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THE TAXATION OF ELECTRONIC COMMERCE

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Electronic Commerce, or EComm, relates to "the ability to perform transactions involving the exchange of goods and services between two parties using electronic tools or techniques". Such tools include, but are not limited to, the Internet. The unprecedented growth in the Information Superhighway in the last few years has brought tremendous opportunities for all walks of life. What started out as an electronic library primarily for academics and government departments has been transformed into a global communications phenomenon with huge potential for revolutionising international business.

However, whenever there is rapid development or change, there is frequently some element which is left behind. At the present time, both government and business are concerned with the possible obsolescence of traditional fiscal concepts as a result of the revolution overtaking customary methods of conducting all manner of international business. Governments fear a significant loss of revenues from the erosion of an established base of business profits which could be shifted to another jurisdiction. Businesses, on the other hand, fear the increased incidence of double taxation if tax authorities squabble over their right to tax elements of a new source of international profits and the familiar mechanisms protecting against double taxation break down. The expansion of electronic commerce has raised the basic question of whether existing tax laws can cope with the latest ways of conducting business.

Much has been written about these fears in the last year or so and the debate is slowly starting to focus more on the opportunities for resolution of the issues rather than the

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issues themselves. In the course of the discussion, it has become apparent that some of the original fears were perhaps unfounded, or at least exaggerated, and that with proper economic analysis of the way in which electronic commerce is conducted, it is possible in many cases for businesses at least to plan around some of the potential pitfalls and thus largely control the after-tax result. This does not mean that no changes are required to existing international fiscal law. Indeed, the methods whereby multinationals may seek to minimise the risk of double taxation may coincide precisely with the cause of the greatest fear of lost revenues by government, namely the natural or forced relocation of economic activity outside their sphere of influence. However, until such time as the OECD and others conclude on the optimal method of taxing revenues generated in cyberspace, it is worth revisiting the technical analysis which should be undertaken by any business currently engaging in electronic commerce to ascertain where the tax risks and opportunities lie.

Prior to entering into a more detailed discussion of the tax issues relating to electronic commerce, it is necessary first to have a general understanding of the Information Superhighway - both what is and how it works. For the rest of this article, I will refer simply to the Internet, although both the principles and the issues involved are of wider application. In addition, although there are important indirect tax issues relating to electronic commerce, I propose here only to look at some of the international direct tax implications.

It is helpful to divide overall Internet activity into three separate business segments:

(a) infrastructure providers: this embraces the business of the telecommunications companies ("Telcos") and Internet services providers ("ISPs") and involves the use of hard assets (including transmission facilities, servers, Internet access and related services).

(b) enabling software providers: this relates to the provision of server network software, user software, website design and so forth.

(c) content providers: this category includes the vast range of potential vendors of information, goods and services, who wish to trade via the Internet.

The distinction between these categories is essential to the tax analysis. The position of a company providing the infrastructure via which the trade can be carried out is, in some respects at least, comparable to the provider of more traditional infrastructure used by or in business, such as telephone or fax. It is, however, potentially completely different from the position of the trader effecting a sale by means of the new electronic facilities.

Most developed countries have a principle of taxing:

(i) worldwide income of residents of that country, and

(ii) income sourced in that country belonging to non-residents.

They do this by characterising income into three categories:

(i) the sale of goods;

(ii) the provision of services;

(iii) the use of intangible assets.

To avoid double taxation, the international network of bilateral treaties then generally make the residence country responsible for giving either credit relief or exemption for income which has already been taxed at source.

Thus, having established the three business segments involved with electronic commerce, it is then necessary to determine what economic functions are actually taking place, so that subsequent further analysis can be undertaken to establish both the nature of the income generated and its source for tax purposes. This requires further understanding of the Internet system itself.

In order to access the Internet, users typically connect via a direct link to their ISP's facility in their home country. The ISP uses telecommunications infrastructure purchased from a number of carriers to send the user's message to the ISP's main operations centre. An ISP's local point of presence normally only requires modems and switching (or routing) equipment. The main operations centre will have high speed data transmission equipment.

The ISP is essentially providing a form of telecoms service, comprising the capability to transmit information on behalf of others, and it will charge accordingly for the service provided. For tax purposes, at each stage of the economic analysis it is therefore helpful simply to ask "For what is the supplier charging (i.e. goods, services or use of intangible assets)?" and "Where is that income being earned?"

After certain security procedures are completed, the user is then "connected to the Internet".

It is important to remember that the Internet has no central computer or organisational structure: it is an interconnecting series of landlines, submarine cable, satellite and so forth. Similarly, there is no centralised ownership or control: different parts of the network are owned by different Telcos and ISPs. What links the Internet together and allows its many disparate parts to communicate is a common protocol which specifies how data is to be broken up into packets and assigned addresses allowing its transmission between different computers, regardless of hardware, software or communication technology. A single message will be broken down into individual packets of information which will typically be sent along a number of different routes - basically whatever path is available at the time that is going in the right general direction - until they all reach their destination address and recombine.

Once connected to the Internet a customer can access any vendor's website, because the vendor will also connect to the Internet via an ISP. The customer's and vendor's ISPs need not be the same because all ISPs will have entered into peering agreements, directly or through one of a number of intermediaries, to carry data to and from one another.

A vendor may maintain a website on his own server connected to an ISPs facility in the same territory or, alternatively, he may lease space on the ISPs own server. As a vendor or an ISP can select the location for their servers, they may choose to locate them in their own home jurisdiction or opt for a different domain, such as a low tax territory or even a tax haven. This is potentially significant for tax purposes, because it is generally accepted that a vendor's "web page" represents his electronic offer for sale and thus the relevant proportion of his business profits will be attributable to that location.

Having accessed the vendor's web page, the customer can complete a transaction by one of a number of different acceptance mechanisms and payment systems. Typically the customer will click on an icon to select the required products or services and click on a further payment icon which will require input of credit card details. Once this process has been successfully completed, the information will be communicated to the vendor to arrange delivery. In these circumstances, the Internet has played only a passive role in the transaction: it provides efficiencies to the parties but adds little, if anything, to the solicitation or negotiation process and does not itself produce or alter the item ultimately delivered. In substance the transaction has been no different from that which would have been achieved using conventional communication and delivery channels. We might therefore expect the tax analysis to be unaffected by the use of electronic commerce.

If, however, a product or service is itself capable of being delivered electronically, then there may be a further mechanism which allows the customer to download the material directly, and in these circumstances the Internet has played a less passive role. The tax authorities in the source country and the country of the vendor's residence may have different interpretations from each other, or from the counterparties, as to the nature of the transaction. It is therefore particularly important to establish the precise nature of the goods or services being acquired. For example, is it a single tangible item (e.g. information which can be conveyed and printed out once at the customer location) or is it a right over intangible property (e.g. information which can be replicated many times by the customer)? Although this analysis may seem more difficult, it should still be ascertainable with relative ease by reference to the facts of the particular situation.

As a result of trading electronically more instances of potential double taxation do arise because there is an inherent change in the nature of certain types of sale (and thus categories of income) and a potential shift in the place where the income is generated. Although some provision is made for income from intangible property, existing tax rules were generally written for transfers of tangible property and the supply of services where physical presence is required. Electronic commerce is challenging traditional definitions of "products" and "services" and turning what was previously typically a sale of goods into the transfer of rights over intangible property or even the provision of services.

In addition, treaty provisions which were designed to eliminate double taxation may not embrace income from certain forms of electronic commerce because the definition may not adequately cater for situations in which an active business can be conducted from a remote location and the only local presence is an apparently isolated piece of computer equipment which does not fit the conventional interpretation of a "permanent establishment". Because existing tax principles are seated in the concepts of source and character of income, provisions which aimed to allocate profits equitably between tax jurisdictions may now have the effect - where they can be practicably applied to electronic commerce - of shifting the balance of profits towards particular jurisdictions, depriving some jurisdictions of large tranches of income which would previously have fallen within their domain.
It is easier to evaluate these issues by reference to four fundamental questions:

(i) Income characterisation - What is the nature of the income generated? Does it derive from the sale of goods, the provision of property, the grant of rights over intangible assets or the supply of services?

(ii) Source or residence - Is the income taxable by reference to the country of its source, the residence of the vendor, or both?

(iii) Permanent establishment - Does the vendor have sufficient presence in a particular territory to be taxable there by virtue of a branch or other permanent establishment?

(iv) Transfer pricing - How should the income (and expenditure) arising be apportioned between relevant territories? In particular, how should the profits of a multi-national group engaged in electronic commerce be apportioned between its various subsidiaries?

As noted above, most developed countries have developed a system of taxing income by reference to three categories: sale of goods, provision of services and use of intangible assets. Transactions which were previously quite clearly a sale of tangible property can now take place in dematerialised form and may for example amount to the grant of a licence to use an intangible asset.

Vendors of computer software are already familiar with the difficulties which have long existed in classifying income from international "sales". Frequently the country of the purchaser regards a transaction as the grant of a licence so that the "purchase price" is treated as a royalty subject to withholding tax. The same transaction, however, may be classified as an absolute sale of goods by the vendor's jurisdiction subject to residence-based tax on profits in the home territory. Occasionally the problem is exacerbated when the home territory seeks to deny relief for the withholding tax suffered on the basis that the purchaser's jurisdiction was not correct to levy withholding tax and the proceeds do not constitute a royalty under the provisions of the relevant double tax treaty.

Computer software can be sold in a number of different forms and this tends to add to the confusion. The ability to trade over the Internet has further extended the opportunities to transact in computer software in a variety of forms, and the nature of the problems already inherent in these transactions is indicative not only of the additional hurdles to be overcome once the trade is concluded electronically, but also of the difficulties which ensue for similar transactions which can now be completed in a similar range of formats in respect of books, music, other CDs and, in fact, any information which can be digitised and transmitted electronically.

However, experience has shown that the difficulties encountered with conventional sales of computer software can often be eliminated by careful analysis of the precise nature of the transaction. Most software companies contend that they are selling goods absolutely when they sell "shrink wrapped" products because, although the goods are sold under a licence, the analogy is made to that of the sale of books where the purchaser is buying for his own use but is restricted by copyright from making copies for sale to or use by others. This position can be contrasted with software provided under licence to a distributor for the specific purpose of replication and onward sale. In these circumstances the price paid by the distributor would typically be classified as a royalty and may even be linked to the volume of onward sales. There are, however, a number of other scenarios which are more difficult to analyse, especially where specific software is tailored to the particular requirements of the customer.

The OECD reviewed the treatment of software sales in 1992 and confirmed the above treatment, concluding that purchases for personal business use should be classified as absolute sales of goods, notwithstanding the existence of a licence agreement, but income from the provision of a licence to a third party for commercial exploitation of software comprised a royalty.

Although a number of jurisdictions reserve the right to tax payments for software at source, this experience tends to confirm the belief that a proper understanding of precisely what is being "sold" from a commercial perspective is often the best, and possibly the only, means by which either a taxpayer or a revenue authority can defend his position. Where a transaction is conducted using electronic commerce, it becomes additionally important to grasp the method by which the electronic sale is concluded in order to classify the income correctly for tax purposes. Classification is then comparatively easy where there is a parallel transaction using conventional trading methods, but it is admitted that it becomes more difficult where entirely new products and services are emerging as a result of being able to do business electronically.

The purchase of CDs is an excellent example of the type of transaction which could previously only have been a transaction in tangible property but which is now capable - as a result of electronic commerce - of comprising a transaction for the use of an intangible asset. In determining whether the income is taxable by reference to the residence of the vendor or the location of the purchaser, it is possible to perform the type of analysis which is already familiar in the case of computer software. If, as a result of the transaction over the Internet, a CD is imported for delivery to the purchaser, then there is little to distinguish it from a conventional sale of goods. However, if the music (or equivalent information) is transmitted via the Internet and downloaded onto the purchaser's computer for local reproduction, it is more difficult to demonstrate that there has been a sale of goods. On the other hand, if payment is being made for the use of intangible property, how does the country of the purchaser impose collection of withholding tax on the royalty?

Similarly, vast quantities of information which was previously only available in bound volumes is now available on the Internet. A customer wishing to acquire such reference material can opt to have the books delivered in conventional hard copy format or CD ROM, shipped in and delivered as above, or alternatively he can access the data on-line. The provision of on-line information in return for a fee is a new concept, and so it is more difficult to determine the nature of the income for tax purposes. Is a payment to access copyright material in a database a royalty? Or is it a fee for a provision of a service? Does the analysis change, or become more akin to the provision of services, when a complementary range of on-line facilities is also available?

Once the character of the income has been established, it is necessary to determine which jurisdiction has the primary right to tax it. The majority of jurisdictions tax the worldwide income of the residents of that country and the income of non-residents sourced in that country. Most trading income is taxable by reference to the concept of residence, unless a non-resident has a place of business in the source country which gives rise to income in that country. Where such a permanent establishment exists, concepts of source taxation take precedence.

The development of electronic commerce challenges these basic, traditional principles from a number of angles:

(a) Electronic commerce is altering the inherent nature of a number of conventional trading transactions such that they give rise to income from the use of intangibles rather than the sale of goods and services; such income is frequently taxable by reference to the concept of source rather than residence which causes a shift in profit base between territories without any change in the underlying economic activity.

(b) Some countries define residence by reference to the incorporation of a company but many others rely on principles relating to management and control: electronic commerce enables business to be conducted from a remote location, which could also cause a major erosion in the tax base of certain territories without any change in the underlying economic activity.

(c) Electronic commerce enables business to be conducted from a variety of locations such that a company may be resident in several territories or, alternatively, in none at all.

(d) Electronic commerce also breaks down the traditional connectivity between location and economic activity so that the provision of services and their consumption need no longer be co-located in space and time. For example, an engineer may no longer need to attend a site to effect repairs: a customer can access a "help" screen, possibly with interactive fault diagnosis, on a vendor's website to obtain after-sales service. The source of the services may be at the customer's premises, the location of the server hosting the relevant website, the location of any database accessed by the website, the location of the maintenance engineer who helped from a remote location, or somewhere else.

This is an area which must be left to the international policy debate to resolve. However, for those conducting business electronically in the interim period, there are both risks and opportunities to be taken into account when determining the legal structure and the operational procedures to be adopted. However, many of the potential uncertainties can still be resolved satisfactorily by full consideration of the facts and circumstances of a structure or transaction at the outset.

Several jurisdictions, of which the UK is one, have specific domestic tax rules which clearly define the operations which may be taxed by reference to residence principles. In the UK, companies incorporated in the UK or centrally managed and controlled in the UK are liable to corporation tax, as are those foreign companies which carry on business through a branch or agency in the UK. If a company does not fall within these criteria, no other factors can bring it within the charge to corporation tax, and it will only generally be necessary to consider what is meant by a permanent establishment ("PE") for the purpose of applying the provisions of double tax agreements with other territories. In other jurisdictions, however, the tests which determine the domestic jurisdiction's right to tax on the basis of residence are more open-ended and any company, domestic or foreign, may be liable to domestic corporate income taxes only if it has PE in the territory. The concept of a PE is therefore of considerable importance either in establishing the primary taxation rights of some jurisdictions or in application of the provisions of relevant double tax treaties to prevent the incidence of double taxation in others.

Article 5 of the OECD Model Income Tax Treaty (as amended in September 1995) defines a PE as a fixed place of business through which the business of an enterprise is wholly or partly carried on, including an office or a branch. The guidelines to this definition identifies the following conditions:

(i) The existence of a place of business, i.e. a facility such as premises or in certain instances machinery or plant.

(ii) The place of business must be fixed, i.e. it must be established at a distinct place with a certain degree of permanence.

(iii) The carrying on of the business of the enterprise usually means that persons conduct that business in the state in which the fixed place is situated.

(iv) The business of the enterprise may be carried on mainly through automatic equipment (the activities of personnel being restricted to setting up, operating or controlling and maintaining such equipment).

Most agreements based on the OECD Model include exemptions to the basic PE clause, for example:

(i) the use of facilities or maintaining a stock of goods or merchandise solely for the purpose of storage, display or delivery;

(ii) maintaining a stock of goods solely for the purpose of processing by another enterprise;

(iii) maintaining a fixed place of business solely to carry out other activity of a preparatory or auxiliary nature.

The OECD commentary notes that in determining whether activities are of a preparatory or auxiliary nature, the fixed place of business may contribute to the productivity of an enterprise but the services which it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to it, for example, a fixed place of business for the purpose of advertising or for the supply of information - only if proprietary or auxiliary in character to the company's business.

A broker, general commission agent, or other independent agent employed in the ordinary course of their business to carry on business on behalf of a non-resident would also normally be excluded from giving the non-resident a PE. On the other hand, a dependent agent who has, and habitually exercises, the authority to conclude contracts in the name of an enterprise will create a PE of the enterprise for whom the agent is acting.

The definitions are important when considering where the vendor is carrying on his business. A vendor conducts electronic business via his website maintained on either his own server or that of an ISP. Can a site on a local host server be a PE, a fixed place of business fulfilling all the criteria noted above? If the website is primarily an advertising page, it probably falls within the specific exemptions - unless the company is in the business of supplying information. On the other hand, if the website has replaced a local sales force, it may well constitute a PE, especially if it is interactive with the customer and capable of actioning the supply chain. Taking the analysis a step further, if it is fully automated, could the website itself be considered a dependent agent of the enterprise and thus constitute a PE?

Where a customer downloads information from a vendor's website to his own computer, it is unlikely that the customer's computer could provide the level of permanence envisaged by the above definition. However, it is possible to envisage a scenario where in a large organisation specific computers were dedicated to managing electronic transactions with foreign suppliers in a manner which might arouse some concern that they gave rise to a PE of the foreign supplier. Nevertheless, I believe it would take some shift in current interpretation to apply this in practice.

A Telco may well have a PE of its own as a result of installing income generating equipment in another territory. However, it is unlikely that a foreign corporation would ever have a PE in another territory simply as a result of passing information through that infrastructure. Similarly, an ISP may create a PE for itself as a result of equipment which it installs in another territory. However, it is unlikely that an ISP could be a PE of its vendor client, or that the customer's ISP could be regarded as such. Each ought to be treated as an independent agent. Nevertheless, all of these situations need careful analysis by reference to the facts of the case. The OECD Model was not written with electronic commerce in mind and it is therefore only possible to draw parallels between the situation now arising in practice and those envisaged when the provisions were written.

The UK provides a specific example of the potential importance - and difficulty - of making such distinctions in determining a territory's right to tax profits. In the UK, trading activities are subject to tax if they amount to the carrying on of a trade in the

UK but are not subject to tax if they amount to no more than the carrying on of a trade with the UK. Much of English law in this area is old: it focussed on the contract for sale as the source of the profit. To determine the place where the contract was made, the English courts applied contract law rules to ascertain where the contract was concluded. It was held that a contract was made in the UK if the offer of a contract was accepted by an agent in the UK. If the offer was accepted by an overseas party mailing an acceptance, the contract was not made in the UK. The leading post-war case is *Firestone Tyre & Rubber Co Ltd v Lewellin* (37 TC 111). In that case, however, Lord Radcliffe noted that "...under the conditions of international business and modern facilities of telecommunications [this test] is capable of proving a somewhat ingenuous one." Although the nature of the test has shifted over time, it is illustrative of the fact that some mechanism is ultimately required to determine the place where profits are earned or income is sourced and a precise understanding of the processes by which a transaction is concluded, particularly the relative importance of the individual players, is likely to be key to the analysis. However, it is widely acknowledged that considerable confusion still reigns over the contractual nature of many agreements concluded over the Internet. Thus where it is not clear whether a website, server or other high tech facility is sufficient to give an enterprise a taxable presence in a territory, reliance on the form of the contractual terms may not be conclusive.

Trailing all of these considerations is the spectre of transfer pricing. On one level electronic commerce does not raise any new issues for transfer pricing. However, electronic commerce is altering the way in which group companies trade with each other. In some cases value added activities are grouped in a single location, servicing from a centre point fundamental group operations in a number of other jurisdictions. In other cases, the incidence of electronic commerce has caused one or more intermediaries to be completely by-passed. There is already considerable international debate about whether the "profit split" method should have greater application where external comparable data is difficult to identify. So far these discussions have related primarily to global trading in financial instruments and derivatives, but there is increasing scope for this to be extended to shared service and business development activity.

Electronic commerce clearly raises some significant issues for certain local taxes, for example, US state taxes, and for indirect taxes, particularly with regard to the collection of tax on trades which cannot be traced. However, while there are some specific issues which could be clarified or simplified to the benefit of the international arena, I do not believe electronic commerce need raise insurmountable problems in the meantime for direct tax purposes. It is true that allocation of profits using traditional methods may cause an erosion of one jurisdiction's traditional tax base in favour of anothers, and it is important for economic stability that such trends be investigated and realigned promptly if appropriate. There are also greater opportunities to plan to avoid, and possibly even evade, tax by means of electronic trade, and this too is an area which must be quickly addressed. But I believe much of the initial anxiety that existing tax rules would completely fail to cope with the electronic era can be shown to be largely unfounded by adopting a relatively simplistic analysis of the electronic system and economic functions by which business may now be conducted.