EUROPEAN COMMISSION
DIRECTORATE GENERAL XXI
CUSTOMS AND INDIRECT TAXATION
INDIRECT TAXATION
VAT and other turnover taxes

XXI/98/0359
3.4.1998
OR.:EN

WORKING PARTY No I

Harmonisation of turnover taxes

Working paper

ORIGIN : COMMISSION

SUBJECT : Interim report on the implications of electronic commerce for VAT and Customs

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1. INTRODUCTION

1.1. This report

This is an interim report, the purpose of which is to summarise the work of the Commission in conjunction with Member States in identifying the problems that are likely to be encountered in the indirect tax and customs fields due to the advent of electronic commerce (e-commerce) and to give an indication of the avenues that need to be explored in order to find solutions.

2. BACKGROUND

2.1. US-EC vision of the development of electronic commerce

The Internet was originally set up and controlled by the US Department of Defence and developed as a tool for communication and exchange of information within the academic and research communities. In the last few years, due to the increasing availability and affordability of personal computers and telecommunication services, its use has become global and there has been an explosion in the level of Internet traffic.

Although the Internet is at present primarily a communication tool there is every evidence that the business community is increasingly aware of its potential use as a marketing and sales medium. At the moment, there is a considerable level of advertising of products and services but little evidence of large-scale commerce being conducted over the networks. However, with the ever increasing sophistication of the networks, and in particular with regard to increasing transmission speeds and the development of secure means of payment, it can be predicted that over the next year or so there will be a rapid expansion of sales of goods and services via this medium.

The United States Treasury policy statements early in 1997 stimulated the high profile debate that has been taking place, both within the EU and at international level regarding these developments. Broadly speaking, it recommended allowing e-commerce to develop, as far as possible, without regulation and without any additional taxes. In July 1997, the US President announced a formal initiative and at the same time released a report, "A Framework for Global Electronic Commerce". All this culminated in an EU-US Summit, on 5 December 1997, at which a joint statement on the subject was agreed and issued. The concerns of EC indirect tax authorities were voiced during this debate and the drafting of the joint statement. It was made clear that, aside from revenue considerations, it would be essential to be able to apply VAT to trade over the networks in order to avoid distortion of competition with similar conventionally traded products.

Anticipating these developments, Commission raised these issues at a meeting of the Directors General, Customs and Indirect Taxes, which took place on 26 March 1997 and was the starting point for Community action to determine the future indirect tax treatment of e-commerce. All participants were of the opinion that the potential impact of e-commerce on Customs and VAT would be such as to justify thorough analysis as a matter of priority. Accordingly, Member States pledged support for a review of Customs and VAT legislation in the light of these developments and where necessary to propose relevant modifications. In June 1997, the Commission started in the N° 1 Working Group to study these problems.

There has also been considerable activity in the OECD in a number of fields concerning development of the networks and e-commerce. Within the Committee on Fiscal Affairs, the Special Sessions on Consumption Taxes has been considering the potential problems for indirect tax systems arising from e-commerce. A sub-group, starting work in July 1996, made a study of potential distortions of competition which could arise as a result of different tax treatment of transactions between OECD member countries. The sub-group is to continue with its work with a view to preparing the ground and making proposals for the framework guidelines to be put to ministers at a meeting in Ottawa in October 1998. The Commission and a number of EC Member States are represented on this sub-group which should avoid any duplication of work in preparation for the Ottawa Conference.

2.2. What is the Information Highway?

The Information Highway consists of collections of interconnected computers operating on the Internet and other networks. These may be located anywhere in the world and use a set of common protocols to communicate with each other. From the outset, the Internet has not been based on any one physical location or any central control system. The geographic whereabouts of a connection is largely irrelevant in enabling access. There are a limited number of central critical functions on which the system depends but they cannot be considered as regulatory in the accepted sense of the word. Appreciating that the character of the network is both global and highly distributed is an important first step in coming to terms with its implications.

The combination of the networks with multimedia systems capable of using text, images and sound is called the World Wide Web. Anybody who has a message they wish to communicate - whether commercial or otherwise - can generally do so by engaging an Internet service provider (ISP) to display their documents on a web site on a computer connected to the network. Physical location is not a factor as the nature of the network means that this site can be accessed by any other computer anywhere in the world that is connected to the Net. For historical reasons, the governance of the system was based largely on self-regulation and the relationships between the players regulated by an expectation of “best efforts”. The weak links

between presence on the networks and the identity and particularly the geographic location underlying such a presence was not considered a flaw. The interjection of profit-driven considerations has in recent times provoked a debate about the regulatory environment - this is a direct result of the development of e-commerce. Regulatory issues arise whether e-commerce is conducted via the internet or via closed networks linking groups of companies usually described as intranets.

2.3. What is e-commerce?

The ability to undertake commercial transactions over the electronic networks, which involve the exchange of value between the parties involved, has given rise to what is commonly called electronic commerce. Transactions which give rise to tax implications may fall into several categories:

– on-line ordering of physical goods from a supplier over the networks, either by e-mail or directly from a website, which are then delivered to customer through established channels,

– ordering of services such as travel and ticketing reservations, financial services, advertising, consultancy, etc. where once the commercial arrangements have been initiated over the network, the supplier provides the service in its traditional format,

– on-line ordering and delivery of "virtual" goods and services which can be downloaded via the networks in digital form. This category includes software, music, information and certain professional services. (For this category, the existing carrying capacity or "bandwidth" of the networks is currently a limiting factor. The relatively slow transmission speeds currently restrict the range of products for which the net is practical for use as a carrier.

Payment may be made either on-line or through conventional channels. Banks and others are currently developing systems to ensure security of on-line payments. In terms of securing and enforcing compliance with tax legislation the latter presents many problems, on the other hand it may also have a role in providing the information and audit trails which tax administrations would require.

The growth[1] and development of e-commerce presents European business with both new means of reaching markets for its products and the opportunity to develop new kinds of profitable business. However, these trading methods may give rise to serious problems in applying the principles of transaction based taxes such as VAT or sales taxes.

The networks put buyers and sellers in direct touch with each other, no matter where they are located and will largely obviate the need for intermediaries. One of the major drawbacks could be that the whereabouts of the buyer and seller would not necessarily be identifiable. Service providers who are commercially driven have been quick to provide commercial solutions. A seller who wants to identify a potential customer with a source of payment can now do so because of the development of banking products. Such innovations are designed to provide security in e-commerce transactions but, in their current stage of development, do not reflect the needs of tax administrations.

E-commerce is a new phenomenon and is still at an early stage of development. No doubt the main players will wish to be compliant and the new environment will not *per se* be tax hostile. However, it will certainly not develop into a tax friendly environment if solely influenced by market forces.

The sophisticated information technology that has enabled e-commerce to grow, certainly presents challenges to the tax system but at the same time should be capable of providing better means for its control. Early action should provide the opportunity for the powerful technologies behind e-commerce to be made available to tax administrations to improve the efficiency of their own operations and the interface with taxpayers. The administrative systems and the tools being developed for business purposes have the elements needed to create a climate of compliance for e-commerce. The onus is on those who carry responsibility for the tax system and its management of taxes to respond to the demand of a new environment.

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1 The work of the groups did not, for practical reasons, try to quantify either the actual level or the growth potential of e-commerce. Such an exercise would involve reaching an agreement on what precisely constitutes e-commerce, locating reliable sources of statistics, establishing benchmarks and in particular, making predictions on future growth. Available estimates vary widely and attempting to resolve them would have added little to the current work. Nevertheless, if it is accepted that tax administrations are faced with vibrant growth from a currently small base, it would be useful to address this shortcoming before the presence of e-commerce becomes manifest through revenue losses. This issue is examined in more detail in OECD paper DAFFE/CFA/CT(98)1

2.4. VAT issues

VAT accounts for 18.6% of the tax revenues of Member States (1994 figure, including social contributions) and, as an own resource, 44% (1996 figure) of the Community's own budget. The risk to these revenues from network commerce lies in business and private individuals exploiting any uncertainty in the VAT regime to achieve savings in tax payment.

Under the VAT system, problems will arise which have the potential to diminish the power of tax administrations to enforce taxation. Some of these involve increases in the scope and volume of transactions, challenging existing administrative and control systems. In other cases, the emergence of new types of business present tax administrations with fundamental problems in identifying a compliance model and developing control tools to ensure that tax is properly accounted for on all transactions. In some instances, the eventual resolution of these problems may be outside the legislative and administrative structures that are available today. Nevertheless, the approach that has been adopted is to see whether existing tax provisions can be applied, reinforced as necessary and to identify where new measures are needed. If the existing system can be successfully applied (with necessary modifications) there will be no need to consider more radical measures. The working groups therefore have not considered alternative forms of taxation.

The immediate problem for VAT is the difficulty in defining a framework with which traders can be asked to conform. Sales by non-EU traders to Community consumers are a particular concern but due to the current tax rate differentials there could also be problems of distortion within the EU between operators in different Member States if distance selling proliferates via e-commerce. The areas of uncertainty include:

– difficulties in securing the identification of the parties to an e-commerce transaction,

– weaknesses in establishing the geographic location or jurisdiction where this is a key element in establishing the liability to tax,

– problems in availability and access to information which may arise when records are kept in other jurisdictions or where the manner in which e-commerce functions leads to a degradation in audit trails.

The existing tax regime provides considerable scope for distortion in treatment between EU and non-EU operators to the advantage of the latter. This will be accentuated with the growth of e-commerce. It is not the function of any tax system to discriminate against domestic business. These problems may occur in both on-line and off-line commerce and are dealt with in more depth later in this report.

E-commerce is a potential threat to VAT revenue and, if not properly addressed, this threat could work to the disadvantage of European businesses. The challenges are real and the Community will need to develop a common approach in responding to them.

2.5. Customs issues

A problem of principle stems from the potential growth in supplies of "virtual" goods. This is on-line, electronically transmitted material, such as music, video or software, which is more conventionally supplied in a physical format recorded on disc, tape or film and in that form is currently subject to customs duty. The treatment of these "virtual" goods depends on whether the on-line operation is classified as a supply of goods or services While under the provisions of EU VAT legislation such operations are deemed to be services, the US refuses to recognise the applicability of the WTO General Agreement on Trade and Service (GATS) to such operations. Clearly, customs duties are never applied to services but the possibility of applying customs duties to a new category in between physical goods and services, i.e. "virtual" goods, could not necessarily be excluded

The main operational problem is the increase in the number of transactions that e-commerce is likely to generate. For physical movement of goods into the EU, the normal declaration requirements will continue to apply. Administrations will continue to require information from importers/declarants and must be able to carry out physical and audit checks to verify and validate this information.

There is an expectation that the development of e-commerce will dramatically reduce many of the relative market advantages currently enjoyed by vendors operating from locally accessible sites. The ability of consumers to buy directly gives rise to a process known as disintermediation and, in so far as purchases of goods originating from outside the Community are concerned, has the potential to cause problems for Customs. When these goods are imported in bulk, by an intermediary, as part of a single operation, any increase will not produce particular control difficulties. However, when private purchasers order goods on the network for their own use, it is likely that intermediaries will be bypassed. This will lead to a fragmentation of traffic placing additional pressures on customs resources.

2.6. The tax issues seen from the business sector

So far, neither the working groups nor the Commission have had any formal substantive discussions with the business sector specifically covering the taxation of network commerce. At the OECD Conference in Turku however (see Annex 1), some of the views expressed by major industry players in the electronic field were significant. Businesses realise that this is a global problem and is one which needs to be resolved both through co-operation between governments and co-operation between businesses and governments. The message was that the business sector wants e-commerce to

operate under clear rules that avoid distortion of competition and can be applied without imposing a burden that might hamper growth. They recognise a common interest and are willing to participate in this procedure and contribute to global solutions.

The Commission will in the next phase of its work develop this aspect and pursue even closer contact with the business and regulatory sectors to find ways of arriving at mutually acceptable solutions. The sub-group of the OECD Special Sessions on consumption taxes, on which the Commission and a number of Member States are represented, will also be meeting with a number of representatives of the sectors concerned.

3. THE WORK

3.1. Organisation and activities

At a meeting of the Working Group N°1 on 1 July 1997 the decision was taken to set up three working groups each composed of a Commission representative and a small number of experts from different Member States. Each group has considered a different aspect of e-commerce in the context of customs and indirect taxation. The subjects for study were broadly defined as off-line supplies, on-line supplies and control methods/opportunities - but inevitably these topics overlap. These working groups have been very active, and this report summarises the issues that have been addressed and the problems that have been identified for customs and indirect taxes in this new environment. It was not envisaged that this initial exploratory study would produce firm conclusions about the treatment of e-commerce. However, the suitability of some of the conventional VAT accounting and control mechanisms such as reverse-charge and fiscal representatives have been considered and the possibility of introducing a withholding system operated by banks etc. has been investigated.

3.2. Main objectives

The networks are opening up opportunities for individuals to by-pass the more traditional ways of doing business around which tax schemes are currently constructed. It is therefore necessary for tax authorities to understand fully how the new environment will develop both technically and organisationally. Changes will be necessary to adapt the existing systems and procedures to prevent loss of revenue and to ensure that there is no discrimination between businesses using the new technology as opposed to those continuing to trade conventionally. What makes this difficult is the lack of certainty over the way in which the networks will evolve in the field of commerce. In particular the nature of the regulatory framework is not yet clear. However, it is of paramount importance for tax authorities to intervene at the earliest opportunity, to influence their structure and content, so that they can be accessed and used in bringing tax to account in the appropriate place and to ensure compliance. Of course it is necessary to state broad

objectives for a tax regime to be applicable to e-commerce and at present it is assumed that the principles of the VAT system will be applicable, the mechanism being adjusted as necessary. However, at this stage it would be premature to decide on any particular legislative scheme without having a clear view of how it can be managed in practice. The purpose of the study to date has been to investigate the structure and find out as much as possible about the way in which e-commerce will develop. Existing VAT principles and administrative techniques are being examined to see the extent to which they could be applied or adapted to suit the new circumstances.

4. TECHNICAL ANALYSIS

4.1. The problem with e-commerce

Due to limitations of available technology, providers of services have until recently made most of their supplies to customers in their own country. In those circumstances a simple place of supply rule was all that was necessary to define the place of taxation of such supplies. However the situation is rapidly being transformed by the developments in communications technology such as the Internet. This has created the potential for large scale international commercial activity with the possibility that suppliers in any country can provide goods and services to customers in any other country. Clearly with the advent of e-commerce, the relatively small amount of distortion which currently exists, due to the non-taxation of supplies from non-EU countries for EU consumption by private persons, is likely to become a serious problem unless a satisfactory way of taxing such transaction is found.

4.2. The principles of the tax

Consumption - VAT is a tax on consumption and there is a broad consensus of opinion that this is the principle that should be applied to transactions which take place over the electronic networks in what can be described as a global, borderless, virtual marketplace. The problems of taxing such supplies are therefore also global and so should be the solutions. The immediate task for the EU is to find a suitable definition of consumption and to be able to apply it to all supplies that are deemed to be "consumed" within the territory of the Member States, including those made on-line via the networks. The problems are not so pressing with the types of supply which are simply arranged over the networks but are delivered in a tangible form as goods - it is possible to deal with these using traditional techniques and controls. The main difficulties are in the field of on-line services and "virtual" goods, such as music video and software, which, being delivered digitally, are intangible and not susceptible to physical controls. Nevertheless, it was agreed that the working groups needed to consider all aspects of e-commerce and to look at its interaction with traditional trading methods.

Neutrality - Tax should accrue at the final stage of consumption and not be a burden at the stage of production or distribution.

Distortion - To avoid distortion, the tax system should, in theory, ensure that a purchaser of a supply in a particular country would pay the same tax whether he purchases his supply from a domestic source or from a supplier in another country. In practice, because of lack of rate harmonisation, under the existing VAT system this is not always the case. However, where e-commerce is concerned, it will be necessary to ensure that there is no difference between the tax treatment of a supply made using that medium compared with the same supply effected by conventional means.

4.3. Place of supply

Place of supply rules determine where different categories of services are deemed to be taxed. The existing rules contained in Article 9 of the Sixth Directive are based on a number of different criteria. - place of supplier's or customer's establishment, place of performance, or of use and enjoyment, etc. – are all concepts used, in effect, to determine the place of "consumption" of services.

In the past, there has been little demand from EC private persons for supplies of services from non-EU countries which is why, under the existing rules, there is little or no provision for taxing supplies of such services. However, as we have recently seen in connection with telecommunication services, advances in technology have led to the globalisation of the market enormously increasing domestic consumption of services from sources outside the Community. New rules have been needed to complement the existing place of establishment rule in an attempt to ensure that all such services are taxed in the EC where they are enjoyed or used. However there is little evidence that effective control is capable of being exercised over supplies to private individuals under this regime. Similar, but more serious, problems could be encountered in the field of e-commerce, which is likely to cover a wide range of product, and for that reason much of the debate in the working groups has been focused on the place of supply rules and relevant aspects of Article 9 which do not always ensure taxation at the place of consumption .

4.4. Possible consumption criteria for e-commerce

There are a number of possibilities, depending on the characteristics of the supplies, to deem where "consumption" takes place.

Criteria:

- The territory of the country of establishment or permanent residence of the customer
- The territory within which the performance of the services takes place
- The territory within which the customer benefits from or enjoys the services
- The territory of the country to which the invoice is sent
- The territory of the country from which the invoice is sent

This list is not exhaustive; other criteria can be envisaged and some others may emerge from the networks themselves as the frameworks are developed. At present there is no obvious choice because of the uncertainty which exists over the availability of means of control of the e-commerce networks.

Up to now, for international services, it has proved more practical to designate the place of supply (consumption) either as being in the country where the service is enjoyed or used, or where the benefit is received by the customer. For the generality of services this could be achieved by designating the place of supply by reference to the establishment or fixed abode of the customer. However, it is not feasible to propose any solution to the problem of taxing services without also considering where and by whom the tax should be accounted for to the fiscal authorities and whether, in practice, they will have the necessary tools to secure compliance.

4.5. Taxable person

Under the existing VAT system there are two alternatives for bringing tax to account on supplies from abroad, the first being to require the supplier of the services to account for the tax to the country of supply, either directly or through a representative. The second is to require tax to be accounted for to the authorities by the recipient of the supply. The latter is possible where the recipient is a taxable person but self-assessment is hardly feasible where customers are private individuals. It is also predicated on knowing the tax status of the customer. This will not necessarily be the case in the world of e-commerce. Therefore , serious doubt arise as to its practicability for traders and whether it would be possible to control and enforce in view of the potential difficulties of locating the parties involved.

For transactions with private persons, it has been suggested that one fiscal representative could be appointed for all the Community trading activities of a non-EU trader. This fiscal representative could declare the tax to any of the Member States, where activities take place, according to the rates in those countries. However, at present, the concept of fiscal representation is not implemented everywhere. The use of a single fiscal representative for all EU activities would be a more favourable scheme than the current telecommunications scheme where several fiscal representatives may be needed.. More work need to be done to test whether this mechanism would be a suitable tool for use in the dynamic world of e-commerce, in particular where non-EU traders are concerned. The systems of Internet Service Providers (ISP's), and the settlement services provided by financial institutions (e.g. possibility of withholding tax) are also being looked at to see if and to what extent they could provide solutions to the problems of collecting tax on e-commerce transactions.

It is clear that current VAT legislation is not necessarily properly equipped to cope with the new e-commerce environment and it is likely that changes to legislation will be necessary. The structures and protocols that will make large scale trading over the networks an economic proposition are still in course of development and need to be carefully observed. Tax authorities need to make their voice heard during that process to ensure that the systems will provide sufficient information and access to enable VAT to operate effectively in the new environment.

5. COMPLIANCE, CONTROL AND ENFORCEMENT ISSUES

5.1. Introduction

Clear and certain rules are required for registration of taxpayers, charging and payment of tax as well as invoicing and record keeping obligations. There should also be an expectation among taxpayers that non-compliance will be detected and penalised. To achieve this, a system of control and enforcement is required which could include access to accounting records and independent verification by third parties. In addition, for transactions involving more than one fiscal jurisdiction, mutual co-operation between administrations is essential.

These fundamental requirements for the orderly care and management of VAT are well established. They apply whether transactions take place electronically or through traditional means. In examining the possibilities for compliance, control and enforcement on the Internet, the objectives remain the same. If the existing VAT system is to function in a new environment, the functioning of e-commerce needs to be analysed to determine where it can be made to meet the needs of fiscal administrations. If this analysis shows that certain aspects are not tax-friendly, these may need to be modified or compensated for. The objective is to achieve a system that will ensure that commerce on the networks remains within the scope of VAT and

gives tax administrations at least the same level of control as they have today.

Achieving compliance for goods ordered over the networks that will continue to be delivered physically is dealt with later. For services which can be ordered electronically on-line and delivered either along traditional lines (e.g., advertising, design, travel or financial services) or where the product can be transmitted digitally from seller to buyer, the problems are different.

5.2. Business-to-business electronic commerce

The rules governing accounting for VAT on international services pose problems of control for tax administrations. The growth of the Internet means that distance is no longer a significant cost factor and the providers of such services will have greater flexibility in where they locate. There will also be an increase in the range of services provided electronically as well as in the number of suppliers. There is a risk that these developments will be seen as another tax planning opportunity by certain businesses such as those in the financial sector. This has the potential to create problems - both legislative and administrative - for the collection of VAT.

There is however overwhelming evidence that business-to-business transactions will remain the most significant element in this type of e-commerce for the foreseeable future. There are legal and administrative measures available to ensure that these remain within the tax net but enforcement measures would need to be reviewed and probably strengthened.

Lessons from the past might suggest that a mechanism for ensuring compliance and control would be the reverse charge mechanism which is essentially a self-assessment procedure. The obligation to declare the transaction and to pay the tax falls on the recipient. Its very nature means that for a transaction generating a reverse charge, the basic self-checking mechanism of VAT will be absent. No charge will have been generated in the books of the supplier which will in any event be outside the jurisdiction of the authority to whom the tax is payable. This negates the process at the heart of VAT control whereby responsibilities are clearly shared out, the supplier being entrusted with the correct invoicing of the tax due and the customer having to provide proof regarding the taxes he deducts. A major consideration is that although the reverse charge mechanism releases non-Community providers of services from all tax obligations if their customers are registered, it does nothing in respect of supplies to private individuals where there is no possibility of establishing an audit trail. Unless some mechanism is available to tax such transactions, the result would be in conflict with the principle of equity in taxation. Separate solutions to the charging of VAT on sales to business and private customers could be difficult to apply in practice in the field of e-commerce, unless providers of services in a third country are able to check whether their customers are registered for VAT.

The Internet has increased the potential for exempt or partially exempt traders (*e.g.*, banking or financial institutions) to enter into business arrangements with service suppliers located inside and outside the EU. This could either take the form of the legitimate displacement of an existing activity to another jurisdiction or the creation of an entirely artificial source of supply. In either event, the motivation would be to evade or avoid tax and the result would be the same.

It is fairly safe to assume that when the reverse charge mechanism was first envisaged, the term "globalisation" was not in such common use. It was developed to deal with a specific set of circumstances at a particular time and it is unlikely that anybody foresaw the ease of access and speed of delivery that the electronic revolution has brought to services. In its favour, it can be said that it is a tool available today for EU tax administrations to tax these transactions. If a reverse-charge mechanism, is to play a significant role in the taxation of e-commerce, it should be robust in its application. Given the likely increase in scale, the human resources implications need to be carefully considered.

5.3. Identification as a compliance and control issue

Identification of the parties to an e-commerce transaction was recognised from the outset as a key element in developing a model for compliance. In order to develop a better understanding of the underlying concepts, informal fact-finding meetings were held with representatives of Internet service providers, Internet registrars and a banking group that are involved in the development of electronic payment systems. An important outcome was to create awareness of the shortcomings in the existing Internet identification systems and to recognise how these might be remedied.

If the objective is to invite traders to become compliant (and in particular those located outside the EU and making supplies to EU customers), there would have to be some degree of certainty as to where their customers are located and the rate of tax to be charged. If traders do not know where their customer is located, it will be difficult to sustain an obligation to apply VAT within the EU.

Examination of the domain name and Internet Protocol (IP) number systems revealed that, within their existing structure, the detail and reliability of the information provided falls far short of what would be required to achieve the degree of certainty that the administration of tax requires. As far as establishing identity is concerned, the search facility "WHOIS?" is limited in its coverage and information - when it is available - is not always dependable. Links between Internet presence and physical location are at best tenuous and can easily be manipulated.

The regulatory environment for Internet registration systems is however likely to develop substantially over the coming years. It is incumbent on tax administrations to become involved in this process and to ensure that the orderly and equitable administration of taxation will be among the general objectives influencing the future governance of the Internet. Certification, by a recognised body, of the identity underlying a network presence should be considered as one of these objectives. Digital signature and encryption mechanisms could also play a significant role.

In considering whether suitable information for compliance purposes might be available within the payment process, the work of the participants concentrated on examining the Secure Electronic Transaction (SET) Protocol for secure credit card payments. Although this is by no means the only Internet payment system in place, it is likely that it is becoming the market leader for personal purchases, not least because credit cards represent a mature technology with which people feel at ease but also because of its powerful commercial backing. The outcome of this investigation came to two conclusions. There are limitations in the use of SET, as it is constituted today, as a means of obtaining compliance. It is necessary to recognise that SET aims at increasing the authenticity and security of the sensitive data needed to effect a payment over the Internet and accordingly concentrates on enhancing this for a restricted number of data fields. Part of this process involves restricting the information available to the merchant by excluding such details as billing addresses or the card issuing bank which might be used to identify a customer with a particular fiscal jurisdiction. The banks involved say that this is justified by security concerns. On the other hand SET is only concerned with the transaction payment phase and does not include order information details of which are restricted to the buyer and the seller. It is likely, however, that this restriction may not apply to all electronic payment systems. Others may have greater potential for distinguishing taxable transactions.

In the longer term, the outlook for using payment systems to support the charging of VAT may be more interesting. In particular, SET incorporates an independent digital certification system that associates the buyer (cardholder) and seller (merchant) with a financial institution and the credit/debit card payment systems. This provides a great deal of information on the parties to a transaction including their identity and their legal residence. This information is currently retained by the banks and there may be resistance to disclosing it. The possibility of linking the tax collecting function to the various payment systems has also been suggested. The idea is to create a tax withholding mechanism operated by the financial institutions concerned. All this needs more investigation and is likely to involve the assistance of experts with specialist knowledge of payment systems.

The indications are that for supplies to non-taxable persons, it is not possible at the existing stage of development of the Internet to be certain that such supplies are taxed in the customer's country. This would require identifying a physical location or jurisdiction for the customer and there is no totally reliable means of so doing. For the moment the only message that can be given to EU traders engaged in e-commerce is that they should make a taxing decision on the basis of whatever information they have about the location and tax status of their customer. If the objective is to tax consumption in the country in which it occurs, we are not now in a position to offer a comprehensive compliance model. This can only be rectified by an active involvement in the development of the (global) protocols that govern e-commerce. The objective should be to ensure that in the future they generate the information flows needed to successfully charge VAT.

Identification of the seller on the Internet is at least as important as identifying the buyer and all of the uncertainties outlined above apply. One partial solution which found support was a proposal in the Australian Tax Office report (see Annex I - Australia) which advocated that all businesses on the Internet display their national registration number on their site. This has potential as an inexpensive and immediately available measure but would be dependent for its success on a widespread adoption.

6. OPPORTUNITIES

Electronic commerce and the technology supporting it raises new challenges for tax administration but also offers the promise of reduced compliance and administration costs. As the use of electronic invoicing and payment systems develops and becomes more widely available, tax administrations should react accordingly. Working together with industry, they should not just seek to remove barriers but to actively seek significant reductions in the cost of compliance.

6.1. The Electronic Administration

European tax administrations have been making significant use of computers for a long time. However, with a few exceptions, they have not been in the forefront in using electronics directly in dealing with their traders. There are many reasons for this cautious approach which include concerns about secrecy, legal standing of electronic communications and, in many instances, the absence of a sufficiently large user base. With an increasing number of companies now using the Internet for business communications (including invoicing and banking), tax administrations will need to become players, using this technology to increase the efficiency of both their own operations and their dealings with taxpayers. Indeed it is difficult to see how a taxing relationship with an electronic trader, particularly those who do not have a physical base of operations within the Community, can be created and sustained unless the tax administration is capable of dealing with it electronically.

The most obvious applications are the provision of on-line declaration facilities and the downloading of information which may be either general or taxpayer specific, including making forms available to taxpayers. The objective should be to use electronic tools not only for information but to improve compliance. The administrative and legal objections usually cited are about the need to protect confidentiality and the legal standing of information exchanged which, in practice, hinges on the acceptance of digital signatures. The Austrian "FINANZOnline" system was examined in the course preparing this report. Using Internet technology, it handles tax declarations for payroll taxes, income taxes and VAT for 80,000 taxpayers and provides for downloading of information and some highly restricted access to records. A key factor in its success, however, is that the majority of Austrian taxpayers deal with the administration through tax agents. In practice, therefore, the system is an intranet to which access is restricted to a relatively small number of accountancy firms who operate via secure dedicated lines and are bound by a sophisticated system of identity checks and electronic signatures. Opening up the system on the Internet and allowing direct access for individual taxpayers will depend on the development of an equivalent level of security.

In the US, 19 million taxpayers are expected to use electronic filing facilities this year. The objective of a nation-wide marketing and educational effort is to have 80% of declarations filed in this manner within a few years. The attraction to the taxpayer is that a faster processing and tax refund facility is available. By using technology, it is possible to eliminate most of the manual steps needed to process paper declarations. Since electronic filing is faster and more accurate than paper, errors can be reduced and the processing time shortened. The payment/refund cycle can be speeded up though using exclusively electronic payment systems. Customer service improvements should be seen as a tool to be used for improving compliance.

Most European tax administrations already operate web-sites as does DG XXI. These contain much useful information but locating a particular item can sometimes be a slow process for somebody who is not familiar with their layout. It should be possible to adopt a standard layout so that essential information could be easily accessed for each Member States**.**

6.2. Identification and Registration of Taxpayers

Identification of taxpayers is a key element in developing a model for compliance for e-commerce - a first step towards enabling electronic traders (wherever based) to register for VAT in respect of sales to EU customers. The question is whether tax administrations can do anything to help Internet traders to be compliant.

It is necessary that administrations are able to identify traders and that traders can identify their customers. In either case, it is essential that they can at least determine to which tax jurisdiction they belong and whether or not they are registered for VAT purposes. Making more information available on the parties to a commercial transaction is a key issue.

The information profile which commercial electronic transactions currently generate is deficient in several respects for the purpose of enforcing VAT. This needs to be rectified urgently. The recent US draft Transition Plan on the Governance of the Internet has opened up a debate, in which the Commission is taking an active part, which will influence the future regulatory regime under which the networks and e-commerce will function. The approach of tax administrations has tended to be cautious but it is necessary to promote a stable and equitable tax environment that will enable e-commerce to develop its full potential and at the same time protect the revenue base. The Commission, in its response to the American document, will stress the importance of orderly administration of taxation among the general objectives influencing the future governance of the Internet. At a specific level, there is a need to push for certainty and transparency in the system for domain names to rectify the shortcomings in the existing system. Tax authorities, as a minimum, should require that registries and registrars offer an accessible, dependable and up-to-date "WHOIS?" function.

In the meantime a number of *ad-hoc* measures can be pursued.

As a routine part of their normal return of taxable activities, all traders registered within the EU could be asked to disclose if they operate a website. Tax authorities should be provided with website addresses, information about any taxable activities being carried on and whether these are segregated from the other activities of the company. EU traders operating websites should be given guidance on how to charge VAT on transactions even if, for the moment, certain shortcomings may dictate a "best efforts" basis.

For the moment there is no mechanism for requiring electronic traders whose seat of operations is located outside the EU to account for tax for on-line sales of services to EU customers. At present, there is every reason to believe that such sales are relatively small but the market is likely to develop as certain technical barriers fall. The question of securing identification needs to be pursued in the appropriate international fora and resolved as part of securing tax on these transactions.

The principle of compulsory general registration of commercial websites with fiscal authorities was first raised in the ATO study "Tax and the Internet" (see Annex I – Australia) and suggested that display of a tax registration or similar identifier should be obligatory on home web pages. It is a relatively simple and low-cost administrative measure which could be put into place without much difficulty. On a national level, it would be no more onerous than existing requirements in relation to disclosure on note-

paper, invoices, registered offices etc. and would not place national operators at any disadvantage. In the longer run however, such a provision would need to cover as many jurisdictions as possible. Co-operation between the EU and non-EU administrations would be important. An OECD model convention exists which should provide a starting point for this. A method for verification would also be required but this could be found in the technology itself. Further study is needed.

6.3. Facilitating Electronic Invoicing and Record Keeping

The outcome of the Matthaeus Tax seminar in Stockholm (July '97) and discussions within the e-commerce working groups have shown that there is a need for a co-ordinated approach at Community level on cross-border electronic invoicing. This was reinforced during the Simpler Legislation for the Internal Market (SLIM COM(97)618) exercise which produced many requests for action in this area and underlined the need for the Commission to take the initiative. For a growing part of intra-Community trade, invoices are generated and transmitted electronically between suppliers and their customers in different jurisdictions. Cheap access to the Internet now means that even relatively small traders can communicate with their suppliers or customers electronically. In effect, electronic invoicing is inseparable from the growth of e-commerce and tax administrations must accept this. If the absence of common standards for electronic invoicing is a barrier to the growth of e-commerce within the Community, then this must be rectified.

Commercial practice has moved ahead of existing VAT accounting and control techniques. Whilst most Member States have provisions or guidelines covering requirements for electronic accounting records, these do not in general cover invoices in electronic format where these have been generated from a source outside their own jurisdiction. The reporting and record keeping requirements for VAT should recognise this and should not act as a brake on the use of technology.

Commercial electronic invoicing operates in the main under a number of protocols which have been developed, in the first instance, by large manufacturing and distribution organisations for use by their own members. They typically operate within closed EDI networks between partners in established commercial relationships. They function on UN-EDIFACT standards and have increasingly been adopted by other operators. They can to some extent therefore be considered as *de facto* standards covering electronic invoicing and self-billing systems.

The demand for simpler, cheaper and more accessible solutions has however led to the development of systems referred to collectively as "Lite-EDI" with the objective of making the procedures more accessible for small operators. They do not depend on large computer systems and allow for invoicing over the Internet. Although Lite-EDI is still in the process of development, its use is already a reality in some sectors and is an additional factor which needs to be considered in arriving at rules acceptable to EU tax administrations.

The concern of tax administrations relate to security and the standard of record keeping. In particular, they require assurances that the recording and control system behind invoicing and self-billing systems that originate in other Member States are as secure as their own. This will require common standards to which all electronic invoicing systems should conform. If existing accepted standard commercial electronic accounting practices meet the domestic requirements of tax administrations, a solution would not be difficult to achieve. It will however have to be applicable to operators of all sizes and should, in so far as is possible, be sufficiently flexible and versatile to take account of on-going developments without compromising the need for security.

In co-operation with the Electronic Data Interchange Working Group a survey was made of national rules and practices for electronic invoicing with the objective of identifying barriers and how they might be overcome. *This survey will be distributed separately*.

The report confirms the patchwork nature of the national provisions. Its findings need to be completed and analysed. The Commission is currently examining other aspects of electronic invoicing including those being developed by industrial standards groups such as ODETTE and EAN. The implications of the development of Lite-EDI need to be considered.

On completion of this work, the Commission will consider what measures are required. What is clear however is that this is a area where tax administrations are in a position to deliver what can be presented as a pro-business solution. The aim should be to achieve two complementary objectives - firstly, to remove an obstacle towards the growth of e-commerce and secondly, to reinforce the security and reliability of the data on which tax audits depend.

6.4. Access to electronic records and audit trails

Tax administrations need to establish themselves as stakeholders in the electronic world. The message to be got across to network administrators, service providers and payment system operators is that the tax administrations were seeking at least the same level and access to information as is now available for traditional commerce. For tax purposes there should be legal provision for tax auditors to have access to encrypted data.

Electronic transactions leave traces at various points on the networks between the point of despatch and the recipient. The routing however is random and the only source of consistent information is at either end. For on-line commercial electronic transactions involving a payment procedure like SET, a bank is another point where information is held which may be accessible for use in withholding tax.

Examination of the records held by purchasers, sellers and banks (where these are physically or legally accessible) do not present any new technical problems to tax administrations who have skills and experience in computer auditing techniques, although e-commerce is likely to introduce new software packages. It may be, however, that the sheer scale of the data involved needs to be considered. An initial examination of Internet payment procedures (specifically SET) has shown that a great deal of detailed information about the participants to a transaction is retained by the banks and not made available to other parties. This is part of a strategy aimed at reinforcing security and creating user confidence. Limits on time and other resources did not permit this issue to be pursued, but there is an urgent need to build up a greater understanding of the information held by the banks on e-commerce transactions. Such information could be used to ease compliance and control problems and to develop standards to assist reporting of financial transactions.

The initial impression may be that little use can be made of the audit trails generated at intermediate points in the transaction chain, either because of the random nature of their path or the fact that they are likely to be rendered unreadable through encryption or other processes. The indicative nature of the information generated can, however, be of use, for instance, in detection of unregistered activities. Tax administrations need to develop an understanding of the records, log files, and storage practices of service providers and other intermediaries in e-commerce. This raises the question of whether reporting requirements should be imposed on such operators.

So far, contacts in this field have been at a very general and exploratory level. In-depth analysis is now needed but this has resource implications requiring, at least, the involvement of specialist computer auditors with a working knowledge of the Internet. It is also worth recalling that many of the underlying procedures are global in their nature and this may cause resistance to imposing local requirements.

7. VAT AND CUSTOMS DUTIES ON PHYSICAL GOODS

7.1. Introduction

The off-line group found that the buying and selling of physical goods using the networks introduced no original problems to the collection of customs duties and VAT. The Internet is merely another way of distance selling. It has however the potential to become an attractive and efficient way for customers to make purchases if it fulfils its potential. The difficulties which customs and indirect tax administrations will need to resolve flow from the increase in volume and are essentially ones of scale. As with any other aspect of e-commerce, agreement on the volume and the rate of growth is elusive but there is evidence available that an upward trend has already commenced.

There are three immediate areas of concern:

- The increase in the number of small packages entering the Community which may increasingly become a source of problems.

- The distortions of competition between EU suppliers (including distance sellers) and those outside the Community.

- The potential for tension or distortion in the operation of the internal cross border distance selling scheme.

These are considered below.

7.2. Qualitative changes to supplies

The Internet will not only cause changes in distance selling of traditional physical goods in terms of value and volume, but will also change the way in which other products and services are delivered to consumers. Three possible scenarios can be considered.

Switch to on-line delivery of services

The Internet will lead to the removal of physical support for the intellectual content and its replacement with pure on-line delivery - e.g., 'specific' software. For VAT on services, this would not represent a significant change. Indeed, it could eliminate current problems relating to the double taxation of such imported services where both the service and the import of the physical support attract VAT. This occurs when the Customs declaration make no distinction between the value of the support medium and the "intellectual" content It would eliminate the distinction for customs duty purposes if such imports ceased and the contentious distinction between generic and specific software would be less of an issue.

Switch to the on-line delivery of "virtual goods".

As technical barriers (such as restrictions in bandwidth) are reduced, it can be expected that the supply of generic software, information or entertainment (of the type currently on CD-ROM) and eventually music and films will, increasingly, be made on line. To the extent that these come from outside the EU today, this will relieve some of the pressure on handling physical imports. It will however only increase control problems for sales to private individuals with a potential loss in VAT revenue as well as customs duties). It will also give rise to difficulties over sustaining "cultural" protection (See Annex II for a more detailed explanation).

Software upgrades

The Internet will allow the distribution of upgrades of the software incorporated in physical goods on-line, a task which at the moment usually involves local physical support. The result would be that imported goods

could be upgraded locally after importation with a consequent saving in customs duty (and possibly VAT). The scale and likelihood of this problem is difficult to estimate. It requires further investigation by tariff and valuation experts to see what, if anything, can be done. (See Annex III for more explanation.)

7.3. Distortions *vis a vis* imports

All imports of physical goods into the Community are subject to customs duties and VAT unless a specific relief operates. One such relief is the 22 ECU tax and duty free allowance for small packages. For VAT purposes only, Member States may apply a 10 ECU threshold if they wish and/or exclude mail order deliveries from the allowance. The result is that there is already a distortion of competition between Community suppliers and distance suppliers from outside the EU.

There are some doubts as to how effective the mail order exclusion is in practice. If this is the case, one way to eliminate the potential distortion between EU and non-EU operators would be to reduce the threshold from its current level of 22 ECU, at least in relation to mail order. Control of such thresholds is often difficult - the value is not given or is manipulated, and distinguishing between mail order and other package may not be easy. An alternative would be to abolish the small parcels allowance altogether.

7.4. Imports - why have a small packages relief?

In this context, it may be worth considering why a small package allowance exists at all. For goods sent between private persons there is another threshold of 45 ECU. These are designed to cut down the workload of the post and customs as well as oiling a point of friction between officialdom and the public. It is obvious that the lower threshold of 22 ECU is solely intended to cut down the workload of customs in chasing small amounts of duty and VAT, and to speed up clearance procedures.

The small package threshold was introduced for postal deliveries only in 1983 and set at 10 ECU. It was raised in 1992 to 22 ECU and extended to all means of delivery and at the same time the VAT options described above were inserted. It seems that some Member States who do not apply the options are concerned about increases in the number of small shipments being sent via the post and (in particular) express carriers. There is a perception in some areas that the only answer is to progressively eliminate more packages from the need for control and payment. Otherwise, with resources being spread more thinly, they will become less effective in applying control where it is most needed. A reduction in the rate of clearance will be detrimental to relationships with traders and customers and will not contribute to the objective of facilitating trade.

In this scenario the increase in small shipments flowing from e-commerce will stretch the system further, perhaps to the point of a breakdown in control. One answer might be to increase the threshold to a realistic level and to remove any need to distinguish between mail order and other packages.

7.5. The different options

A choice has to be made between the different ways of meeting the difficulties. It is perhaps worth pointing out that a proposal from the Commission in 1984 to raise the 22 ECU threshold to 45 ECU, ending the options for a lower limit and excluding mail order, still languishes in the Council. No Presidency seems willing to reopen the question, as there does not seem to be any real prospect of unanimity.

What then are the options? For the increase in small packages coming from outside the Community - and this is accepted as the most important area of operational concern for off-line traffic - it can include raising exemption thresholds and/or implementing improved control techniques.

Adjusting thresholds might consist of any or a combination of the following:

- A higher threshold, with either a total exclusion for distance selling or alternatively a lower threshold, 10 or 22 ECU?

- Abolition or lowering of the threshold, more use being made of not entering amounts in the accounts in non-distance sale cases?

- Abolition or lowering of the threshold, with the introduction of a standard or average rate of charge up to a higher limit?

In terms of improving control techniques, it seems clear that the best options lie in the use of information technology by administrations to improve the efficiency and delivery of their services. Administrations have an opportunity to make more extensive use of the control mechanisms already developed in conjunction with fast parcel operators including direct access to their computer systems. This means developing a more business centred relationship between the regulated and the regulators.

The global fast parcel industry is dominated by 4 large express carriers who already have sophisticated systems in place which allow effective control to be applied. There is a need to develop the working relationships that already exist between tax and customs administrations in order to both facilitate and control the future movements of small packages. The UK Customs & Excise for instance have direct access to express carriers' information systems as part of the conditions allowing these companies to operate simplified import procedures.

A more extensive use of measures such as these could be the necessary precondition for a radical reduction or abolition of the small parcels' threshold. If this could be achieved without disrupting the physical flow, it would be the best remedy for the distortive impact that off-line e-commerce is likely to have on EU traders.

To avoid creating new distortions, it is vital that any such measures are applied evenly. This means that all operators, including postal services[2] are placed under the same obligations and have the same responsibilities for allowing access. It would also mean that all EU administrations would accept the need for common standards and rules for dealing with external traffic and eliminate the potential for distortion of optional provisions.

7.6. Internal aspects-VAT

The internal cross border distance selling scheme could face tension if the level of distance selling continues to increase. Within an EU Member State distance sales by a registered domestic trader fall within the normal VAT regime. If the transaction involves another Member State, the seller's rate of VAT continues to apply until such time as the total of his sales to any particular Member State reaches a nationally prescribed threshold[3]. The seller is then obliged to register in that jurisdiction and charge and account for VAT accordingly. The system was introduced to avoid distortions which may be caused by differences in VAT rates and to protect national VAT revenues[4].

The perceived drawback of this system is that the leverage point for enforcing control is outside the hands of the Member States most affected. The resources available did not allow for an in-depth examination of this question but there is at least anecdotal evidence of stress. Books for off-line delivery are a popular Internet purchase and it cannot be coincidence that the more high profile websites (including some for specialist and high priced items such as medical textbooks) are located in jurisdictions which apply a zero-rate. There is certainly a perception that this is a lightly policed area.

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2 This is a complex point and may, in certain Member States, raise the possible need for alterations of existing national legislation in respect of postal traffic.

3 The normal threshold is 100 000 ECU of sales, but the Member States may opt for a lower threshold of 35 000 ECU if they wish.

4 Thresholds for distance sales

35 000 ECU - Belgium, Denmark, Finland, Greece, Ireland, Italy, Portugal, Spain, Sweden

100 000 ECU - Austria, France, Germany, Luxembourg, The Netherlands, The United Kingdom

8. CONCLUSIONS AND FUTURE WORK

Community action was initiated, with the full support of Member States DGs. in order to analyse the implications of e-commerce for the administrative systems and legislation underlying Customs and VAT. The objective was to identify where shortcomings might arise and to propose appropriate measures to remedy them. At the meeting of Working Group No 1 in June 1997 it was decided to approach the work by separating the issues into three broad categories each to be examined by a different working group.

The immediate task was to identify the problems which would arise in the fields of customs and VAT from the growth of e-commerce and to review current legislation together with existing compliance, control and enforcement techniques.

It was clear from the outset that a purely legislative approach to taxing e-commerce was not the answer. Any solutions would have to be tested against the practicalities of compliance, control and enforcement. Current VAT legislation is designed to cope with existing forms of economic activity and it was always likely that new techniques might be needed to deal with e-commerce. As a result of the analysis undertaken, it has been possible to draw some broad conclusions about the implications for taxation.

In many instances, the existing mechanisms and legal base will ensure that taxes will continue to be collected but there is a need to address the problems likely to be caused by an increase in the scale of transactions. Elsewhere however, serious shortcomings in the existing protocols surrounding e-commerce will cause difficulties for tax administration if not rectified.

The continued use of the reverse charge mechanism for supplies to taxable persons was broadly supported whilst at the same time acknowledging the need to examine further the practical implications which it raises including the difficulty for a supplier in distinguishing the tax status of his customers. Similarly, for imports of physical goods into the Community, the remedy lies in the updating and reinforcement of the existing regime so that it may cope with the demands which it is likely to face from the trend towards globalisation.

Where fundamental difficulties were identified in areas such as identification, auditibility and payment systems, the important message is that the protocols are evolving to meet the needs of their users. The protocols in place today are unlikely to be the same in three years' time. If the direction they have taken so far is not conducive to good tax administration, the reason may lie with the tax administrations themselves who have not yet succeeded in asserting their role as a stakeholder in e-commerce. The next step should be to rectify this.

Consideration has been given to a number of practical ways of improving tax compliance in e-commerce, particularly for taxing supplies to private persons. One such idea was to consider the possibility for a single tax representative to account for tax in one Member State for all of a trader's e-commerce supplies to EU customers. Another involved an investigation of the possibility of using a

withholding tax system for such supplies operated by banks and other financial settlement organisations. These and other ideas need to be developed in sufficient detail to assess whether they are viable for use in whole or in part as solutions to the problem of controlling and collecting the tax. This should form part of the continuing work.

The next stage of the work should therefore be to explore and evaluate in more depth the new environment in which e-commerce takes place. Without detailed knowledge of the way in which the networks operate and are likely to develop it will be impossible to make such an assessment. A stronger insight into the technicalities and organisational aspects of the Internet will be needed to equip tax authorities with the knowledge which will enable them to influence the shape of e-commerce structures so that a clear and simple tax framework can be constructed and operated.

From the outset, the need to consult the players involved in this new industry has been recognised. It necessary to know how the system functions and is likely to develop in a technical sense and also to ascertain the needs of businesses and consumers who are likely to use the networks for commercial purposes. On some occasions external experts from the private sector have already been invited to informal discussions with the working groups. These preliminary experiences have proved to be very profitable. It is considered imperative that this consultation process should be continued on a larger scale and in more detail during next stage of the No 1 Working Group's examination of e-commerce. Similarly, advantage should be taken of the expertise of the OECD and other Commission Directorates and the work carried forward in close co-operation wherever there are a mutual interest.

The OECD Turku conference, provided the first opportunity for a debate of the issues with the business community. The Ottawa Conference will provide a forum for more detailed consideration of a tax framework to provide the business sector with a clear and simple set of rules for operating with the e-commerce environment. Therefore the Community needs at an early stage to be in a position to put forward ideas for taxing and controlling e-commerce based on the EU VAT system in order to influence the debate at the Ottawa Conference.

ANNEX I

HIGH LEVEL POLICY DISCUSSIONS

EU–US Summit

The intense discussion and negotiation which took place during the drafting of the joint statement on e-commerce certainly served to raise awareness of the issues both within the Commission and in the Member States. The agreed statement sets out the general principles which should govern trade over the Internet and in particular states that taxes should be neutral and non-discriminatory. However, in the more detailed statements concerning Customs treatment of electronic transactions concerning goods, some problems of interpretation have arisen which need to be resolved. The main problem is with the Customs treatment of importations of goods in a physical form as opposed to the same "virtual" goods, which can be transmitted directly over the Internet. This could lead to unequal treatment if one is subject to Customs duty and the other is not.

ECOFIN

At a meeting of the ECOFIN Council on 1 December 1997 the issue of taxation and e-commerce was raised in the context of the EU-US Joint Statement which was signed later that week. Since the content of the Joint Statement was only of a very general nature, substantive discussion of the subject was deferred until a clearer picture emerges of the way in which e-commerce is likely to develop.

Policy and technical papers

There are at least three papers on policy issues that are of interest for the taxation of e-commerce. The Commission itself has presented a policy document as well as the US Government and the Japanese Government. The Australian Tax Administration has presented a comprehensive report on a study of all aspects of e-commerce on their tax system.

United States

On 1 July 1997, the US president announced an e-commerce initiative by releasing the report called "A framework for Global Electronic Commerce". This report sets out the US administration's vision of the emerging electronic market-place and outlines the guiding principles of the US Government. The president called upon all Internet users to join and seek a global consensus, and where necessary, agreements on the issues raised in the report by 31 December 1999.

The report reflects the opinion of the US administration on all important issues of the global information infrastructure and e-commerce. It covers final aspects, like taxation and payment systems, legal issues such as intellectual property protection, privacy and security, and market access issues such as telecommunications infrastructure and interoperability, content issues and technical standards. The paper sets out main principles in these fields clearly indicating the US desire that Internet

should develop as a market driven arena and not a regulated industry. Even where collective action is necessary it recommends that industry should self-regulate and that governments should refrain from imposing new and unnecessary regulations, bureaucratic procedures or new taxes and tariffs on commercial activities that take place via the Internet.

Where government involvement is needed, its aim should be to support and enforce a minimum legal environment for commerce. Its role should not be to regulate but to ensure competition, protect intellectual property and privacy, prevent fraud, foster transparency, and facilitate dispute resolution. The aim should be to facilitate Internet on a global basis, as a global market-place, and therefore the legal framework supporting commercial transactions should be consistent and predictable regardless of the jurisdiction in which a particular buyer and seller reside.

On taxation and tariffs it says that Internet should be declared a tariff-free environment whenever it is used to deliver products and services. The Internet is a truly global medium, and all nations will benefit from barrier-free trade across it. Therefore, no new taxes should be imposed on Internet commerce. Existing taxes that are applied to e-commerce should be consistent across national and sub-national jurisdictions and should be simple to understand and administer. State and local governments should co-operate to develop a uniform, simple approach to the taxation of e-commerce, based on existing principles of taxation.

On payment systems, which also is a question of interest for taxation, the US paper states that the technological environment for electronic payments is changing rapidly, which makes it difficult to develop an appropriate policy. It therefore recommends that inflexible and highly prescriptive regulations and rules are inappropriate and potentially harmful.

European Commission

The European Commission launched on 15 April 1997 a Communication paper called “A European Initiative on Electronic Commerce”, COM (97) 157. The aim of this Initiative was to encourage the vigorous growth of e-commerce in Europe. This initiative consists of a coherent set of action-orientated policy recommendations. The purpose of the paper is to establish a common European position in order to achieve global consensus through international negotiations.

These recommendations address access to the global market-place, legal and regulatory issues, and promotion of a favourable business environment. Their implementation will involve close consultation with the relevant industry sectors and involve all relevant policy domains. Coherence between technological, regulatory and support actions is an essential element of the approach advocated by this Initiative.

In the tax field, the Initiative first sets out some general policy statements. To allow e-commerce to develop it is vital for tax systems to provide legal certainty (so that tax obligations are clear, transparent and predictable), and tax neutrality (so there is no extra burden on these new activities as compared to more traditional commerce).

The potential speed, intractability and anonymity of electronic transactions may also create new possibilities for tax avoidance and evasion. These need to be addressed in order to safeguard the revenue interests of governments and to prevent market distortions.

As far as indirect taxation is concerned, and particularly VAT, the Initiative emphasises that this is an area in which the Community rules are most harmonised. Electronic trade in goods and services clearly falls within the scope of VAT, in the same way as more traditional forms of trade do. However, it says that thorough analysis is needed to evaluate the possible impact of e-commerce on the present VAT legislation (on issues such as definition, control and enforceability) and to judge if, and to what extent, the present legislation needs to be adapted, while ensuring tax neutrality. Adaptations should avoid putting excessive burdens on small companies. While some commentators have suggested that there might be a need to look at alternative taxes such as "bit tax", the Commission is of the opinion that this is not appropriate since VAT already applies to these transactions. "EU-tax" is not in any sense to be regarded as a VAT substitute since, *inter alia*, it would take no account of the true value of the material being supplied.

Japan

The Japanese Ministry of International Trade and Industry has published a policy paper called "Towards the Age of the Digital Economy". The paper explicitly comes to the conclusion that the rules which applied in the past can no longer be applied in the future. The establishment of new rules adapted to the conditions of cyberspace is therefore considered necessary. The paper describes the various policy issues and makes suggestions for the general direction to solve them. The paper sees for example a need to harmonise internationally the legal rules governing transactions and policies on different issues. Regarding tax laws, the paper recognises new problems that should be dealt with swiftly and positively always bearing in mind the matter of international harmony.

Australia

One of the earliest and strongest contribution to the debate on tax and e-commerce came from the Australian tax administration[5]. This covered all aspects of their taxation system and although Australia does not have a VAT system, many of their findings and recommendations are of relevance. The appendices dealing with technical features of the Internet and banking issues have been a useful source of information.

5 Tax and the Internet - Discussion report of the Australian Tax Office Electronic Commerce Project Team on the challenges of electronic commerce for tax administrations. (August 1997 Australian Govt. Publishing Services, Canberra.)

The contents and findings of the report do however emphasise the difficulty faced by a single administration acting alone in confronting the problems of e-commerce. It is likely that many of the more prescriptive recommendations will prove difficult to implement in isolation. In setting a number of benchmarks for the taxation of e-commerce, the ATO has taken an invaluable first step in showing the way to other tax administrations.

The report cautions against unnecessary or burdensome regulation and emphasises the principle that there should be broad neutrality between the treatment of businesses engaged in traditional physical commerce and those engaged in e-commerce. A number of the recommendations - in particular those which relate to the identification of businesses on the Internet - have been reflected in the work leading to the compilation of this report.

Conferences

Bonn

At a conference which took place in Bonn in July 1997, ministers of 29 European countries agreed on a number of key principles that will pave the way for a rapid growth in Europe of the use of Global information networks. The objective of the conference was to broaden the common understanding of the use of Global Information Networks, to identify barriers to their use, to discuss possible solutions and to undertake an open dialogue on further possibilities for European and international co-operation.

Ministers agreed on the principle that there would be no new trade barriers or taxes imposed on companies or individuals wishing to do business in cyberspace. This was stated in a document, the "Bonn Declaration", which was signed by all EU Member States, Eastern European nations and members of the European Free Trade Association. In respect of taxes, they supported the principle of non-discriminatory taxes on the use of Global Information Networks. They also agreed that tax issues relating to e-commerce call for international co-operation.

Turku

At an OECD conference held in Turku, Finland, in November 1997 on the topic "Dismantling the Barriers to Global Electronic Commerce" participants from the private and public sectors set out their point of view on the need for a global framework for e-commerce. BIAC, the business and industry advisory committee to the OECD, had arranged a pre-meeting with a round table discussion on aspects of taxation.

It was concluded that tax should not be a barrier to the development of e-commerce, but at the same time e-commerce should not undermine the tax system which all parties agreed should continue to be based on the principle of consumption. Governments should first try to apply the existing rules and concepts before looking at new approaches to taxation and participants did not see the need for a "bit tax". It was also concluded that tax administrations need to work in close partnership on this

matter and that there is a need for international co-operation and the development of internationally consistent solutions. Administrations should also take the opportunity to improve their service to taxpayers, using the new technology.

As a follow-up to the Turku conference, a new conference has been announced to take place at ministerial level in Ottawa, Canada in October 1998, with the aim of endorsing a set of framework guidelines, to include location, within which e-commerce can develop.

ANNEX II

"Cultural" protection

Traditionally customs duties have been for the protection of industries producing physical goods. However, in the last round of tariff reductions there has been an exemption for what are called cultural goods. This has been negotiated to hinder the increasing dominance of American English language and culture over local languages and culture. Thus the media that carry this culture, CD ROM's, CDs, books, videos etc. have not been subject to tariff reductions. Any move to substituting on-line delivery, either for commercial masters (for reproduction in the Community) or for final consumers (insofar as tariffs are being paid at present on small parcels) would mean that these tariffs would have less relevance. Additionally, insofar as VAT would no longer be paid there would be a reinforced tendency for final consumers to source supply outside the Community, which would also defeat the intention of "cultural" protection. However we should not forget that the inverse is also true, the EU is also major exporters of culture.

From this it can be argued both ways, both based on the need to avoid distortion of the market. Either some way needs to be found to tax the import of "virtual goods"[6], essentially customs duty on all imports and VAT on the direct supplies to final consumers, or that the customs duties on the physical goods should be eliminated. This is not strictly speaking an e-commerce issue, nor is it a customs issue; it is a trade and cultural policy issue. Nevertheless the working group feels that the policy makers should take full account of the practical issues involved in making decisions.

The main practical issue is that with the present state of the art it is not easy to see how customs duties could be applied in practise to on-line imports. They would need to follow a reverse VAT charge made on the normal VAT return rather than at the actual time of import as for goods. However there is the problem that currently the internationally agreed customs valuation approach in cases of 'specific' software is to deduct the intellectual value from the total value when it is separately invoiced so that duty and VAT is only applied to the value of the support. The VAT on the service is of course applicable. More importantly, we can see no way of charging VAT and thus customs duties, on on-line supplies made to individuals (which is where we would expect the competition to physical goods to be). We have no legal or physical jurisdiction over persons established outside the Community or any possibility of tracing the sale or the purchaser.

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6 A customs duty on virtual goods would need to be accepted internationally in the WTO but it is difficult to imagine given the attitude of the USA how this could be agreed. At present, except for electricity, all the tariff headings in the Harmonised System of Tariff Classification are for physical goods.

ANNEX III

Goods -reconfigured or upgraded

The idea is that the increasing potentiality of electronics could be used systematically to upgrade electronic components installed in machines so that their capabilities are increased. The idea advanced is that low grade 'stupid' machines with a relatively low value, and/or which fell into a tariff heading with a low rate of duty, would be imported. These would then be upgraded by reprogramming the built in electronics when in the Community, either before or after sale to the public or companies. Thus although the correct amount, more or less of VAT would result the customs duties 'due' would be underpaid as the machines actually had a 'real' higher value for customs purposes and/or the rate of duty was 'artificially' low.

There are many considerations that have to be taken into account here, among them being that duty is assessed on the actual product presented to customs on declaration for home use, no account can be taken of modifications made afterwards. This being said the nomenclature clearly already in some cases does compensate for changes made after import, such as unassembled articles being regarded as complete articles. Customs valuation also allows the 'full' value to be calculated when computers are imported where there is the possibility later to 'unlock' blocked off memory upon the payment of a consideration. This consideration being added to the declared value.

The working group felt that these possibilities should be looked at by the experts concerned to see if there was a possibility of real abuse and to see what, if anything, could be done.
