



**OECD RECOMMENDATIONS
ON E-COMMERCE
TAXATION**

By

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Objectives

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● **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 minimized 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 minimized.

● **Flexibility**

Taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments.



Taxation Framework Conditions

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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 and 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.

Agenda

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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.

Technical Advisory Groups

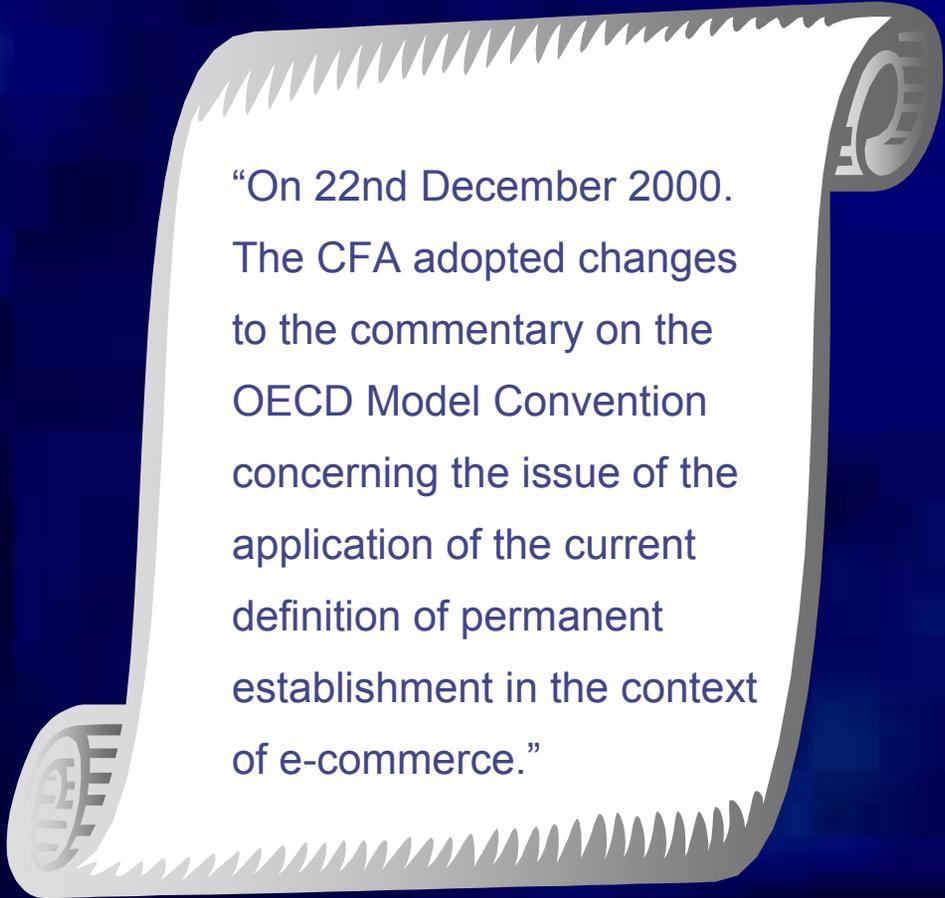
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Five TAGs created were :

- **Treaty Characterization TAG** whose work primarily involved a consideration of the application of the definition of royalties in the context of e-commerce. The TAG examined the distinction between 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.
- **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.
- **Consumption Tax TAG** focused on the practical implementation of the Ottawa principle of taxation in the place of consumption.
- **Technology TAG** provided, in the main, expert technological input into the work of the other TAGs.
- **Professional Data Assessment TAG** examined the feasibility and practicality of developing internationally compatible information and record-keeping requirements and tax collection arrangements.



Application of Tax Treaty Concepts to Electronic E-commerce



“On 22nd December 2000. The CFA adopted changes to the commentary on the OECD Model Convention concerning the issue of the application of the current definition of permanent establishment in the context of e-commerce.”

Changes to Commentary

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The major changes to the commentary of Article 5 were introduced of paragraphs 42.10 immediately after paragraph 42 of the commentary of Article 5.

In brief it is the following :

- Whether the mere use of computer equipment in electronic commerce operations in a country could constitute a Permanent Establishment (PE);
- Whilst a location where automated equipment is operated by an enterprise could constitute a PE, a distinction needs to be drawn between the equipment and the data and software which is used by or stored on that equipment. A web site which is a combination of software and electronic data does not itself constitute a tangible property.
- The distinction between a web site and server is importance since the enterprise that operates a server may be different from the enterprise that carries on business through the web site. It would be different if the enterprises owns (or leases) the server.
- Computer equipment at a given location may only constitute a PE if it meets the requirement of being fixed;

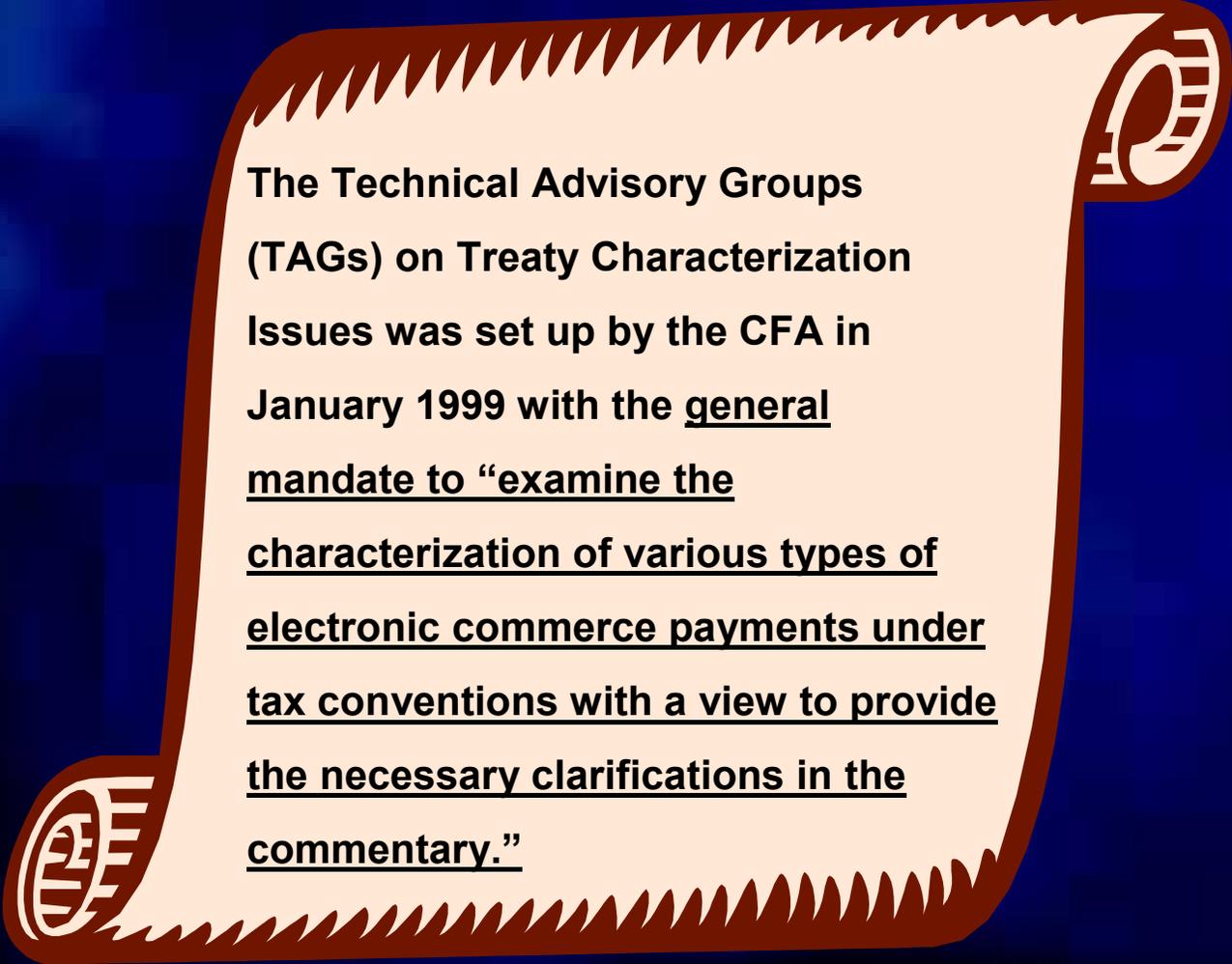
Changes to Commentary (Contd.)

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- Whether the business of the enterprise is fully or partly carried on at a location where the enterprise has equipment such as a server has to be examined on a case by case basis having regard to the business functions of the enterprise.
 - No human intervention is necessary for operation of computer equipment to constitute a PE.
 - Question whether electronic commerce operations are carried on through the computer equipment are preparatory or auxiliary has to be examined on a case to case basis.
 - Where such communications are an essential and significant part of the business activity of the enterprise as a whole, or other core functions are carried on through the computer equipment it would constitute a PE.
 - Core functions depend on the nature of the business;
 - Normally an internet service provider would not constitute an agent.

Treaty Characterisation Issues

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The Technical Advisory Groups (TAGs) on Treaty Characterization Issues was set up by the CFA in January 1999 with the general mandate to “examine the characterization of various types of electronic commerce payments under tax conventions with a view to provide the necessary clarifications in the commentary.”

Recommendations to working party no. 1 in tag report in February 2001

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The TAG made recommendations to the OECD Working Party No.1 of the Committee on Fiscal Affairs to issue a document clarifying how the various tax treaty characterization issues arising from e-commerce should be solved, including recommendations for changes to the Commentary of the OECD Model Convention.

Business Profits and Royalties

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- 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 payment of any kind received as a consideration for the use of, or the right to use, any copyright of literacy, 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 Tax Convention, the definition also includes: “payment for the use, or right to use, industrial or commercial or scientific equipment” and some bilateral conventions still include this provision in the definition of royalties.**

The TAG group analyzed classification issues arising from the possible application of various elements of these two definitions to payments made in e-commerce transactions. It also examined classification issues arising from alternative treaty provisions which dealt with the provisions of services or technical fees.



Suggested Changes to the Commentary (Nasscom)(kp)

The group has suggested that paragraphs 17.1 to 17.4 be inserted in the commentary on Article 12 of the OECD Model Tax Convention

The main suggestions are :

- Principles regarding software payment are also applicable in relation to transactions concerning other digital products such as images, sounds or text.

Under relevant legislation of some countries, transactions which permit customer to electronically download digital products may give rise to a use of a copyright by the customer e.g. because a right to make one or more copies of the digital content is granted under the contract.

Suggested Changes to the Commentary (Nasscom)(kp) (Contd.)

- **Where the consideration is essentially for something other than for 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, net work or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".**

Transactions that permit the customer to electronically download digital products for the customer's use or enjoyment does not constitute royalty but falls within Article 7 or Article 13 as the case may be.

Transactions where the essential consideration is the granting of the right to use a copy right in a digital product, the payment will give rise to royalties.

Business Profit and Payments for Know-how

- 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 e la Propriete 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”**.

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 recognized 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.

Business Profit and Payments for Know-how (Contd.)

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- This type of contract 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.

The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provisions of services.

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.

Business Profit and Payments for Know-how (Contd.)

- The supply of know-how requires very little more to be done by the supplier under the contract other than to supply existing information or reproduce existing material.
- A contract for the performance of services generally involves a much greater level of expenditure by the supplier in order to perform his contractual obligations.
 - (a) 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.
 - (b) In a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment is made for the provision of 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 authorization, and
 - where it is subject to any available trade secret protection.

Business Profit and Payments for Know-how (Contd.)

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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.

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.

Attribution of Profits to Permanent Establishment 2001-12-05MB-ZXE332(Nasscom)(kp)

- Much attention has been focused on what constitutes a Permanent Establishment. Now that the threshold question has been settled. Attention is turned to what profits can be attributed to e-commerce activities that have passed the threshold of Article 5 where a PE is held to exist.
- The discussion paper is an attempt at exploring the interpretation and application of Article 7 to PE carrying on retail e-commerce activities (“e-tailing”).

Attribution of Profits to Permanent Establishment (Contd.)

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The paper illustrates various steps of the analysis that are required to attributed profit to a PE in four different variations of the example:-

- The first variation is an extreme case of a **stand alone computer** performing automated function (in particular, on line processing of transactions and transmission of digitized products) without the presence of personnel in the **PE**.
- The second variation examines the case of **multiple servers** performing identical tasks.
- The third variation assumes persons or personnel in the PE to provide **online services** and maintain the server.
- The last variation assumes that **the development of the hardware and software used by the PE was entirely performed in the PE**.

Steps to Determine Attribution

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The interpretation under Article 7(2) has been made in the form of a two step analysis, as follows:

- The first step determining the character and functions of the hypothesized distinct and separate enterprise.
- The second step determining the profits of the hypothesized distinct and separate enterprise based on a comparability analysis.

In Just two Years Since the Ottawa Conference, the CFA:

- **Agreed Upon Clarification of the Commentary on the Model Tax Convention (Model) in Respect of the Definition of Permanent Establishment (PE) and in respect of Income Characterization**
- **Clearly Identified the Challenges Presented by E-commerce**
- **Identified a Series of Best Practices That Can Guide Tax Administrations to Improve the Service Provided to Taxpayers and Reduce Compliance and Administrative Costs of Collecting Taxes.**
- **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.**
- **Developed Strategic Partnerships With Regional and Other Tax Organizations As a Means of Taking Forward the Post-Ottawa Agenda.**

OECD's objectives in the area of e-commerce and taxation for 2001-2003

- CFA has agreed to progress further the work towards the implementation of the taxation framework conditions and the strengthening of the international dialogue.
- CFA has narrowed the focus of the main fields of further work to a number of key issues
 - 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.
- As of 1 April 2001, there are three TAGs:
 - Business Profits,
 - Consumption Tax TAG and
 - Compliance, Information, and Documentation TAG