

INDIRECT TAXATION OF ELECTRONIC COMMERCE: POSITION PAPER

COMPUTER SYSTEMS POLICY PROJECT

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EXECUTIVE SUMMARY

Tax policy will be instrumental in determining whether the vast potential of global electronic commerce is realized, or alternatively, frustrated. CSPP recognizes that the taxation of goods and services is a necessary function of governments in order to generate adequate revenue streams for public functions. We believe that global electronic commerce will enhance this revenue stream provided that taxes are applied in a neutral and simplified manner. Presented below is a set of tax policy objectives and recommendations for appropriate taxation of electronic commerce:

Tax Policy Objectives

Neutrality: The sale of goods or services through electronic commerce, whether delivery occurs on-line or off-line, should not be taxed more heavily than any similar transactions completed through other forms of commerce. Electronic commerce, including Internet services, should not be subject to special taxes that are not generally applicable to other forms of commerce.

Simplicity: In order to optimize the worldwide reach of electronic commerce, governments should simplify and harmonize tax systems in a manner that minimizes compliance costs. Tax authorities should take advantage of new technologies to reduce the costs of complying with tax rules.

Recommendations

General:

- 1) Significant changes in the direction of policy regarding application of sales and VAT taxes on goods delivered in electronic form (i.e., intangible goods) should await further development both of the electronic commerce business model and the means to accommodate the unique nature of digitized goods.
- 2) Indirect taxes should not be applied in the on-line world to services that are not currently subject to taxes in the physical world.
- 3) Policy decisions relating to the application of indirect taxation to e-commerce should recognize the global nature of this business channel and should, therefore, be designed globally while remaining locally enforceable. Requisite features include international uniform classification, registration (if required), remittance, and technologies.
- 4) Adoption of an international, transaction-based compliance system for indirect taxes that removes the vendor from collection responsibility, relies on the tax authority (or its agents) for collection and employs emerging technologies such as electronic clearinghouses should be considered. Potential solutions for tax administration and collection are, in fact, resident within the very technologies that comprise the e-commerce infrastructure, e.g., worldwide interconnectivity, intelligence in the network, user certification, electronic clearinghouses, etc.

International:

- 1) Present VAT systems generally meet tax policy objectives on the delivery of tangible goods. Future application of VAT to electronically delivered goods should be accompanied by simplifying reforms including, minimally, uniform classification and taxation at the place of consumption.

United States:

- 1) State and local authorities should simplify existing local sales and use tax regimes, using reforms, such as one rate per state and uniform national rules for tax classification and should look to emerging technologies for collection and administration purposes.
- 2) Tax systems should attempt to reduce the cascading effect of sales/use taxes on purchases by business customers.
- 3) Energies should be focused on future tax systems that use emerging technologies for collection and administration, and potentially a transaction-based approach to indirect taxation.

INTRODUCTION

The Computer Systems Policy Project (CSPP) is an affiliation of chief executive officers of twelve major U.S. companies that develop, build, market, service and support information processing systems, software and solutions. The CSPP member companies are: Apple Computer, Inc.; Cisco Systems, Inc.; Compaq Computer Corporation; Data General Corporation; Dell Computer Corporation; Hewlett-Packard Company; IBM Corporation; Intel Corporation; NCR Corporation; SGI; Sun Microsystems, Inc.; and Unisys Corporation.

CSPP recognizes that the taxation of goods and services is a necessary function of governments in order to generate adequate revenue streams for public functions. We believe Global Electronic Commerce is not a threat to this revenue stream, but rather is likely to support and strengthen it. But in the new electronic marketplace enabled by the Internet, taxes must be applied in a neutral and simplified manner.

The recent enactment in the United States of the Internet Tax Freedom Act (ITFA) was a prudent measure for producing sound tax policy in the future. The ITFA establishes a three-year moratorium on new Internet-related taxes and establishes a commission of experts to study global electronic commerce-related tax issues and to make recommendations for the direction of tax policy at the end of the three years.

Policy in the U.S. and abroad must be coordinated and free from taxes that penalize businesses and consumers who choose to conduct transactions electronically rather than through traditional channels of commerce.

Additionally, the complex and varied tax collection and administration systems that exist around the world greatly complicate developing fair and consistent tax policy that promotes tax neutrality. Complexity adds costs to businesses and consumers and limits the scope of and creativity of potential tax policy solutions.

In 1998, CSPP published the "Indirect Taxation of Electronic Commerce: Options Paper," which identified a series of options for addressing the indirect taxation challenge. This position paper takes the next step and provides a recommended course of action on several tax policy challenges.

TAX POLICY OBJECTIVES

CSPP endorses the following tax objectives as a foundation for tax policies that promote the use of Global Electronic Commerce and its many social and economic benefits while allowing governments to collect tax revenues in a fair, consistent, transparent, and simplified manner.

1) **Neutrality**

- A. Electronic commerce, whether delivery occurs on- or off-line, should *not* be taxed at a higher rate than similar transactions completed through other forms of commerce.
- B. Electronic commerce, whether delivery occurs on- or off-line, should *not* be subject to special taxes that are not generally applicable to similar transactions completed through other forms of commerce, i.e., no new or discriminatory taxes on electronic commerce.
- C. Foreign vendors should *not* be subject to VAT or similar transaction taxes in a way (e.g. higher rate, added administrative burdens) that is discriminatory when compared to the regime applicable to domestic vendors.

2) **Classification of Transactions**

- A. Transactions involving the delivery of physical goods “off-line” which were ordered “on-line” pose no new challenges for tax authorities; existing tax systems currently deal with such transactions.
- B. Not all digital transfers are the same. Some may be goods and some may be services. Transactions involving digital transfers need to be analyzed and appropriately classified for tax purposes.

3) **Fiscal Balance**

- A. The CSPP recognizes the legitimate need for governments to collect revenue, and does *not* insist that electronic commerce be tax free, provided that any taxes are imposed in a neutral and easily administrated manner.

4) **Simplicity**

- A. Rules for taxing electronic commerce should be clear.
- B. Uniform classification of on-line electronic commerce transactions should be adopted.

- C. Taxes on electronic commerce should be imposed in a manner that minimizes compliance costs, especially since electronic commerce enables companies to do business across so many taxing jurisdictions.
- D. Tax authorities should take advantage of new technology to reduce the costs of complying with tax rules.

5) Technological Efficiency

- A. Tax policy should contribute to the development of superior electronic commerce technologies and business models.

6) Free Trade

- A. Consistent with current practice, and the treatment of intangible goods and services generally, on-line electronic commerce trade should remain duty free.
- B. Electronic commerce imports, whether delivery occurs on- or off-line, should be free from discriminatory taxation (i.e., national treatment).
- C. Double indirect taxation of electronic commerce trade (by the country of export and the country of import) should not occur.

GLOBAL INDIRECT TAXES **(e.g. EU VAT System)**

Internet tax policy should be considered from two perspectives: first, when something is ordered on-line and delivered on-line; and second, when something is ordered on-line and delivered off-line.

On-line Order, On-line Delivery

Although policymakers have devoted much attention to the application of value-added taxes (VAT) to digitally delivered products, these transactions currently account for a very small percentage of electronic commerce. While digitized products currently constitute a small portion of electronic trade, they represent the most challenging technical problem to existing tax systems. *Due to the potential for discriminatory and administratively burdensome tax rules, authorities should carefully study ways to develop simple, neutral and uniform tax collection mechanisms before prematurely mandating a particular solution.*

Classification

International consensus must be reached on how to classify digital transactions for VAT purposes, which affects the determination of the place of supply and applicable tax rates. In April 1998, the European Commission proposed to treat the supply of all digital products as services for VAT purposes. Clearly, not all digitally delivered products are services, and this classification creates some differences in tax treatment between functionally equivalent products delivered on-line versus off-line. CSPP recommends classification of all digitized products be done only after careful study and consultation with industry and other international groups to ensure that uniformity is achieved. In the interim, tax authorities might consider zero-rating digitally delivered products.

Place of Taxation

Another area requiring international agreement is whether to apply an origin -- or destination based -- VAT system for digitally delivered products. The EU has delayed the effective date for a "definitive" origin-based VAT system until January 1, 2002, and it is commonly believed that this date will slip further. Under the origin-based system, vendors generally would be taxable on sales of goods within the EU, at local VAT rates, regardless of the destination of the goods. An EU clearinghouse mechanism would be established to redistribute revenues from exporting to importing countries to achieve roughly the same distribution of revenue as the current destination-based system. Services also would be taxable on an origin basis, consistent with the taxation of goods. To avoid excessive tax competition among EU member states, EU member countries should seek to harmonize VAT rates.

Although an origin-based system would provide simplification for transactions within the EU, such a system is sustainable only if the VAT regime applicable to transactions between EU and non-EU entities results in no discrimination of one set of vendors over another. Stated differently, customers should not prefer an EU supplier over a non-EU one (and vice-versa) because of differing VAT rules and rates.

An origin-based system would need to be globally adopted in order for the system to be workable. Alternatively an enforceable destination-based approach, where purchases are treated identically for VAT irrespective of the vendor's location, would provide a level playing field for industry and government alike.

On-line Order, Off-line Delivery

Currently, VAT-registered vendors are liable for tax on the sale of *goods* when (1) the goods are delivered; (2) the invoice is rendered; or (3) payment is received, whichever comes first. Exports of goods generally are taxed at a zero rate. Tax on the importation of goods is imposed on the importer, generally at the same time and manner as customs duties.

Due to the elimination of internal border controls, special rules apply to sales of goods between European Union ("EU") countries. Where the purchaser is registered for VAT, the VAT on the acquisition of goods is self-assessed by the purchaser (under the so-called "reverse charge" method). Where the purchaser is not registered for tax, the vendor is required to register for VAT in the territory of the customer if the monetary value of sales exceeds a specified annual threshold (typically ECU 35,000 to 100,000). These "distance selling" rules essentially impose VAT collection on EU vendors.

The status quo generally appears consistent with the CSPP's indirect tax objectives.

Recommended Reforms

CSPP recommends that any future application of VAT to e-commerce transactions be accompanied by simplification reforms, including:

- 1) Consider a transaction-based compliance system that removes the vendor from the collection process by using emerging technologies such as clearinghouses for consumption tax, so the taxes can be efficiently collected at the source in an enforceable manner;
- 2) Allow a simplified indirect tax registration and payment system that scales internationally. The use of a clearinghouse would facilitate the collection of taxes and might operate as part of a distributed tax collection network which would include vendors, certificate authorities (trusted third parties), and other intermediaries.
- 3) Require internationally uniform rules for tax classification (but not necessarily uniform rates);
- 4) Adopt uniform registration, return, remittance, and exemption procedures that can be scaled internationally;
- 5) If and where vendors collect tax, provide additional protections, as appropriate, for vendors who act in good faith;
- 6) Agree that vendor collection responsibility for use tax creates no inference regarding nexus for any purpose, including sales/use tax or income tax;
- 7) Agree that a website or a server alone is not sufficient to create tax nexus;

- 8) If and where vendors collect tax, provide reasonable allowances to cover vendor collection costs; and
- 9) Adopt rules for protecting vendors from multiple taxation.

U.S. INDIRECT TAXES: STATE AND LOCAL SALES AND USE TAXES

In the U.S., consumption taxes are applied in a different manner than most nations in that they are applied at a sub-national level.

On-line Order, On-line Delivery

Under present law, there is considerable uncertainty about application of retail sales and use taxes to on-line deliveries. CSPP recommends that policy decisions regarding application of taxes on electronic deliveries should await further development of the electronic commerce business model and the means to accommodate in a neutral manner the unique nature of digitized transactions.

Classification

CSPP recommends classification of all digitized products be done only after careful study and consultation with industry and other international groups to ensure that uniformity is achieved. In the interim, tax authorities might consider not taxing digitally delivered products. To the extent a transaction is characterized as a service, CSPP recommends that sales tax be applied to online services only where the same service is taxed when delivered through other channels.

On-line Order, Off-line Delivery

States have focused exclusively on vendors to collect their taxes. Without jurisdiction over non-resident (both out-of-state and out-of-country) vendors, states will always have a collection problem. For any tax where the point of consumption determines which jurisdiction has the right to tax, that jurisdiction needs to re-focus its attention on the transaction itself. States need to look to emerging technologies to solve this problem.

Recommended Reforms

CSPP recommends that states take the following actions to create a more simple, transparent, consistent, and fair sales tax system:

- 1) Consider a transaction-based compliance system that removes the vendor from the collection process by using emerging technologies such as clearinghouses for consumption tax, so the taxes can be efficiently collected at the source in an enforceable manner;
- 2) Allow a simplified indirect tax registration and payment system that scales internationally. The use of a clearinghouse would facilitate the collection of taxes and might operate as part of a distributed tax collection network which would include vendors, certificate authorities (trusted third parties), and other intermediaries.
- 3) Require internationally uniform rules for tax classification (but not necessarily uniform rates);
- 4) Adopt uniform registration, return, remittance, and exemption procedures that can be scaled internationally;

- 5) Require major simplification of the existing local option consumption tax regimes, such as the single state tax rate proposal made by the National Governors' Association;
- 6) Attempt to reduce tax cascading on purchases by business customers;
- 7) If and where vendors collect tax, provide additional protections, as appropriate, for vendors who act in good faith;
- 8) Agree that vendor collection of use tax creates no implication regarding nexus for any purpose;
- 9) Agree that a website or a server alone is not sufficient to create tax nexus;
- 10) If and where vendors collect tax, provide reasonable allowances to cover vendor collection costs; and
- 11) Adopt rules for protecting vendors from multiple taxation.

INTERNATIONAL TRADE

On-line Order, On-line Delivery

Under present law, transactions involving a U.S. vendor and a foreign customer, in theory, could be subject to both state sales tax and foreign VAT. Such double taxation would be harmful to the growth of global electronic commerce.

CSPP believes that in order to avoid double taxation, a clause should be added to the US and OECD model tax treaties relating to double indirect taxation. In addition, if the OECD and EU are able to develop uniform classification and place of supply rules for purposes of VAT, the states should incorporate these rules within their sales and use tax systems for purposes of international trade.

On-line Order, Off-line Delivery

Under present law, international trade in tangible property generally is taxed on a destination basis, consistent with free trade principles. The status quo generally is consistent with the CSPP's indirect tax policy objectives.