News_BMFE_2000-5.pdf

E-Commerce and taxation

DAILY NEWS, FRIDAY DECEMBER 01, 2000

Base Paper for 5th Annual Oration on Taxation - 2000 at the Institute of Chartered Accountants of Sri Lanka By Mr. O. P. Vaish, Senior Advocate, Supreme Court of India

A FAMOUS cartoon had two dogs sitting in front of a computer. On the Internet, ran the caption "nobody knows you're a dog". Such anonymity poses problems for taxman.

Perhaps the most significant characteristic of internet relevant for electronic commerce and international tax policy is the total irrelevance of geographical considerations. Internet is borderless technology. Servers may be located anywhere. Their location is often unknown and unimportant in a business transaction. There is little central control over the internet. One might call it a triumph of private sector capitalism. The features that make electronic commerce attractive to business and consumers may be worrisome for tax authorities on account of difficulties in identifying transactions and tracing where transactions take place.

Tax issues created by global electronic commerce are emerging abruptly and dramatically from the shadowy realm of theory and hypothesis.

The subject is occupying attention of international bodies like the OECD and the EU, governments, academic, industry and professional organizations around the world.

It is as much a matter of concern for businesses to determine the rights and objectives of the parties engaged in or contemplating e-commerce transactions. Familiarity with the potential for tax exposure and the opportunities for tax Planning that e-commerce brings with it is becoming indispensable for enterprises wishing to maintain their competitive edge.

Alertness to the issues in the landscape of uncertainty that surrounds certain aspects of internet taxation will help businesses to position themselves more effectively as the future contours of internet taxation materialize.

Brief experience has demonstrated that e-commerce tax issues differ significantly from industry to industry-whether it be web-based retailing, online delivery of software or music, online services such as news and information, banking, brokerage, insurance or auctions, or the provision of internet access, web hosting, and data transmission services.

E-commerce itself is a broad mix of transactions. Companies engaged in global e-commerce may be confronted with familiar international tax issues like controlled foreign company (CFC) rules, transfer pricing etc.

A number of tax authorities started responding to the internet challenge after it had become an active commercial medium. The peripatetic nature of the internet and the anonymity it offers, coupled with potentially untraceable transactions, quickly captured the attention of tax authorities worldwide.

Last three years have seen a stream of documents in the form of exposure drafts, discussion, policy papers emanating from various levels of government and international organizations.

Technical tax issues on the table in the e-commerce debate are:

(1) What constitutes taxable presence from the use of internet?

(2) What is the tax classification of income from electronic activities; especially in the context of withholding of taxes and indirect taxes?

(3) How are taxpayers identified and their transaction audited?

(4) What are the implications for transfer pricing and the use of tax havens?

Issues (3) and (4) involve both inbound and outbound e-business, while issues (1) and (2) are primarily the concern of the country where the web customers are located. Historically, OECD member countries have entered into income tax treaties that have a fairly high threshold of taxable presence for foreign vendors and suppliers, as expressed in the PE provision of the model convention.

OECD treaties also largely eliminate withholding taxes on imports of intangibles (licence royalties and services). Consistent with the same, one may expect the OECD to recommend guidelines that may not consider the mere existence of website or computer server as resulting in PE, and preclude the application of withholding tax on delivery of most forms of digitized material like software, music, data, books, images etc. Of course, even if OECD recommends such guidelines, individual member countries may dissent or express reservation with respect to the recommendations.

Substantive international tax issues in e-commerce are taxable presence, character and source of income, transfer pricing, and application of Control Foreign Corporation (CFC) legislation - concepts contained in well-developed body of domestic and/or treaty rules that have evolved over many decades.

Application of the concepts of PE and character of income will in effect decide which country, that of the seller or the buyer, will be able to tax a particular cross-border transaction.

Implicit in this is allocation of revenue between the country of residence and the country of source.

Both internationally and at the state level in the US, there is tension between those jurisdictions that regard themselves as importers in the internet world and those that are seen to be exporters and, therefore, beneficiaries of the status quo.

An early question in the debate was whether the current international tax regime is adequate to deal with e-commerce. Both the OECD and the US Treasury have concluded that existing tax principles, with appropriate modifications, should be applied to e-commerce.

Permanent establishment (PE)

The PE concept which serves as the taxation threshold for business income derived by non-residents, was developed by the League of Nations group of specialists and has underpinned tax treaties ever since. The tax of Article 5 of the current OECD model treaty varies little from the 1963 model, which was based on the earlier League of Nations model.

It was generally agreed early in the evolution of international tax treaties that business income should be taxable in the source country only if it is attributable to a certain level of physical presence in that country. Article 5 defines that level of local activity as that carried out through a fixed place of business, like an office, a factory, a shop, a branch, etc., or through the use of a local person that functions as a dependent agent. Since its inception, Article 5 also has included several exclusions to PE status for activities such as storage, display, delivery, processing, purchasing, research, advertising, and in a catch-all phrase, "similar activities which have a preparatory or auxiliary character".

Without the exclusions, the enumerated activities could give rise to a PE. The exception were added to strike a balance between the desire to "tax foreigners" and the long-term economic and administrative benefit of relinquishing some tax revenue.

The OECD model PE concept is reflected more or less in the domestic tax of a number of the 29 countries that make up the OECD, but it is not widely acceptedoutside those countries.

Outside the OECD, the developing countries regard source country as having the primary right to tax income derived from the developing countries regard source country activities or assets located within their borders and sometimes from services performed outside its borders. The tax structures of these countries are typically characterized by high withholding taxes on the import of intangibles, information and technical services, the absence of income tax treaties, and taxable presence thresholds in national law that are lower than those in the OECD model convention.

It seems likely that the OECD and tax authorities in OECD countries will retain existing international tax principles. They will, however, have to decide several questions of interpretation in common e-commerce scenarios. For example:

* Will the accessibility of a website on the PC of a customer located in a country be considered a PE of the foreign vendor?

* Will a computer server located in non-OECD country create a PE for European Internet Services Provider (ISP) or On-line Service Provider?

* Will the activities of a host country ISP be attributed to the foreign vendor?

Character of income:

Income characterization issues are crucial to the tax treatment of e-commerce transactions under the Income Tax Acts and for Income and Indirect tax purposes. Whether income will be taxed by the source or residence country depends in part on the character of the income, ie, whether the transaction is characterized as sale, service or copyright related transactions. In the absence of a tax treaty, royalty income is almost universally subject to withholding tax in the source country, while income from the sale of goods or services is taxable in the source country only if the seller or service provider has a taxable presence in that country by way of a PE.

Incompatible income classification by the source and residence countries may result in multiple taxation.

For example, under US tax rules, foreign taxes are creditable to the extent they are imposed on "foreign-source income". Characterization of an e-business payment as a royalty by the source country and as income from the sale of property by the US (as in the case of shrink-wrap software) may result in double taxation since the income may be subject to foreign withholding tax, while at best 50% of the income may be foreign-source income for US foreign tax credit purposes.

Even in the treaty context, not all characterization differences can be resolved by the mutual agreement procedure.

Current efforts to define the tax treatment of software transactions are a significant step towards a body of principles for defining common e-commerce transactions.

The commentary to Article 12 (Royalties) of the OECD model treaty was expanded in 1992 to address the tax treatment of software.

The OECD commentary recognized that transfers of software could range from the alienation of the entire bundle of rights to a mere sale of the software product. The key point emerging from the 1992 changes is the notion that software purchased for the customer's own use should be treated as a sale and not a license, giving rise to business profit rather than royalty for treaty purposes. Several countries, including the US and Canada, recently addressed the software issues in an effort to bring the tax treatment in line with the aforesaid approach. Software characterization problems arise because software is transmitted by means of a license for purposes of intellectual property law, even though economically these transactions are more often analogous to the sale of a copyrighted article such as a book.

> The OECD commentary recognized that transfers of software could range from the alienation of the entire bundle of rights to a mere sale of the software product.
> The key point emerging from the 1992 changes is the notion that software purchased for the customer's own use should be treated as a sale and not a license, giving rise to business profit rather than royalty for treaty purposes.

Continued on page 42