Listed current or emerging standards or statements of best practice which are relevant for accessing electronic data or assessing its reliability.

c) Conducted, and reported on, a survey of private-sector and public-sector auditors, dealing with electronic records, seeking views on a variety of relevant issues.

d) Identified, and reported on, the desirable data elements for business and tax purposes, for use in trading, payment or transaction recording systems.

e) Catalogued existing or emerging mechanisms that could:

• Provide for authenticity and reliability of data.
• Facilitate “remote access” audits.
• Protect against or recover from, loss of encryption keys,
• As well as reporting on the costs and benefits involved.

In order to give a full representation of the work of the TAG and to give a greater depth of technical discussion for specialised readers, this report is structured with a number of annexes which report in detail on the work carried out by
the members of the TAG. Further annexes cover additional information such as the mandate, membership and work plan of the TAG.\textsuperscript{14}

**Purpose, scope and methods of the PDA TAG**

The purpose of the PDA TAG is to provide input into the OECD's work in taking forward the tax administration conditions contained in Section V of the report, "Electronic Commerce: Taxation Framework Conditions", which was welcomed by Ministers at an OECD Ministerial meeting in Ottawa, Canada in October 1998.\textsuperscript{15}

The role of the PDA TAG is advisory. The TAG's work is supervised by the Forum on Strategic Management, which is the Committee on Fiscal Affairs subsidiary body responsible for tax administration matters.

The purpose of the PDA TAG has been a subject of some debate between the members of the TAG and much confusion by people outside of the TAG. The name of the TAG – Professional Data Assessment – was intended to convey information about the purpose: that the TAG was to report on data assessment as conducted by the professions, primarily the accounting and information technology professions.

The TAG was premised on the understanding that private sector external auditors had developed techniques and approaches to address audit issues in the Internet e-commerce environment, and that fiscal auditors should examine the private-sector techniques for their suitability to fiscal audits to avoid conflicting expectations between fiscal auditors and other external auditors. At the first meeting of the TAG, private sector external auditors advised that the private sector did not yet have a "codified" approach to auditing in the Internet e-commerce environment. The financial statement audit approaches for "dot-com" entities were primarily developed and performed on a "case-by-case" basis. The private-sector external auditors were, however, very willing to explore the relevant audit and technology issues and their implications for auditing in an e-commerce environment.

From this point it was possible to agree a refined purpose of the TAG: it would identify the audit risks posed by the Internet e-commerce environment considering such matters as access to data, systems controls and the audit quality of the data, and make recommendations based on the assessment of those risks and the available techniques and technology.

Some of the risks identified are not new. They have existed since accounting systems were first computerised. However, it is worth restating these findings. Other risks are new, or have assumed different magnitudes due to some of the characteristics of Internet e-commerce, particularly the ability to more freely interconnect systems.
There are also a number of important e-commerce issues, both in the general arena and specific matters relating to audit practices, which were deemed to be outside the mandate of the PDA TAG. Predominant among these is fraud: the TAG was not mandated to consider fraud issues.

In addition, while acknowledging the important role played by internal auditors, the area found to be of common knowledge and interest between the business and government representatives on the TAG primarily concerned external audit issues. These external issues were, however, confined to the data contained within an enterprise. In an audit of a business using paper-based accounting systems, the auditor does not audit external infrastructure such as the postal system that delivers accounts payable and accounts receivable documents. Similarly, the members of the PDA TAG were not primarily concerned with addressing the risks associated with external infrastructure for business engaged in Internet e-commerce. However, an auditor in a paper-based environment may choose to rely on the date evidence contained in a postmark, so the PDA TAG representatives kept themselves informed about technologies and data outside of the enterprise where this external data may be of assistance in verifying the internal data of the enterprise.

Finally, the TAG was not fiscally focused, in that it did not concentrate on issues such as the deductibility or otherwise of the expenses associated with creating an Internet web site. Likewise, the TAG was not concerned with issues such as the timing of revenue recognition. These issues are a matter of law, rules and interpretation in each country. What the TAG did concentrate on was ensuring that the data relating to the web site expense or revenue would be available, reliable and verifiable so that the laws, rules, standards and practices relating to such data could be adhered to and properly administered.

The TAG conducted its business principally through face-to-face meetings, some of which were joint meetings with other TAGs. The TAG’s own electronic discussion group (EDG) and Internet e-mail were also used extensively to further its deliberations. The establishment of teams (headed by a team leader) was successfully employed in progressing work on tasks.

**Audit risks**

Implicit in the general mandate of the PDA TAG is an understanding that there are risks which need to be managed by assessing data for “… authenticity, completeness, reliability and verifiability…”. The specific mandate of the TAG echoes these areas of risk and charges the members of the TAG to collate and advise about relevant international audit or accounting standards and to advise on best practices to address the identified risks, particularly those that can reduce the burden on business during external audits.
The need to reduce the burden on business and the need to take into account the special considerations of small and medium-sized enterprises (SMEs) was an overlay to the PDA TAG’s work.

In analysing the risks in the Internet e-commerce environment, it is important to distinguish why this environment is different. Remote selling by mail order, telephone or facsimile has been common in many countries for decades. Similarly, computerised accounting systems and electronic data interchange between businesses are not new concepts.

What is notable about the Internet e-commerce environment is the convergence of these and other practices to create some unique characteristics.

Mail order, facsimile and telephone order technologies are primarily concerned with the remote delivery of physical objects. Internet e-commerce is not restricted in the same way. Mail, facsimile and telephone ordering systems operate on mature infrastructure platforms which give reasonably reliable information, for example, about the jurisdiction of the seller and or buyer and have, in-built audit evidence such as physical, dated postmarks or country-specific telecommunication prefixes. The infrastructure platform for Internet e-commerce is not as mature and does not offer such audit evidence as a matter of course.

Computerised accounting systems of the late 20th century are predominantly closed systems, operated within a business enterprise with data entry linked to physical documentation associated with a paper-based accounting system. Where computerised accounting systems are more open, with electronic linkages to external enterprises, these linkages have tended to conform to formal data structures such as UN/EDIFACT standard electronic data interchange (EDI) messages. The process of creating such standardised messages and the protocols around their use have ensured that audit evidence is available where these systems are used. Further, their use has not been widespread and so the risks represented by any weakness in their audit evidence value was accordingly reduced.

Internet e-commerce, which may change the magnitude of existing risks in an enterprise, may also present new risks. One example of a new risk is that the ability to do business in a wholly electronic environment via the Internet changes the nature of audit evidence and the reliability an auditor can place on that evidence. Another example is the increasing complexity of computer systems, including greater integration of business systems between partners. Furthermore, the increased numbers of smaller transactions in companies with business-to-consumer (B2C) trading creates its own risks. The availability of counters to these risks varies according to the business model and, in the absence of any such counters, requires new or updated proportionate responses.

However, with the exception of the adoption of digital cash or unaccounted payment systems which may have adverse implications for reconciliation controls,
audit risks are not necessarily constant for all business models; a number of variables were identified which need to be taken into consideration. The first variable was the presence or absence of internal controls. Typically, small businesses have fewer or weaker internal controls than do large businesses and, broadly speaking, the risks associated with weak internal controls require more substantive testing. Another variable is the extent to which the technology itself provides assurance as to the reliability of electronic audit evidence. The other main variable was the emergence of new business models for Internet e-commerce, which may contain different types of risk.

Findings

The use of e-commerce via the Internet changes the magnitude of existing risks in an enterprise and presents new risks.

Electronic documents from an external source may be, without additional measures, less reliable than their paper equivalents. The loss in reliability can be compensated to an extent by adequate internal controls that give audit assurance. However, some SMEs may not have adequate internal controls; therefore, the auditor cannot rely on their documentation when conducting an audit. This means that a systems approach and a substantive testing approach to the audit may be seriously compromised.

The emergence of new business models for e-commerce may also bring new risks according to the nature of the model.

The digital cash payment model, including unaccounted payment systems, may seriously inhibit the auditor’s use of reconciliation techniques to agree sales and profit declarations.

Data access

Prior to any assessment of data an auditor needs to have access to the data. The OECD paper, “Electronic Commerce: A Discussion Paper on Taxation Issues”, identified a risk that data might be stored in a jurisdiction other than that where a client is located. The specific mandate of the PDA TAG contemplated that it may be possible to remotely access data stored in a remote location.

There is very little practical experience with remote access of data for external audit purposes. An analysis of the current technologies in relation to remote access to data, and a theoretical analysis of the benefits, showed that remote access offers the client advantages in terms of time savings and greater convenience; the auditor would also find greater convenience and potential cost savings through reduced travel and potential reduced audit time. However, allowing remote access to data reduces the ability of the auditor to conduct certain types of
substantive tests, such as observation, and there are concerns that it represents a security risk for the client.

As regards the potential security risk for the client, however, after conducting a survey, reviewing the information from a survey conducted by the Information Systems Audit and Control Association (ISACA), and reviewing existing standards, it was considered that obtaining access to remotely stored data was not a key security risk, assuming appropriate security measures were in place. However, survey sources and other research revealed concerns that remote access to data for audit purposes could compromise confidentiality.

Also under the heading of data access, the TAG considered the implications for auditors where businesses use encryption techniques for commercial reasons to ensure privacy, by keeping sensitive information from unintended viewers. One potential impact for an auditor might arise where there is an unintentional or deliberate loss of encryption keys.

**Findings**

From published evidence, obtaining access to remotely stored data is not identified as a key security risk.

Remote access to data offers potential advantages to both the auditor and client. However, these advantages will not be realised until the technology is much more mature.

There was a strong concern in the client community that allowing an auditor to access company data remotely via the web could compromise confidentiality.

There is no evidence of significant widespread use of encryption of records for storage, retention or validation.

Current legislative record-keeping requirements, weighed against evidence of encryption use, would appear adequate in the short to medium term.

**Internal control**

As noted above, the PDA TAG had access to a wide range of material to assist it in determining risks in the Internet e-commerce environment. One of the common themes to emerge from the collation and analysis of this material was that Internet e-commerce systems had to have integrity, characterised as system processing which is complete, accurate, timely and verifiable.

It was also noted that a well-functioning Internet e-commerce system could provide greater levels of integrity than a conventional paper-based system. The need to determine whether a particular Internet e-commerce system was functioning well led to an analysis of systems or internal controls.
Testing of internal controls in a computerised accounting environment is not new. However, as noted above, the open system architecture of Internet e-commerce presents new challenges in that there may be reduced physical evidence (paper documents) to support electronic data entries. As a result, tests of internal control will need to be adapted to respond to the nature of Internet e-commerce. Given that most testing of internal controls for conventional computerised accounting systems is conducted by auditors with additional information technology training and skills, the PDA TAG expects that testing internal controls in an Internet e-commerce environment will require specialised skills.

In conjunction with an increased reliance on internal control evaluation, consideration was given as to whether technological solutions were available to compensate for the reduced reliability associated with electronic records compared to their paper equivalents. Authenticity and reliability mechanisms such as encryption, message digests and time-stamping were assessed in terms of their value for auditors and any costs associated in implementation by business.19

Findings

Testing of internal controls in an Internet e-commerce environment will require specialised training.

The market for technological solutions which provide assurance as to data authenticity and integrity is immature at this time. However, time-stamping was identified as giving some assurance now. It has a high cost, however, and therefore it is used commercially only on a very limited basis for particular high-value transactions.

In terms of authenticity and reliability of data, the emerging mechanisms alone appear insufficient. It will be necessary for auditors to hone their skills in terms of systems audit capability and to possibly adopt new audit techniques.

Substantive tests

Where internal controls are weak, greater reliance must be placed on performing substantive testing and interpreting the results.Traditionally, smaller enterprises have had weaker internal controls than larger enterprises, and there is no evidence that Internet e-commerce will change this general tendency. In fact, the trend identified by accounting firms was that they tend to make greater use of substantive tests in an Internet e-commerce environment. By extrapolation then, external audits of smaller businesses engaged in Internet e-commerce will tend to require more comprehensive substantive testing.

In conducting substantive tests, it is common for an external auditor to seek collaborating evidence to verify data contained in the records of an enterprise.
This collaborating evidence may be obtained from a number of sources, including data from external sources, analysis of other internal data and inspection of physical evidence, such as inventory. One of the characteristics of Internet e-commerce that distinguishes it from other forms of remote sales, like mail order, is the capacity to deliver an intangible or digital product. Where the inventory of an enterprise consists of digital products, which can be readily duplicated, substantive testing based on physical inspection is not possible.

As is mentioned above, another substantive test is to verify the data of the enterprise against external sources of data. In an Internet e-commerce environment, the data from external sources may be electronic. The view of the PDA TAG is that external electronic data may be, without additional measures, less reliable than external physical data or documents. The convergence of an enterprise with weak internal controls and an electronic trading system that only provides external evidence in an electronic form represents a risk which was present prior to Internet e-commerce but which has acquired new magnitude in the Internet e-commerce environment because of the potential prevalence of this convergence. The combination of weak internal controls and less reliable external electronic data may require even more detailed substantive testing before an audit opinion can be formed. This finding is supported by the experience of accounting firms.

Because external electronic data may be, without additional measures, less reliable than external physical data at any given level of internal control, more extensive substantive testing may be required where external data is electronic rather than physical.

Accounting firms indicated that they are making extensive use of file interrogation and data analysis software for substantive testing and also of computer-assisted audit techniques. As noted above, however, substantive testing, particularly if performed on data stored on the system under examination, can be intrusive and costly to the client. In enterprises with good internal systems controls, the accounting firms are placing greater reliance on system-control evaluation and less intrusive testing. Enterprises found to have weaker internal controls may be subject to more detailed substantive testing. SMEs are found to fall within this latter category, with the result that businesses with the least capacity to absorb compliance costs may be subject to those costs.

As regards the question of minimising compliance costs when substantive testing is performed by fiscal auditors, and when audits are conducted generally, the TAG did not discuss this matter to any great degree but it was agreed that it was an area where, with co-operation from the developers of software packages used for e-commerce trading, progress in minimising such costs could possibly be made. It was also felt that this was a potential future work area for the TAG.
Finally, data in an Internet e-commerce environment is more easily subject to analysis. Analysis of data in an active system can be intrusive and raises the potential risk of inadvertently corrupting actual accounting data. However, in conducting audits on computerised accounting systems, auditors would be familiar with obtaining a copy of the client data for analytical testing, in order to reduce the inconvenience to clients and to protect against corruption of the original data.

**Findings**

Audits of smaller businesses engaged in e-commerce will tend to require more substantive testing than larger businesses with better internal controls.

More extensive substantive testing may be required where external data is electronic rather than physical.

Accounting firms indicated that they are making greater use of file interrogation and data-analysis software and also of computer-assisted audit techniques.

**Current auditing standards and guidelines**

In addition to their own specialist knowledge, the TAG participants analysed published national and international accounting and auditing standards or guidance notes on e-commerce, conducted a small survey of external and Government auditors engaged in audits of businesses carrying on Internet e-commerce, approached the public accounting firms and had access to a more substantive survey conducted by the Information Systems Audit and Control Association (ISACA).

**Findings**

While there were limited numbers of standards specifically focussed on the e-commerce environment, more standards will emerge over the next few years.

While audits have been conducted on e-commerce operations, the level of experience of auditors in conducting such audits is low.

**Approach to audits and auditor training and development**

As is stated above, the level of experience which auditors have in conducting audits of Internet e-commerce businesses is low at this point. However, the TAG considers that auditors, in both private and public sector, may need to re-think their audit methodology when faced with e-commerce audits. Auditors may make more extensive use of file interrogation and data analysis software and may adopt new techniques, such as querying electronic transactional log files. Fiscal auditors, in particular, may need to rely more heavily on a business's systems or internal controls. In order to adapt to the potential changing nature of the audit, auditors will need to be re-trained. They will also have to have sufficient knowledge to....
understand the e-commerce trading environment and the technological issues involved. In order to be able to perform effectively in the new environment, auditors will need appropriate additional training and development.

Findings

New audit techniques may have to be adopted by auditors in the absence of the traditional audit trail.

Auditors may have to place greater reliance on systems controls.

Desirable data elements

The vast majority of the work of the PDA TAG, covering risk and research into matters such as techniques to provide for authenticity and reliability of data, was fundamental work that could be applied to any set of data in any system. However, the members of the PDA TAG were conscious of dealing with Internet e-commerce systems that support commercial transactions, and of the reliance, particularly of consumption tax, on transactional level data. Hence, a particular practical stream of their work was to apply their expertise to the consideration of what data, from an audit perspective, would be desirable in Internet e-commerce trading systems to assist the reliability of those systems.

The work on “desirable data elements” was not designed to specify minimum requirements. Rather, this work sought to summarise the generic elements of most tax systems and to accommodate both direct and consumption taxes. Its purpose was to provide a specification of desirable data for a generic system.

In addition to providing that specification, the data elements would appear to satisfy substantially, or fully, the vast majority of consumption tax system requirements for systems used by OECD Member countries. The data elements may thus be a useful addition to the knowledge base of those parties considering simplifications to consumption tax systems.

Conclusions

Since its inception, the PDA TAG has examined a wide range of issues in delivering on the terms of its mandate and work plan. However, the nature of Internet e-commerce trading is that it is constantly evolving, with new business models and technologies pushing the boundaries of commerce out further, implying consequences for the audit function. In addition, at the time the TAG was conducting its work the Internet e-commerce market was relatively immature. For these reasons, the TAG members are of the view that there are opportunities for further work in this area and they have sought to highlight a number of specific topics in this Report. Suggested future topics include:
a) Ongoing monitoring of developments in auditing standards, data assurance mechanisms and Internet e-commerce business models as well as the impact of these developments on the audit function.

b) Research into, and development of, future audit standards and methodologies.

c) Consideration of the implications of electronic data storage and retention as audit evidence; and

d) Examination of opportunities to minimise compliance costs associated with Internet e-commerce audits.

The members of the PDA TAG believe that the TAG process, with private-sector external auditors and government auditors working together, is a suitable vehicle for continuing and building upon the work which is presented to you in this Report. The PDA TAG members urge the members of the FSM Sub-group on Electronic Commerce to recommend this proposal to the main Forum on Strategic Management and onwards to the Committee on Fiscal Affairs.

Recommendations

Finally, arising from the deliberations of the PDA TAG, the following 18 recommendations have been agreed by the TAG members:

Data access

1. There should be continued monitoring of remote access technologies by public-sector and private-sector auditors with a view to incorporating discussion of remote access into appropriate standards or training material.

2. To alleviate the concern that confidential data could be compromised, all relevant parties, including auditors and management, should be trained on best practices for e-commerce and web security, particularly regarding mechanisms to minimise the risks associated with accessing business data.

3. Businesses should be encouraged to use prudential systems for the management of encryption keys.

Internal control

4. In the context of SMEs, tax administrations should work with software developers to encourage the incorporation of internal controls in their products for use in e-commerce trading.

5. Tax administrations should encourage the use of new assurance technologies such as time-stamping on the grounds that its adoption can give
greater assurance over the integrity of data when combined with other systems controls.

6. Tax administrations should engage with software developers to encourage the adoption of time-stamping technologies within their software design.

7. Tax administrations should also encourage business to adopt strong authentication measures using technologies such as Public Key Infrastructure.

**Substantive tests**

8. In clients with good internal controls, fiscal auditors should consider placing greater reliance on the system controls and the use of less intrusive tests.

9. In clients with weak internal controls, fiscal auditors should examine the use of computer-assisted audit techniques where these will give reasonable audit assurance at a reduced compliance cost to the client.

**Current auditing standards and guidelines**

10. Tax administrations should continue to monitor new standards from standard-setting bodies, best practices from the private sector and any emerging protocols.

11. Tax administrations should provide input, as appropriate, to standard-setting bodies and other relevant parties.

**Approach to audits and auditor training and development**

12. Public-sector and private-sector auditors working in the electronic environment of e-commerce must be provided with the requisite training in order to understand that environment, to employ the correct computer-assisted audit tools and techniques, including web-based technologies, and to conduct systems audits.

13. Public-sector and private-sector auditors need to be trained in data-assurance mechanisms and understand what assurances these mechanisms provide in an audit context. They must also know how to audit the relevant mechanisms.

14. Consideration should be given by the OECD to conducting a further survey at some future stage to assess the level of experience of auditors in the e-commerce environment.
Desirable data elements

15. The list of desirable data elements should be provided to the appropriate fora considering consumption tax issues at the OECD and elsewhere, as an aid in furthering their work.

16. The list of elements should be issued by the OECD in the form of an information or best-practice note.

17. The list of elements should be refined and incorporated into a de facto protocol such as XML or other protocols.

18. Tax administrations should approach software developers and standards bodies with a view to ensuring that the list of elements is considered in the development of appropriate systems and standards.

5.4. Main findings/conclusions of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (Business Profits TAG)

Introduction

The general mandate of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (BP TAG) is to “examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules.” To this end, the TAG has identified a number of relevant issues and developed a work programme, described below.

Composition of the TAG

The BP TAG met three times, in September 1999, July 2000 and December 2000. Membership consists of Member country Delegates of Working Party No. 1 and Working Party No. 6, representatives from non-member economies and representatives of business and industry. The three Co-Chairs are Ron Haigh (OECD Member countries), Ron van de Merwe (non-member countries) and John Clark (business representatives).

Table 1 shows a list of the people who participated in the activities of the TAG and attended one or more of its meetings.
Table 1. Composition of the Business Profits TAG

<table>
<thead>
<tr>
<th>Full name</th>
<th>Company/organisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr. John CLARK</td>
<td>British Telecom</td>
</tr>
<tr>
<td>(Business Co-Chair of the TAG)</td>
<td></td>
</tr>
<tr>
<td>Mr. Ron HAIGH</td>
<td>Inland Revenue, United Kingdom</td>
</tr>
<tr>
<td>(Member Government Co-Chair of the TAG)</td>
<td></td>
</tr>
<tr>
<td>Mr. Ron VAN DER MERWE</td>
<td>South Africa Revenue Service</td>
</tr>
<tr>
<td>(Non-member Government Co-Chair of the TAG)</td>
<td></td>
</tr>
</tbody>
</table>

**Government representatives**
- Ms. Ariane PICKERING: Australian Taxation Office
- Mr. Alain CASTONGUAY: Department of Finance, Canada
- Mr. Wolfgang BÜTTNER/Mr. Helmut KRABBE: Bundesministerium der Finanzen, Germany
- Mr. Brendan MCCORMACK: Office of the Revenue Commissioners, Ireland
- Mr. Kenichiro ASAGAMI: National Tax Administration, Japan
- Ms. Silvia FROHOFER: Swiss Federal Tax Administration
- Mr. Michael MUNDACA: United States Treasury
- Mr. Talmon DE FREITAS/Ms. Iraci KAHAN: Ministry of Finance, Brazil
- Mr. Shubin MU: State Administration of Taxation, China
- Mr. A. BALASUBRAMIAN: Ministry of Finance, India
- Mr. Vijay MATHUR: Central Board of Direct Taxes, India

**Business representatives**
- Ms. Carol CAYO: Vertex Inc., United States
- Mr. Matthias GEURTS: Bundesverband Deutscher Banken, Germany
- Mr. Paul HUMPHREYS: AMP, Australia
- Mr. Dan KOSTENBAUDER: Hewlett-Packard Company, United States
- Mr. David OLIVE: Fujitsu Corporation, United States
- Mr. Torbjörn PERSSON: Volkswagen AG, Germany
- Ms. Heidrun ZIRFAS: Volkswagen AG, Germany
- Mr. Pieter RIJKELS: EDS Belgium
- Mr. William SAMPLE: Microsoft Corporation, United States

**Work Programme of the TAG**

The work programme developed by the BP TAG contains six main elements:

1. Consideration of how the current treaty rules for the taxation of business profits apply in the context of electronic commerce. Emphasis is placed in particular on four issues:
   1. The “place of effective management”.
   2. The concept of a Permanent Establishment (PE).
c) The attribution of profit to a server PE; and

d) Transfer pricing.

2. A consideration of the pros and cons of applying the existing treaty rules, taking into account anticipated developments in electronic commerce.

3. Development of criteria to facilitate the evaluation of existing treaty rules in the context of electronic commerce.

4. An assessment of whether, and if so how, the current treaty rules should be clarified in the light of electronic commerce.

5. Identification of alternatives to the current treaty rules for determining the taxing rights of source and residence countries and to the current treaty rules for the allocation of profit between the taxing jurisdictions.

6. An assessment of the alternatives to the current rules on the basis of the evaluation criteria.

The BP TAG is in the process of finalising two discussion papers that have been posted on the public EDG (electronic discussion group) and the OECD website. These discussion drafts are also found in this publication in Chapters 4.3 and 4.4, as the texts stood when we went to press.

Chapter 4.3 is a discussion paper on the allocation of profit to a PE involved in electronic commerce transactions. This identifies issues connected with applying the arm's-length principle in Article 7(2) of the OECD Model Convention in order to allocate profit to a server PE carrying out an e-tailing function.

Chapter 4.4 is a discussion paper on the application of the “place of effective management” tie-breaker rule in an electronic commerce environment. The paper identifies possible limitations of the tie-breaker rule in Article 4 of the OECD Model Convention, which determines the residence for treaty purposes of a “dual resident” person, in the context of current and future developments in electronic commerce. These papers provide a comprehensive analysis of the issues involved and invite comment from interested parties. Between them, these papers address the issues raised in items 1a) and 1c) above.

The TAG is currently working on drafts of a paper on the pros and cons of the current treaty rules in the context of electronic commerce. This paper builds on the preliminary conclusions contained in the two finalised discussion papers. Work on this paper involves a consideration of current treaty rules and an identification of possible alternatives. This addresses issues raised in items 2, 4 and 5 above and provides a foundation for future work contained in 3 and 6 above.
**Future work of the TAG**

If the mandate of the BP TAG is extended, it is envisaged that work would continue in four main areas:

- To continue the work on the allocation of profit to a server PE and the “place of effective management” concept in the tie-breaker rule in the light of comments received on the discussion papers.
- To evaluate the adequacy of the current treaty rules in the electronic commerce context, taking into account possible alternatives, and then, if it is considered necessary, consider how present rules could be clarified or modified.
- To address the transfer pricing issue at 1d) above, i.e. the allocation of income between associated enterprises engaging in electronic commerce. This work would be informed by feedback sought from business on what are seen as the priority issues.
- To monitor developments in electronic commerce that impact on the treaty rules related to the taxation of business profits.

**5.5. Main findings/conclusions of the Treaty Characterisation Technical Advisory Group (TAG)**

**Major achievements in the context of the TAG mandate**

The Treaty Characterisation TAG discussed the characterisation of various types of e-commerce payments under tax conventions. In particular, it examined and provided comments on the distinction that can be drawn between business profits and royalties and on the specific distinctions between:

- Business profits and payments for the use of, or the right to use, a copyright.
- Business profits and payments for know-how.
- Business profits and payments for the use of, or the right to use, industrial, commercial or scientific equipment; and
- Business profits and technical fees, including fees for technical, managerial or consultancy services.

The TAG also discussed the distinction that can be drawn between payments for the provision of services and other payments.

Finally, the TAG discussed the treatment of mixed payments that may arise in the e-commerce context.

The TAG identified 28 typical categories of e-commerce transactions and applied, to the income arising from these transactions, the characterisation principles derived from the above analyses for the purpose of tax conventions.
The Treaty Characterisation TAG achieved consensus on all the major conclusions and recommendations put forward by the TAG and completed the TAG's mandate in full and on time.

The conclusions and recommendations are provided in the form of general principles. This means that these principles should be applicable to any type of similar e-commerce transactions, including future ones, ensuring the appropriate legal characterisation every time. Nevertheless, it will be necessary to monitor the practical application of these principles to see whether they need to be elaborated or modified from time to time to continue to achieve the correct policy results.

The Treaty Characterisation TAG believes that the distinctions drawn between various types of payments will provide useful guidance when dealing with non-e-commerce transactions as well.

During its term, the Treaty Characterisation TAG also produced a number of major outputs as follows:

- A document which described 26 categories of e-commerce transactions together with the analysis and preliminary conclusions of the TAG was released for comments on 24 March 2000.
- A revised document was released for comments on 1 September 2000. That document described the various treaty characterisation issues that were identified by the TAG and presented the view of the TAG concerning these issues. Where different views had been taken within the TAG, all views were articulated and comments sought. The document also included a revised analysis of the various categories of typical e-commerce transactions identified in the previous draft.
- The final report to Working Party No. 1 was released on 1 February 2001 (see Chapter 4.2 and appendices to Chapter 4). That report includes the TAG's:
  - General recommendation to Working Party No. 1.
  - Analysis and conclusions on treaty characterisation issues arising from e-commerce transactions.
  - Suggestions for changes to the Commentary to the OECD Model Tax Convention.
  - Analysis of various categories of typical e-commerce transactions; and
  - Mandate and composition.

The Co-Chairs agreed that the TAG process was a very valuable way of identifying and resolving characterisation issues arising in the context of e-commerce. TAG members commend the Committee on Fiscal Affairs for this initiative.
**Principal conclusions and/or recommendations**

The TAG’s principal conclusions and recommendations are set out in its report to Working Party No. 1. In summary, the TAG concluded that:

- In any given transaction, the main question to be addressed is the identification of the consideration for the payment.

**With regard to the OECD Model Tax Convention:**

- One of the most important characterisation issues arising from e-commerce is the distinction between business profits and the part of the treaty definition of “royalties” that deals with payments for the use of, or the right to use, a copyright. In the case of transactions that permit the customer to electronically download digitised products, the TAG concluded that the payment is made essentially to acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquiror. To the extent that the act of capturing the digital signal constitutes the use of a copyright by the customer, this is merely an incidental part of the transaction. Therefore, the payment should be characterised as business profits rather than as a royalty. The TAG recommends the inclusion of additional clarification in the Commentary on Article 12 to reflect this analysis.

- E-commerce transactions resulting in know-how payments are relatively rare. However, where it is necessary to distinguish between the provision of services and the provision of know-how, the report provides a number of criteria and examples and recommends the inclusion of additional clarification in the Commentary on Article 12 to reflect the criteria and examples provided.

- There are a number of e-commerce transactions where the consideration of the payment could be considered to cover various elements. Where the predominant part of the consideration has one character and other parts are only of an ancillary and unimportant character, it would be more practical to apply the treatment applicable to the principal part to the whole consideration. Accordingly, the TAG recommends the inclusion of additional clarification in the Commentary on Article 12 to reflect this conclusion.

**With regard to alternative provisions found in some conventions but not in the current OECD Model Tax Convention:**

- Payments for time-limited use of digital products cannot be considered as payments for the use of, or the right to use, an industrial, commercial or scientific equipment (referred to as “rental payments”) for one or more of the following reasons:
  - Digital products cannot be considered as “equipment”; or
Such products cannot be viewed as “industrial, commercial or scientific”, especially when provided to the private consumer; or

The payments may, in fact, be to acquire property designed to have a short useful life.

- A non-exclusive list of factors provided in the report will assist in determining whether a payment is for the use of, or the right to use, an industrial, commercial or scientific equipment. In applying these factors to e-commerce transactions such as application hosting and data warehousing, the TAG concluded that these should give rise to services income rather than rental payments.

- A distinction may be drawn between transactions in services and transactions for the acquisition of property. The report provides some guidance on this issue in the e-commerce context.

- In relation to technical fees, such as fees paid for a technical, managerial or consultancy services, the following may provide some guidance in determining whether the payment in question is a technical fee.

  - Services are of a technical nature when special skills or knowledge related to a technical field are required when such services are provided to the customer. The fact that technology is used in providing a service is not indicative of whether the service is of technical nature.

  - Services of a managerial nature are services rendered in performing management functions; and

  - “Consultancy services” refer to services constituting in the provision of advice by someone, such as a professional, who has special qualifications allowing him to do so.

**Outstanding work in the context of the TAG mandate**

The TAG’s mandate was achieved in full.

**Specific issues for further work outside the original TAG mandate**

The TAG wishes to stress that a comprehensive and workable solution to all aspects of the e-commerce challenge is needed, and that it will be necessary to monitor the practical application of the rules governing the characterisation of e-commerce revenue to ensure that they continue to achieve the correct policy results.
Notes


2. See Chapter 2.


4. “Virtual products”, as used in this section (5.2), includes all goods or services which are or can be provided completely over electronic media. This term covers goods and services which may not be subject to tax or which may be the subject of disagreement or inconsistent national and sub-national classification. It is not the intent of this section to address those issues.

5. Less than a computer but more than a phone. Most will have touch screens and small hard drives along the lines of today’s larger Personal Data Assistants (Palm, Psion, Pocket PCs).

6. With an understanding that certain jurisdictions such as the United States have complex sub-national sales and use tax systems which pose similar issues.

7. See www.oecd.org/daf/fa/ for a link to the full Report by the Technology TAG: “Public Release of OECD Reports”.

8. Internet Protocol numbers are the Internet equivalent of a phone number or address. The current protocol is Internet Protocol Version 4 (IPv4) which defines an Internet address as a unique number consisting of 4 parts separated by dots, e.g. 165.113.245.2

9. The experience of US-based cryptography exporters in using IP numbers to verify purchasers’ country in order to meet Bureau of Export Exchange requirements is that of an estimated 60 to 70% matching of IP address with the self-declaration was achieved. Note that a mismatch was not the only check as companies also checked against a denied parties’ access list, which increased the reliability for the agencies involved.

10. See www.oecd.org/daf/fa/ for a link to the full Report by the Technology TAG: “Public Release of OECD Reports”.

11. It should be noted that all Tax at Source and Transfer, the Trusted Third Party and the Hybrid models discussed in this section have the same underlying logical model. The differences stem from how the model is implemented and responsibilities for the various functions are shared/split between the business, trusted third parties and revenue authorities involved in the tax calculation and collection process.
12. Note that this analysis presumes a perfect world where no policy issues exist as to which jurisdiction’s rules should be used for remittance and calculation or which classification is appropriate.

13. “Relative” refers to the fact that database entries are logged in relation to each other for the purposes of reconstruction of the database.

14. All of the annexes are included in the full “Report by the Professional Data Assessment TAG”, which may be accessed via the link www.oecd.org/da/fa: “Public Release of OECD Reports”.


17. A more detailed analysis of remote access in the Internet e-commerce environment is available in Annex VI of the full Report, available on the web. See footnote 14.


19. A detailed paper on the available technologies which would support data authenticity and integrity is contained in Annex V of the full Report, available on the web. See footnote 14.


Part III
TAKING FORWARD THE CFA’S WORK ON TAXATION AND ELECTRONIC COMMERCE
Chapter 6

The Next Phase of Implementing the Taxation Framework Conditions: Progressing Further Work and Strengthening the International Dialogue

In publishing this consolidated progress report on the implementation of the Ottawa Taxation Framework Conditions,* the Committee on Fiscal Affairs (CFA) recognises that further work remains to be done in a number of fields. Several of the reports in this volume specifically identify further work topics and issues. These include, amongst others:

- On direct tax issues, allocation of income.
- On consumption tax issues, the role of technology-based systems in tax collection.
- On tax administration issues, the means to address significant compliance challenges and to exploit taxpayer service opportunities.

In line with its working methods since Ottawa, the CFA intends to take forward this further work through its subsidiary bodies (Working Parties, etc.) with continued input from, and close working with, business and non-member economies. In January 2001, the CFA not only endorsed the elements of a work programme for 2001-03, but also approved proposals for a continuation and refinement of the TAG (Technical Advisory Group) process.

As of 1 April 2001, the following TAG arrangements will operate. There will be three TAGs:

- A “Business Profits” TAG continuing to pursue the mandate of the previous TAG.
- A “Consumption Tax” TAG, again continued to advise and support the work on consumption tax related questions.
- A “Compliance, Information, and Documentation” TAG, which will build upon the work of the previous Professional Data Assessment TAG and examine a broader range of tax administration issues.

These three TAGs will be supported by a smaller **Technology Panel** which will provide technical advice as required/requested, either directly or by acting as a conduit for advice from experts in the wider business and technology community.

Building on positive experience to date, the TAGs will continue to be tripartite in composition (OECD government; non-member government; business community) and be co-chaired. Membership of TAGs will likewise draw on past participants in the process while pulling in some new blood and strengthening non-member economy involvement.

Diagrammatically, the new structure will thus be along the lines set out in Figure 1.

**Figure 1. New TAG structure, 2001-03**

The CFA will continue to undertake its work on the taxation aspects of electronic commerce in an open and transparent manner (issuing discussion drafts for comment; regular updates on progress, etc.) with the express aim of continuing to strengthen the emerging international consensus on these issues. Working in partnership with the international business community, and with economies outside the OECD, remains central to building that international consensus and so providing the certainty and confidence that governments and business both seek.
ANNEXES
Annex I
The Ottawa Taxation Framework Conditions

The Draft Ministerial Report
Preface

This Report has been prepared by the Committee on Fiscal Affairs of the OECD. The Report has benefited from inputs by the European Commission and the World Customs Organisation in the area of indirect taxes and from an exchange of views with the business community.
Electronic Commerce: Taxation Framework Conditions

A Report by the Committee on Fiscal Affairs

I. Introduction

Electronic commerce has the potential to be one of the great economic developments of the 21st Century. The information and communication technologies which underlie this new way of doing business open up opportunities to improve global quality of life and economic well being. Electronic commerce has the potential to spur growth and employment in industrialised, emerging and developing countries.

Revenue authorities have a role to play in realising this potential. Governments must provide a fiscal climate within which electronic commerce can flourish, weighed against the obligation to operate a fair and predictable taxation system that provides the revenue required to meet the legitimate expectations of citizens for publicly provided services. Striking the right balance between these objectives is the aim of this Report.

II. Main conclusions

The Committee on Fiscal Affairs (CFA) recognises that the technologies which underlie electronic commerce offer Revenue authorities significant new opportunities to improve taxpayer service and Member countries are committed to exploiting fully these opportunities (see Section III).

The taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. The CFA believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles.

This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.

Any arrangements for the application of these principles to electronic commerce adopted domestically and any adaptation of existing international taxation principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double taxation and unintentional non taxation (see Section IV). Revenue authorities acting within the OECD or other fora, must take an active role in encouraging protocols and standards for electronic commerce which are compatible with these principles.

The CFA has been able to reach conclusions on conditions for a taxation framework needed to implement these principles (see Section V). Intensified co-operation and consultation with
business will be an important part of the process of implementing these principles (see Section VI).

III. Taxpayer service opportunities

Revenue authorities recognise that electronic commerce technologies will open up new ways by which they can undertake their business of administering tax law and collecting tax revenues and new ways by which they interact with the wider community.

<table>
<thead>
<tr>
<th>Box 1. Taxpayer service opportunities offered by new technologies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Improving service standards</strong></td>
</tr>
<tr>
<td>i) Communications facilities and access to information can be enhanced to assist taxpayers and to improve response times.</td>
</tr>
<tr>
<td><strong>Minimising business compliance costs</strong></td>
</tr>
<tr>
<td>ii) Tax registration and filing requirements could be simplified and norms promoted for the acceptance of electronic material.</td>
</tr>
<tr>
<td><strong>Enhance voluntary compliance</strong></td>
</tr>
<tr>
<td>iii) Electronic assessment and collection of tax could be encouraged. Easier, quicker and more secure ways of paying taxes and obtaining tax refunds could be facilitated.</td>
</tr>
</tbody>
</table>

IV. The broad taxation principles which should apply to electronic commerce

Box 2 sets out the widely accepted general tax principles that should apply to electronic commerce.

The full application of the principles set out in Box 2 will require further work after the Ottawa Ministerial meeting.

V. The challenge of implementing these broad principles

The challenge facing Revenue authorities is how to implement the broad taxation principles identified in Box 2 in a rapidly changing environment. In a number of areas the CFA has been able to reach conclusions on the elements of a taxation framework that will incorporate these principles. These are summarised in Box 3.
Box 2. **Broad taxation principles which should apply to electronic commerce**

**Neutrality**

i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

**Efficiency**

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

**Certainty and simplicity**

iii) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

**Effectiveness and fairness**

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

**Flexibility**

v) The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.
Box 3.  **Electronic commerce: elements of a taxation framework**

**Taxpayer service**

i) Revenue authorities should make use of the available technology and harness commercial developments in administering their tax system to continuously improve taxpayer service.

**Tax administration, identification and information needs**

ii) Revenue authorities should maintain their ability to secure access to reliable and verifiable information in order to identify taxpayers and obtain the information necessary to administer their tax system.

**Tax collection and control**

iii) Countries should ensure that appropriate systems are in place to control and collect taxes.

iv) International mechanisms for assistance in the collection of tax should be developed, including proposals for an insert of language in the OECD Model Tax Convention.

**Consumption taxes**

v) Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.

vi) For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.

vii) Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

viii) Countries should ensure that appropriate systems are developed in co-operation with the WCO and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers.

**International tax arrangements and co-operation**

ix) While the OECD believes that the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing (through the Model Tax Convention and the Transfer Pricing Guidelines) are capable of being applied to electronic commerce, there should be a clarification of how the Model Tax Convention applies with respect to some aspects of electronic commerce.
The CFA also recognises that there are ongoing developments in areas such as establishing electronic trading, payment, certification and technical standards and protocols and in the reform of Internet governance where Revenue authorities both individually and in such international fora as the OECD may need to play a role if they are to succeed in implementing the tax principles set out in Box 2. In addition, Revenue authorities in co-operation with other appropriate authorities, will closely monitor developments in electronic means of payment, particularly unaccounted systems.

Recognising the global nature of electronic commerce, Revenue Authorities will intensify their use of existing co-operative arrangements, explore options for multilateral administrative assistance and examine the application of the recommendations relating to geographically mobile activities contained in the OECD Report *Harmful Tax Competition* to the electronic commerce environment.*

The CFA believes that an implementation of the framework conditions set out in Box 3 will enable Governments to harness the opportunities and to respond to the challenges of electronic commerce and thereby lead to an internationally consistent taxation approach to electronic commerce.

VI. The post-Ottawa agenda and process

The Turku conference of November 1997 initiated work on developing taxation framework conditions for electronic commerce. The Ottawa Ministerial meeting of October 1998 will take this process further. However, much remains to be done. This Report has identified the broad taxation principles which should apply to electronic commerce and identified implementation issues, including how these new technologies offer Revenue authorities the opportunity to improve the service they provide to taxpayers.

The Committee on Fiscal Affairs further recognises that the full application of the principles which underlie these arrangements will require further work after the Ottawa Ministerial meeting. It also accepts that any taxation arrangements put in place must be capable of developing as the technological and commercial environment changes. The Committee welcomes the willingness of business to work with Government in developing further approaches for the implementation of these principles and looks forward to working with business at both the technological and policy level. This further dialogue entails a recognition of the place of Revenue authorities as stake holders in electronic commerce and the validity of their involvement in the development of the standards and protocols which are now emerging.

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* Luxembourg and Switzerland abstained from the Council recommendation which accompanied this report.
Box 4. **The post-Ottawa agenda**

Revenue authorities will work through the OECD and in consultation with business to identify concrete substantive steps that can help implement and extend the taxation framework conditions described in Box 3, and to consider the feasibility and practicality of those steps, including the following:

**Taxpayer service**

i) Developing an international consensus on ways to simplify taxation systems to minimise the cost of tax compliance, particularly for small- to medium-sized enterprises.

**Tax administration, identification and information needs**

ii) Adopting conventional identification practices for businesses engaged in electronic commerce.

iii) Developing internationally acceptable guidelines on the levels of identification sufficient to allow digital signatures to be considered acceptable evidence of identity in tax matters.

iv) Developing internationally compatible information requirements, such as acceptance of electronic records, format of records, access to third party information and other access arrangements and periods of retention and tax collection arrangements.

**Tax collection and control**

v) Designing appropriate strategies and measures to improve tax compliance with regard to electronic commerce transactions, including measures to improve voluntary compliance.

**Consumption taxes**

vi) Reaching agreement on, inter alia, defining place of consumption, on place of taxation rules and on internationally compatible definitions of services and intangible property.

vii) Developing options for ensuring the continued effective administration and collection of consumption taxes as electronic commerce develops.
Box 4. **The post-Ottawa agenda (cont.)**

**International tax arrangements and co-operation**

viii) With regard to the OECD Model Tax Convention, clarifying how the concepts used in the Convention apply to electronic commerce, in particular:
   
   a) To determine taxing rights, such as the concepts of “permanent establishment” and the attribution of income; and
   
   b) To classify income for purposes of taxation, such as the concepts of intangible property, royalties, and services, and in particular as regards digitised information.

ix) Monitoring of developments in, and tax administration challenges presented by, electronic commerce, in the application of the OECD Transfer Pricing Guidelines.

x) Improving the use of existing bilateral and multilateral agreements for administrative assistance.

xi) Considering how harmful tax competition for electronic commerce is to be avoided, in the context of the Recommendations on geographically mobile activities accompanying the OECD Report Harmful Tax Competition.

Box 5. **The post-Ottawa process**

To pursue the post Ottawa agenda, Revenue Authorities will continue to:

i) Carry forward the work programme in the Committee on Fiscal Affairs including monitoring developments in, and tax administration challenges presented by, electronic commerce and continuing its close relationship with the European Commission and the World Customs Organisation.

ii) Intensify co-operation and regular consultation with the business community.

iii) Develop its contacts with interested non-member economies.

iv) Report back periodically to the OECD Council and, if appropriate, to Ministers.

Source: OECD, Secretariat.
Annex III


Business Profits TAG
Australia, Brazil, Canada, China, Germany, India, Ireland, Japan, Morocco, South Africa, Switzerland, United Kingdom, United States, AMP, British Telecom, Bundesverband Deutscher Banken, Joint EBF / ABA, EDS Belgium, Fujitsu, Hewlett-Packard, Information Technology Association of America, Microsoft Corporation, Vertex Inc., Volkswagen AG

Consumption Tax TAG
Argentina, Australia, Brazil, European Commission, Japan, Netherlands, Russian Federation, Singapore, United Kingdom, ABN AMRO Bank N.V., America Online Inc., AT&T, Chartered Institute of Taxation, Electronic Data Systems Corporation, Keidanren, KPMG, Microsoft Corporation, Nortel Networks, Phillips International, Rhone-Poulenc S.A., Swisscom AG, UBS AG

Treaty Characterisation TAG
Australia, Chile, China, Germany, India, Israel, Japan, Norway, Philippines, Switzerland, United Kingdom, United States, Baker and McKenzie, IBM Canada Ltd., NTT Data Institute of Management Consulting Inc., Reed Elsevier Inc., Software Publishers Association, The Walt Disney Company

Professional Data Assessment TAG
Argentina, Australia, Canada, France, Ireland, Netherlands, New Zealand, Spain, Tunisia, United Kingdom, United States, American Institute of CPAs (AICPA), Arthur Andersen, Australian Society of CPAs, ACL Services Ltd., Chuo Aoyama Audit Corporation, Deloitte and Touche, Ernst and Young, IETF Trade Working Group, International Federation of Accountants (IFAC), ISACA Internet Open Trading Protocol (IOTP), KPMG, Sagesoft Ltd.

Technology TAG
Australia, Brazil, Egypt, Chinese Taipei, France, Ireland, Japan, Malaysia, Norway, Thailand, United States, AddTrust AB, British Telecom, Cisco, Citigroup Inc., Consumers International, EICTA, Ernst and Young, EUROBIT, European Certification Authority Forum (ECAF), Hewlett-Packard, Hitachi Ltd., IBM Corporation, ICANN, IETF, Intel Corporation UK Ltd., Mondex, NASSCOM, NTT, Oracle, Siemens AG, TUAC