TOPIC 11

FARMING

AND

THE TAXATION OF ELECTRONIC-COMMERCE TRANSACTIONS

LEARNING OBJECTIVES

After studying the material for this week you should be able to:

- Explain the main features for the taxation of farm income;
- Outline why e-commerce provides a taxation collection challenge for taxation authorities;
- Discuss the role of various international organisations in providing a lead for the taxation of e-commerce;
- Describe the underlying principles promulgated for the taxation of e-commerce;
- Discuss the ongoing work of the OECD committees to establish broad based rules for taxation uniformity between countries;
- Discuss the approach of the New Zealand IRD.
- Demonstrate an ability to research and cross reference sections of the NZT.

Supplementary Readings

1. Supplementary Readings in this Study Guide:

		Page:
(a)	Commerce Clearing House (2008). *New Zealand Master Tax Guide for Students* (Chap 34: *E-Commerce*). Wellington: Author.	21
(b)	Inland Revenue Department. (2002). *Guide to tax consequences of trading over the internet*, pp. 3-6; 14-16. http://www.ird.govt.nz/ library/ecommerce/	33
(c)	GST Guidelines for Recipients of Imported Services (October 2004) Policy Advice Division of Inland Revenue Department pp1-6	40
(d)	Inland Revenue Department E-commerce and Tax Online Trading downloaded from http://www.ird.govt.nz/ecommerce-tax/onlinetrading.html on 25 March 2009.	46
(e)	OECD Committee on Fiscal Affairs (2003). Implementation of the Ottawa Taxation Framework Conditions. *The 2003 Report*, pp. 7-14; 18-22. http://www.oecd/org/taxation	47

Additional Readings

2. Additional Reading References:

(i) Alley, Chan, et al (2009). *New Zealand Taxation*. (Chap. 1, 1.9.4 – 1.9.5, and Chap. 16). Wellington: Thomson Brookers.

(ii) Lawry, Jillian. (1999). *Guide to Taxing Internet Transactions*, Wellington: CCH New Zealand Ltd.

Topic Eleven Outline

A. Farm Taxation

1. What is a farming or agricultural business?

2. Gross income for farmers.

3. Deductions for farmers.

4. Income smoothing schemes available to farmers.

5. Valuation of livestock.

B. Taxation of E-commerce transactions

6. The impact of the internet

7. Explanation and meaning of e-commerce

8. How e-commerce differs from traditional commerce

9. The International response - the Ottawa Taxation Framework Conditions

10. The taxation principles adopted for e-commerce

11. The role of the Organisation for Economic Cooperation and Development (OECD)

12. The OECD committees

13. The significance of the term 'Permanent Establishment' (PE)

14. The response by the NZ Inland Revenue Department (IRD)

Explanatory Notes

FARM TAXATION

1. What is a farming or agricultural business?

Refer to **NZT** 16.1.2

1.1 Introduction

Farming businesses are treated slightly different for tax purposes than non-farming activities. In this part of Topic 11 we focus on those differences.

To begin with we must ascertain two things:

- What is a farming or agriculture business?
  The existence of a 'business" depends on several factors. These have been considered in *Topic* 4 (and a review of these factors would be helpful) and **NZT** 3.2.

- Secondly we must determine whether the business carried on is for farming or agricultural purposes. A list of such activities has been provided in **NZT** 16.1.2.

There are, however, activities associated with the farming industry, which fall outside the definition of farming/agricultural ventures.

Therefore the decision, whether an activity is a farming business, is two-fold:-

- Is there a business?
- Is it a farming/agricultural business?

2. Gross income for farmers

Refer to **NZT** 16.2.

3. Deductions for farmers

Refer to **NZT** 16.3

Farmers are allowed deductions for similar expenses as a sole trader. However, due to the nature of their business they are allowed other deductions which have been developed through IRD policies and practices. An example is a deduction

for the interest paid on the land occupied by the farm dwelling. This is IRD policy rather than legislation.
In addition to the deductions listed in **NZT** farmers are allowed the following expenses:

(a) For single farmers - wages to a housekeeper.

(b) Cost of transporting employees children to school - This is liable for fringe benefit tax which is deductible to the farmer.

(c) Consumable stores - i.e. fertiliser, stock feed, drench, blow fly oil, dip etc. are fully deductible in the year of purchase.

(d) Compensation for sheep worrying.

(e) Hay - i.e. where hay is acquired upon the purchase of the farm or acquired during the year for stock feed it is deductible.

(f) Pest Destruction Board rates.

(g) Rates - no apportionment, between business/private usage, of this expense for the farm dwelling. Case G13 - may apportion if the farming operation is small or part time.

(h) Subscriptions - for any organisation which is connected with farming, e.g. A&P Association or Federated Farmers.

(i) Mail Delivery Charges - can deduct any mail delivery charges that the farmer may have to pay.

This list is not exhaustive.

3.3 Development Expenditure

Refer to **NZT** 16.3.10

This scheme was developed as an incentive to farmers to improve their land and was previously 100% deductible. From 1 April, 1987 the legislation was amended to gradually reduce the deductible portion of the development expenditure so that, by 1992 income year, none of such expenditure is deductible and is to be fully capitalised. The portion which was no longer deductible was to be capitalised and amortised although the full deductibility status of a few development expenditures has been reinstated.

The main sections of the ITA which deals with the deductibility of such expenditure are *Sec DO 1* and *DO 4.* Sections *DO 2* and *DO 3* applies to deductions for tree planting/maintenance.

Qualifying Conditions

In order to qualify for a deduction under *Sec DO 1* and *DO* 4 there are certain conditions which have to be satisfied. **NZT** 16.3.10 provides a summary of these conditions.

3.4 **Fertiliser and Lime**

Refer to **NZT** 16.3.5

3.6 **Tree Planting**

Refer to **NZT** 16.3.10 (and *Sec DO 2 & DO 3*)

The purpose of the (capital) expenditure will determine which provision of the ITA will apply. Where a farmer has incurred expenditure on planting trees for preventing or combating erosion of the land or, for providing shelter to the land then *Sec DO 2* may apply. The farming operation *may not* necessarily be the principal business carried out on the land.

Section *DO 3* applies where the land is principally used for farming and expenditure is incurred in planting or maintaining trees. The deduction excludes expenditure which has been allowed under Sec DO 2, or in relation to planting of fruit trees, or for trees planted under a forestry encouragement agreement (per Forestry Encouragement Act 1962). There is a limit as to the amount of the expenditure which is deductible.

4. Income smoothing schemes available to farmers

4.1 Income Equalisation Schemes

Refer to **NZT** 16.5

There are three schemes and each serves a different purpose. The first two schemes have been outlined in NZT.

The third income equalisation scheme was introduced in the 2004 ITA and deals with forestry income from thinning of trees by a company which carries on a forestry business. The rules applying under this scheme are similar to the other two schemes and enforced by *Sec EH 63 – 79*.

5. Valuation of livestock

Refer to **NZT** 16.4

Why is stock carried by farmers treated differently from non-farming businesses? Under *s EE 1* non-farming taxpayers are eligible to value their stock at either cost, market, or replacement values, whichever is the lower. While these options are open to farmers the nature of the stock complicates the application of any of the valuation methods available.

One of the significant differences with respect to farming stock is the capacity of the stock to multiply while they are on hand; animals tend to breed when mated! In an ordinary business this phenomenon is not likely to occur. Therefore, farmers have the added complication of how to value the progeny besides the main stock numbers, and this issue is one reason for the different valuation methods available to farmers.

5.2 Specified and Non-specified Livestock

Before any of the valuation methods can be adopted it is necessary to identify whether the livestock is in the category of a *specified* or a *non-specified livestock*. In the Act the terms are defined:

- ***Specified livestock*** - includes sheep, cattle, deer, goats and pigs, as determined Schedule **17**, c**olumn 1** of the 2007 Act. This category of livestock is valued as either:
  - Herd Scheme (*s EC 14 – EC 21*);
  - National Standard Cost (Sec *EC 22 – EC 24*), or Self-assessed Cost (*Sec EC 25, EC 10)*;
  - Market or Replacement Value (*s EC 25*);
  - High priced specified livestock must be valued under the High Priced Livestock Scheme (*Sec EC 32 – EC 36*);
- Valuations are *GST exclusive*.
- ***Non-specified livestock*** – These are livestock other than specified livestock (*Sec YA1*) e.g. chooks, ferrets, rabbits, llamas. They are valued at Cost, Market, Replacement Price or at a Standard Value approved by the Commissioner (Sec *EC 30*).

5.3 Bloodstock

This type of livestock is valued differently from the rest under a separate regime. Students are not required to know the method of valuation except that it exists in *Sec EC 38 – EC 48* of the 2007 Act.

5.4 Valuation Methods

A. *Herd Scheme* (**NZT** 16.4.2, 16.4.4 & 16.4.6)

The philosophy underlying the herd scheme is that the livestock should be treated as capital asset. Hence changes in the National Average Market Values (NAMV), adopted in evaluating the livestock, are treated as non-assessable capital gain or loss.

- all **specified** livestock can be valued under this valuation scheme. Effectively, the herd scheme can now be used to value on an 'animal by animal' basis.

- once the scheme has been adopted any increase in livestock, above the "base number", may be valued using an alternative option.

- farmers have a choice in valuing their livestock under the herd scheme. The value adopted can be at NAMV or at either 90%, 100%, 110%, 120%, or 130% of the current year's NAMV. This provision takes into account regional differences in animal prices.

- the % increase/decrease in valuation adopted must be supported by a stock agent valuation. Any change to a higher percentage value will be taxable and any decrease will be deductible in the year of change.

- these options provide increased flexibility, but also adds complexity to the scheme.

- if a farmer wishes to exit this scheme the farmer has to notify the IRD of the new valuation scheme to be adopted and give two years prior notice of the change.

- on adopting the herd scheme, opening stock is revalued each year. Any difference between the closing stock of the previous year and the revalued opening stock is debited or credited to the capital livestock revaluation reserve.

- only change in stock numbers will have an effect on assessable income.

- the advantage of this scheme is that it is inflation-proof. However, when stock prices are falling no tax relief is gained by way of deductible unrealised losses.

B. *Cost Scheme*

1. **National Standard Cost Option** (NSC).

Refer to **NZT** 16.4.3, 16.4.5 & 16.4.6

This scheme and the Self-assessed Cost Option (SAC) are the two cost options available to farmers for livestock valuation purposes. The NSC and SAC cannot be used for livestock currently in the herd scheme.

- under this scheme the IRD will release national standard costs:
  - BRG : breeding, rearing and growing costs of rising one-year livestock of each class;
  - RG : rearing and growing costs for rising two-year livestock of each class (except pigs);
  - RG costs for three-year male cattle.
- these costs are an approximation of the National Average of farmers' direct costs of production for each class of livestock. These costs do not include the costs of purchased livestock.
- freight and insurance costs incurred in purchasing the livestock have to be included in the final per head cost of closing stock for the year.
- under the NSC scheme the accumulated cost of sheep, in each income year, is the opening cost plus the rearing and growing costs.
- no cost is assigned to stock purchased during the year other than the average purchase price. Costs are accumulated until the stock reaches maturity (i.e. usually rising two-year) and are held at that level until the stock is disposed of.
- where a farmer uses the NSC option FIFO, average cost, or specific identification inventory system is to be used.
- a farmer may change from NSC to the Self-assessed Cost scheme after providing a two year period of notice, in writing, to the Commissioner of Inland Revenue. All livestock must change to the new option. Only one of the costs options can be adopted at any given time.

2. **Self-assessed Cost Option** (SAC).

Basically the same method as the NSC option is applied, but farmers will be able to calculate the cost of breeding, rearing and growing of the animals, particular to their own farming operations. Compliance costs are likely to be high, given the complicated calculation involved.

C. *Market or Replacement Value*.

- either method can be used as an alternative when using the cost options. These methods would be used when NSC/SAC values produce higher values than market or replacement prices.

- market value - a stock agent values the livestock to determine their current value if sold on today's market.

D. *High-Priced Livestock (***NZT** 16.4.7*)*.

- Specified livestock used for breeding stock i.e. stud/pedigree stock such as bulls, rams, cows, may be valued under this scheme if:

  The cost of the stock is greater than $500 and is 5 x the greater of the national average market value for that income year or the average market value for the income year prior to purchase. The livestock purchased must be, at the time of purchase, capable of being used for breeding or expected to be capable of being used for breeding upon reaching maturity prior to purchase (4 x in the case of sheep and goats). Essentially only true and stud stock purchases are included in the regime.

- Under this scheme the stock is treated as a depreciable asset. The depreciation rates include:

Sheep	25%CP (or 37.5%DV)
Cattle	20%CP (or 30%DV)
Stags	20%CP (or 30%DV)
Goats	20%CP (or 30%DV)

Once the animals have been depreciated to the National Average Market Value for that class of livestock, they will be included in the other valuation schemes adopted by the farmer.

For this course students are required to have a basic understanding of the different treatment of income and expenditure and valuation methods available to farmers and the philosophy behind the introduction of these methods.

TAXATION OF E-COMMERCE TRANSACTIONS

6. The impact of the internet

The arrival of the internet has always had the potential for developing and sophisticating commercial transactions. During the 1990s the delivery and speed of electronic communication encouraged firms and individuals to experiment with transacting commerce on the internet and develop new ways of doing business[1].

By the late 1990s, alerted to the increasing traffic in electronic transactions taxation authorities began to question their ability to adequately capture those transactions in the taxation net. The possibilities of under and over taxation and their implications for taxation administration systems were becoming alarming. On the other hand, however, the new technology offered almost unlimited possibilities for stream lining the collection of taxation.

The internet offers anonymity by providing business with a direct link with the consumer, effectively removing the need for a physical presence.[2] It provides for the creation of virtual business organizations, linking and employing specialists in a complex adaptive system that behaves in unusual ways[3]. As a result the relied upon rules of 'residence jurisdiction' and 'source of income' methods[4] of taxation[5] have been under review.

7. Explanation and meaning of e-commerce

E-commerce - is the electronic or digitalized transaction of business between two or more parties from various locations.

An e-transaction between businesses is known as 'B2B'. An e-transaction involving a consumer is known as 'B2C'. Most e-commerce transactions are performed in the B2B category.

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[1] Implementation of the Ottawa Taxation Framework Conditions, 2003 Report, OECD Committee on Fiscal Affairs. Source: http://www.oecd/org/taxation
[2] Internet tax: An overview for Business Taxpayers Discussion Paper March 2000, IFCA (International Federation of Accountants) Information Technology Committee. Para. 124/125
[3] Lawry, Jillian. (1999) *Guide to Taxing Internet Transactions,* CCH NZ Ltd.
[4]The current bases of income taxation are:
• "residence" -New Zealand residents are liable for taxation on their worldwide income, and
• "source" - with non-residents taxed on income sourced from New Zealand
source; 'Guide to tax consequences of trading over the internet' issued May 2002, http://www.ird.govt.nz/library/ecommerce/.
[5] Refer to Topic 7 p. 3 – 6 for revision of the NZ requirements for resident and source.

Because of the diverse nature of consumers, evidencing and capturing their transaction details presents unique challenges. This is particularly so in **the trading of services** which are easily delivered electronically without any trace of the transaction visible to the taxation authorities to alert them that the transaction has occurred.

Where the trading of services is B2B, the challenge may be less acute as most businesses are registered somewhere for taxation and/or other purposes with the result that existing data collection and verification systems may alert the tax authorities to the transaction.

In contrast **trade in physical goods** flows over country boarders and can more easily be seen, identified and captured for taxation purposes. An example is GST charged on goods delivered into NZ: the Customs Department reads the Free On Board (FOB) value written on the package, calculates the 12.5% GST and **invoices the recipient** of the goods for the cost of the GST, whether they are a business or a consumer.

It is interesting to note that while NZ exempts from GST imported goods with an FOB value under NZ$400, Finland offers no exemptions and charges tax on all goods. They found an exemption resulted in a considerable leakage of taxation revenues.

8. How e-commerce differs from traditional commerce

The difference between e-commerce and traditional commerce can best be illustrated by an example. Imagine you have sufficient financial resources to engage a well known Australian architect to build your dream home. You commission her to draw up plans based on a detailed brief of your requirements. Instructions and drawings are sent via email and you pay all her fees by directly crediting her Sydney bank account.

You are very happy with the excellent result. The house looks magnificent and is much admired. 'House and Garden' magazine features the house in its February edition. A staff member of the IRD reads about your satisfaction with the Australian architect and becomes inquisitive about the GST on the transaction. You receive an IRD letter enquiring how you paid for her services.

Naturally you are honest and reveal the process. Have you broken any tax law? Is this any different from the transaction being conducted via mail?

8.1 Have you broken any tax law?

Prior to 2002 the answer is no as there was no GST on imported services. But in 2003 the Government enacted a law that requires the **recipient of services** to pay GST on the cost of the services. This is known as a '**reverse charge'.** The reverse charge concept is one that the OECD

favours for cross-border transactions. In NZ this charge applies to any person where their taxable supplies are above the GST registration threshold of $40,000. It deems the recipient of the service to be the supplier. You will have to check the level of the fee in relation to other imported services you have received during the last 12 months. You may be required to register for GST and make payment to the IRD.

From an income tax point of view the fees you paid the architect will not be taxed in NZ but will form part of the architect's taxable income in Australian. This is because there is a Double Tax Agreement (DTA) between New Zealand and Australia, and because the architect does not have a permanent business establishment (PE) in NZ. If the architect had a PE in NZ, she would have to pay local NZ taxes on her income but would receive a tax credit in Australia for taxation she paid in NZ.

8.2 Is this any different from the transaction being conducted via mail?

Yes and no. As we know, the tracing of the electronic transactions would be very difficult. Emails can be wiped and you could have transferred money electronically into your own Australian bank account before sending it on to the architect. Prior to the internet, letter, registered post or courier would have been the means of transacting the business. Payment would probably have been through your local bank account.

This example illustrates why neutrality is the guiding principle of the OECD i.e. not to make the delivery method, such as the internet or mail, the trigger for different types of taxation.

The downloading of computer programmes is another example of how the internet delivers a 'silent' product making it very difficult for the authorities to tax the transaction. The very process of digitization transforms these goods into intangible goods, blurring existing taxable classifications[6]. Most relevant here is the application of consumption taxes such as GST or Value Added Tax (VAT).

The above examples illustrate some of the issues facing taxation authorities. These are[7]:

1. difficulties identifying the parties behind e-commerce transactions;

2. the ability of firms engaging in e-commerce transactions to store records offshore or encrypt them or alter or destroy them without trace;

[6] *Ibid* Footnote 2 para. 136
[7] Australian Tax Office, 'Tax and the Internet' August 1997.

3. the removal of efficient collection points such as 'middlemen' in the distribution chain from producer to consumer; and

4. the ability of various technologies to change the nature of a product through digitization and their treatment for tax purposes.

9. The International response - the Ottawa Taxation Framework Conditions

In 1997 the Organisation for Economic Cooperation and Development (OECD) convened two conferences in Turku, Finland and in 1998, a conference in Ottawa, Canada to discuss how the international community should respond to the changing commercial environment brought about by e-commerce. A suggested taxation framework for e-commerce was discussed in Canada. The aim was to develop and agree upon a set of principles which would lead to international harmonisation and best practice in the taxing of e-commerce without hindering its development.

The result was the adoption of the Ottawa Resolution in which the implementation of Taxation Framework Conditions and supporting administrative arrangements became priories.

10. The taxation principles adopted for E-commerce

The Ottawa Framework Conditions spelt out 5 principles[8] to guide the development of adequate taxation policies --

- Neutrality,
- Efficiency,
- Certainty and Simplicity,
- Effectiveness and Fairness, and
- Flexibility.

These can be compared with Adam Smith's principles (refer Topic 1) and the specific requirements of various countries:

- The EU's threefold goal of providing legal certainty, to avoid undue revenue losses, and to ensure neutrality.

- Japan wants the taxation of e-commerce to be fair, neutral and simple.

- NZ guidelines9 promote neutrality and the use of the current taxation system.

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[8] The OECD's Committee of Fiscal Affairs 2001 report confirmed that these principles apply equally to conventional commerce.

[9] Guide to tax consequences of trading over the internet, NZ Inland Revenue Department, May 2002. Source: http://www.ird.govt.nz/library/ecommerce/

- The US goals are not to distort or hinder commerce (neutrality), simplicity and transparency, and to accommodate existing tax systems, concepts and principles10.

Neutrality jumps out as the overriding principle to be adopted. By *Neutrality* the OECD means:

- taxation should seek to be neutral between e-commerce and traditional commerce;

- business decisions should be motivated by economic not tax considerations; and

- similar transactions should attract similar levels of taxation.

Indeed the OECD concludes

> "…that attempts to consider the taxation of electronic commerce in isolation from other features of international taxation (especially of services) run a risk of breaching the neutrality aspirations of the Ottawa Framework"[11].

11. The role of the Organisation for Economic Cooperation and Development (OECD)

The OECD's Model Tax Convention (OMT) is the guiding document for the taxing of international commerce between member countries. This code provides specifics for taxing residents, non-residents and defines what constitutes a permanent place of abode/establishment (PE). The latter determines whether a taxpayer's location in a foreign country attracts resident taxation. The PE definition has had to be amended recently to accommodate the characteristics of e-commerce, for example, whether the location of a service provider's website renders a user liable for residence taxation. The OECD's work is on going with progressive reports widely circulated.

12. The OECD committees

The OECD's Committee of Fiscal Affairs (CFA) is the managing body of four sub-committees known as Technical Advisory Groups (TAG). Each TAG produces detailed policy recommendations following wide consultation with OECD, non OECD organizations and business representatives. Each TAG has responsibility for a certain area of the reform program. The CFA recently

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[10] *Ibid* para 151-163

[11] Report of the Consumption Tax TAG, OECD, 20th June 2003. Source: http://www.OECD.org/taxation

reported its main conclusions for 2003 as follows[12]:

1. Direct taxes - Business Profits TAG – included work on the permanent establishment (PE) definition for e-commerce and on the characterisation of certain e-commerce transaction payments under the OECD Model Tax Convention;

2. Consumption Taxes TAG – a key principle outlined in the Ottawa Framework is that e-commerce should be taxed in the place of consumption. Guidelines developed for the place of consumption affirm that for B2B supplies tax (GST/VAT) should accrue in the jurisdiction in which the recipient has located its business presence. Collection of the tax via a reverse charge (self assessment) was the most appropriate method. For B2C supplies the place of consumption should be where the recipient has his/her usual residence. In the interim a simplified registration system was adopted to cut compliance costs;

   (i) Tax Administration TAG – compliance, information and documentation – much work through intensified discussions with business and non-member economies was undertaken; and

   (ii) A technology panel to support the other 3 TAGs.

   (iii) Each TAG reports regularly on its progress and recommendations are made widely available[13].

13. The significance of the term 'Permanent Establishment' (PE)

Through the OECD's OMT and DTAs, a member country's taxation rights are levied on:

1. a **resident** taxpayer's profits/income from both local and worldwide sources (subject to the resident country eliminating resident –source double taxation).

2. **a non-resident** taxpayer's profits/income attributed to a permanent establishment (PE) situated in that country.

The concept of a PE is the basic nexus/threshold rule for determining this right to tax non-residents. The basic definition of a PE is "a fixed place of business where the enterprise's business is wholly or partly carried on" (refer to **NZT** 17.11.6, *Introduction*). This incorporates both a **geographical** requirement i.e. fixed physical location, and a **time** requirement i.e. not a temporary presence for activities of a preparatory or auxiliary nature for the type of business.

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[12] Implementation of the Ottawa Taxation Framework Conditions, The 2003 Report, OECD Committee on Fiscal Affairs. Source: http://www.OECD.org/taxation

[13] Available on The OECD website http://www.OECD.org/taxation

Resident and non-resident profits/income are determined and taxed by the source country on the separate entity accounting and arms length principles. Thus each legal person or PE is generally treated as a separate taxpayer regardless of relationships with other entities[14].

The OECD considers the PE definition applies to e-commerce. In particular:

1. a website is not a PE;

2. website hosting does not result in a PE for the hosted business;

3. a Internet Service Provider (ISP) will not generally constitute a PE for service receivers; and

4. location of computer equipment e.g. a server, performing activities of a preparatory or auxiliary nature is not a PE.

There are some classifications of profit that are taxed by the source country regardless of the existence of a PE in the country. Those are from:

1. immovable property (e.g. hotels and mines etc.);

2. performance of entertainers and athletes;

3. certain types of payments e.g. dividends, interest, royalties or technical fees where a limited tax on the gross income is levied;

4. collecting insurance premiums or insuring risks; and

5. provision of services if the provider's presence exceeds 183 days in 12 months.

However in spite of a PE, profits from airline and shipping operations are not taxed in the source country.

The OECD Model Tax Convention (and DTAs) tie breaker rules provide that a company with dual residence is resident only where its place of effective (key) management is situated[15]. This concept has caused much contention resulting in the OECD issuing a discussion paper in 2003[16]

There is always the risk that business conducted in non OECD member countries could be double taxed.

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[14] Report of Business Profit TAG November 2003. OECD. http://www.OECD.org/taxation
[15] *Ibid*
[16] Place of effective management concept: Suggestions for changes to the OECD Model Tax Convention, OECD, May 2003. OECD. http://www.OECD.org/taxation.

14. The response by the NZ Inland Revenue Department (IRD)

New Zealand values its membership of the OECD and is contributing to the e-commerce debate via the OECD committees while adopting a pragmatic approach to implementation of taxation policy.

The IRD first published its 'Guidelines to Taxation and the Internet'[17] in March 1998 and updates this with current legislative and policy changes. The IRD:

> '…applies the principle of neutrality when dealing with e-commerce - that is, there should be no tax advantage or disadvantage for individuals or entities conducting e-commerce in comparison to other forms of commerce'[18] and
>
> "… where relevant, current tax laws and interpretations will be applied to e-commerce transactions"[19]

The May 2002 guide[20] is a very useful and practical summary of the IRD's approach to e-commerce. Indeed for any business or individual it is an excellent start to the department's classification of e-commerce transactions.

In the rapidly evolving e-commerce environment corrective legislation takes time to implement. For instance the NZ government's electronic strategy[21] identified the non-taxation of imported services as potentially undermining the GST base in 2000. This is again referred to in the IRD's Guide and discussed above, but took until late 2003 to close the loophole. The OECD recommends the new GST reverse charge mechanism.

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[17] Now called 'Guide to tax consequences of trading over the internet', NZ Inland Revenue Department, May 2002, Source: http://www.ird.govt.nz/library/ecommerce/

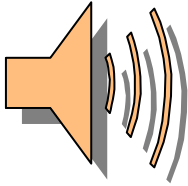
[18] *Ibid* p 5

[19] *Ibid* p 14

[20] *Ibid*

[21] E-Commerce: Building the Strategy for New Zealand, NZ Inland Revenue Department, November 2000

Work Preparation



Read and study the material required for this week.

Review the following questions.

Farming Taxation

1. Mark MacDonald is a dairy farmer. He wishes to know which of the following expenses are deductible.

a. Depreciation on the farmhouse (brick with a wooden frame).

b. The purchase and running expenses of the family car.

c. The purchase of grass seed and the sowing of new pastures.

d. Construction of new fencing and repairs to old fences.

e. Fertiliser and top dressing expenditure.

f. Purchase of hay and supplementary feeding materials.

g. Telephone rental and toll expenses.

h. Electricity for homestead use.

i. The purchase of 30 cows.

2. John Deere is a dairy farmer. He has made a significant amount of profit this year and is considering utilising the Income Equalisation Scheme. Your task is to write a letter to Mr Deere advising him of the requirements that he must meet to use the scheme and what the basic rules are regarding the application of the scheme.

Taxation of E-commerce transactions

3 How does e-commerce differ from traditional commerce? Give two examples.

4 Explain how the arrival of e-commerce has affected rules of 'residence jurisdiction' and 'source of income' methods of taxation. Clearly illustrate how these methods work.

5 Do you think the reverse charge (self assessment) on GST will increase the NZ tax collection? Explain whether this is so and how this charge operates.

6 For B2C service and intangible e-commerce transactions the OECD has recommended an interim registration of consumers. Why is the OECD not recommending a permanent registration system? Can you think of other ways of capturing consumers in the GST taxation net when transacting e-commerce?

7 The NZ IRD says it wants to

Maintain transaction neutrality between e-commerce and traditional commerce and where applicable apply current taxation laws and interpretations to e-commerce.

(a) What is the IRD's reasoning behind these statements?

(b) What other taxation principles are important?

Commerce Clearing House (2008). ***New Zealand Master Tax Guide for Students*** **(Chap 34: *E-Commerce*). Wellington: Author.**

Chapter 34 E-COMMERCE

	Para
Introduction	34-010
Residence and Source	34-020
Double Tax Agreements	34-030
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¶34-010 Introduction

This chapter considers domestic and international tax issues which arise as a result of e-commerce and the Internet in particular. For more detailed information, see CCH, *Guide to Taxing Internet Transactions*. Also see the New Zealand Institute of Chartered Accountants seminar paper, "Tax and E-commerce", May 2002.

E-commerce is a business activity carried on by electronic means. It has been defined as "any transaction involving the exchange of goods and services between two or more parties using electronic tools and techniques" (US Treasury Department, "Selected Tax Policy

Implications of Global Electronic Commerce").

The *Income Tax Act 2004* does not contain specific provisions that contemplate trading taking place within an e-commerce environment. As such, determining the taxation consequences of any e-commerce transaction involves using the parameters of our existing tax framework, which is sometimes unsuited to the task. Concepts of residence and source, which underpin our tax system's base for imposing tax, potentially become very complex when considered in an e-commerce context. The Inland Revenue Department produced a booklet in May 2002, "Guide to tax consequences of trading over the Internet" (hereafter referred to as "the IRD guide"). This is available on the Department's website at www.ird.govt.nz.

The New Zealand tax system is not unique in this regard. Every jurisdiction is struggling with exactly the same challenges. In recent years the OECD has served as a focal point for member countries to meet and discuss these tax issues, and attempt to steer towards some collective conclusions as to how these problems should best be resolved. New Zealand's Inland Revenue Department has shown a willingness to follow the OECD's lead in the recommendations it makes. The discussion document issued by the Government in June 2001 entitled "GST and Imported Services" is an example of this: the recommendations contained in the discussion document reflect those made by the OECD's technical advisory group on consumption taxes.

In 2003 the *Goods and Services Tax Act 1985* was expanded to cover e-commerce transactions. See ¶32-066 for telecommunications services and ¶32-400 for GST on imported services. The Department has also issued its interpretation guideline on the New Zealand income tax implications for payments derived from New Zealand by non-resident software suppliers. See ¶26-210.

RESIDENCE AND SOURCE

¶34-020 Residence

IT04 s OE 2(1); IT07 s YD 2

The usual income tax rules apply to cross-border Internet transactions. See ¶5-135 to ¶5-150. The test for residence of an individual (see ¶1-120) poses no particular difficulty in an e-commerce environment.

Residence of a company

A company can be treated as resident in New Zealand under any one of four tests. See ¶1-140. The last two tests, which define a company as resident if it has its centre of management in New Zealand or the control of the company by its directors is exercised in New Zealand, can raise some difficulties in an e-commerce environment.

The traditional test for deciding whether a company has a centre of management in New Zealand focuses on factors such as where the directors reside and where board meetings are held. These factors cannot be so readily relied on in an e-commerce environment. For example, a company that has three directors based in three different countries might hold directors' meetings using teleconferencing or email. In such a case, the company might be resident in all three jurisdictions, so that the "tie-breaker" provisions of the relevant double tax agreements are invoked.

Control of the company can be exercised through untraceable electronic communications and/or through directors based in several different jurisdictions. The legislative concepts of control and centre of management, therefore, raise difficulties in determining whether a company is resident in New Zealand for tax purposes.

The OECD released a discussion draft in January 2001 on "The Impact of the Communications Revolution on the Application of 'Place of Effective Management'" as a tie breaker rule.

¶34-025 Source of income

IT04 s OE 4; IT07 s YD 4

The *Income Tax Act 2004* imposes income tax on income derived in New Zealand. Practical problems arise in an e-commerce environment in deciding exactly from where income is sourced. Traditionally, income is sourced in the jurisdiction where the transaction occurs or where title and risk pass to the purchaser. For example, a US company that sells various items to several overseas countries by mail order catalogue will have its income taxed in the United States. A similar transaction carried out over the Internet might appear to be more complex, but the analogy with mail order is useful.

Example:

A New Zealand resident purchases a gift for his sister from an online catalogue while on holiday in Australia. The order is placed and payment made through a credit card company based in the United States. The company selling the goods is based in England. It sends the gift to the buyer's sister who lives in Singapore. Depending on the mail order company's other activities, its income from the sale would most likely be taxed in England.

The Income Tax Act deems a number of classes of income to be sourced or derived from New Zealand. The categories relevant to the e-commerce environment are listed below.

Income from any business wholly or partly carried on in New Zealand (s OE 4(1)(a))

In an e-commerce environment, the types of transactions likely to constitute a business wholly or partly carried on in New Zealand include trading in merchandise and the provision of services. Preliminary or marketing activities are unlikely to be caught by this provision.

The more interactive a website is, the more probable it is that the party offering goods and services will be carrying on business in New Zealand. A non-interactive website using an offshore server that merely provides advertising is unlikely to be considered to be carrying on business in New Zealand. On the other hand, a website that:

- provides contact with New Zealand customers
- has a New Zealand server
- targets potential New Zealand customers, and
- is tailored to the New Zealand environment,

is far more likely to be considered to be carrying on business in New Zealand.

Once a non-resident is regarded as wholly or partly carrying on business in New Zealand, in the absence of relief under a relevant double taxation agreement the issue becomes one of apportionment of income and profits to New Zealand and other sources.

Income derived from the sale or other disposition of any property situated in New Zealand (s OE 4(1)(l))

For income to fall within this category, the property in question must be situated in New Zealand when the sale (or disposition) is concluded. Sometimes this will be clear-cut — for example, if an order for goods is lodged by email and paid for by credit card while the goods are held in New Zealand. On the other hand, if the sale is concluded while the goods are out of New Zealand, there is no New Zealand source. E-commerce makes the distinction between the provision of goods, services and intangibles more difficult to determine. For example, the sale of a magazine or newspaper will normally be treated as the sale of goods. Where the magazine or newspaper is delivered digitally rather than on paper, the question arises as to whether it is the provision of goods or whether it is a service that is being provided (which would be outside the scope of this provision of the Income Tax Act) or a licence to use the copyright. This is a difficult area of the law. It is generally accepted that, for the purpose of indirect or consumption taxes (such as GST), the provision of a digital product is not the provision of goods. This view appears to have been confirmed in 2003 — see ¶32-400.

Income derived from contracts performed (wholly or partly) or made in New Zealand (s OE 4(1)(q))

The issue of whether a contract has been either made or partly performed in New Zealand becomes complex where Internet transactions are concerned. The following example illustrates some of the inherent difficulties in deciding where an e-commerce contract is made.

Example:

Using an electronic bidding system, a US manufacturer emails qualified suppliers throughout the

world notifying them that a job is up for tender and providing them with access to information through the Internet. The suppliers use the system to return their bids. A New Zealand bidder is successful.

Contract law principles would dictate that the contract is made where the bid has been accepted, ie the US location. This would expose the New Zealand bidder to US tax on any profit on the supply. However, the New Zealand bidder would receive double tax agreement (DTA) relief provided it had no permanent establishment in the US. Therefore, as prudent business practice, vendors should clearly state on the website whether the data constitutes an invitation to treat or an offer. If it is an offer, the foreign bidder would be taxed in its own jurisdiction. Income from contracting to provide a service may be caught by the source rule covering "contracts made or performed in New Zealand".

Payments for the use, or right to use, any personal property in New Zealand (s OE 4(1)(s))

Such payments are deemed to be sourced from New Zealand if:

- the person paying for use of the property is a New Zealand tax resident, or
- the person paying for the use of the property is a non-resident and is allowed a deduction on the payments in New Zealand.

An e-commerce transaction that would potentially trigger this provision is one that involves the use of a New Zealand-based Internet service provider (ISP). (An ISP is an entity that provides access to the internet.) However, a New Zealand ISP will not, in itself, give a foreign website owner a taxable presence in New Zealand. The exception would be if the ISP is considered to be a dependent agent for the website owner. See ¶34-030.

Income from salaries and wages earned in New Zealand (s OE 4(1)(c))

As far as salaries and wages are concerned, most DTAs provide that an employee will be taxed in New Zealand only if he or she has been "present" in New Zealand for 183 days in any 12-month period. This has repercussions for workers who are employed on a telecommuting basis.

Example:

A New Zealand software company that operates in a highly specialised field decides to recruit new staff overseas. Two employees are hired, one from the US and one from Canada. Both new employees telecommute, communicating with their new employer and their fellow workers solely by email and telephone. Neither employee has any plans to move to New Zealand.

Some commentators have suggested that, because the relevant wording in DTAs requires only a "presence" in New Zealand (rather than a physical presence), an employee who is "virtually present" in New Zealand should be taxed in New Zealand. The better view may be that an employee must be physically present in New Zealand to be taxed in New Zealand. The idea of a "virtual presence" being sufficient runs against a basic cornerstone of taxing the derivation of income — namely, it is taxed where the physical effort takes place. Depending on the domestic laws that apply in the Canadian and US jurisdictions, each employee in the above example may be taxed in his or her own jurisdiction.

Income derived from any other source in New Zealand (s OE 4(1)(u))

This provision of the Income Tax Act has not been utilised to a great extent by the Inland

Revenue Department. In the absence of provisions specifically designed to capture e-commerce income it considers to be sourced in New Zealand, the Department may decide to make more use of this catch-all provision.

Royalties (s OE 4(1)(r))

Royalties are discussed at ¶34-035.

DOUBLE TAX AGREEMENTS

¶34-030 Double tax agreements

IT04 s BH 1; IT07 s BH 1

The principles governing double tax agreements (DTAs) are discussed at ¶26-335 – ¶26-350. Where a non-resident has a "permanent establishment" (PE) in New Zealand and the business profit is attributable to the PE, the relevant DTA will provide that the non-resident entity is subject to tax in New Zealand.

Permanent establishment

Permanent establishments are discussed at ¶26-337. E-commerce raises several questions about what does and does not constitute a PE, for example, whether having the ability to access a website in a country constitutes having a PE in that country; whether the presence of a server constitutes a PE; whether the presence of a virtual office constitutes a PE; and whether using an Internet service provider (ISP) in a country constitutes having a PE in that country.

The OECD has concluded that human intervention is not a prerequisite for a PE to exist and further clarification of how this concept applies in the context of e-commerce was included in the January 2003 update of Art 5 of the OECD Model DTA.

Website

Article 5 of the OECD Model DTA states that a website cannot, in itself, constitute a PE. Therefore the taxpayer is not considered to have a physical presence in the foreign jurisdiction simply by the fact it has a website in that jurisdiction.

Web server

A web server is a computer on which the software and data that make up a website resides. A web server that is essentially an advertising site would be unlikely to trigger the PE provisions of a DTA because advertising is generally considered to be preparatory or auxiliary in nature. This activity is outside the scope of a PE. A web server that both

presents information and records orders (or concludes contracts) may result in a PE in a country if it is leased or owned by the taxpayer in question.

Virtual office

Some companies have their base in one location but operate in a number of other locations, using a variety of telecommunications technologies: cellular phones, laptop computers, video conferencing equipment and email. These virtual offices make it possible for entire projects to be carried out without the need for an office (in the traditional sense of the word) in that country. It is unlikely that a virtual office conducting business in New Zealand would be considered a PE under DTAs based on the OECD model. The model (on which New Zealand DTAs are based) assumes, but does not specify, that a physical presence is required.

Internet service provider (ISP)

An ISP is an entity that provides access to the Internet. There has been some suggestion that the location of a person's ISP determines the jurisdiction in which that person can be said to be located. There has also been some discussion of whether an ISP can be said to be a dependent agent of the internet user. The OECD, however, has since concluded that the ISP is an agent of independent status acting in the course of its business when it provides access to the internet and facilitates a transaction. As an agent of independent status, the ISP will not trigger the PE provisions in respect of its principal (the Internet user). This conclusion was affirmed in the January 2003 update of Art 5 of the OECD Model DTA.

OECD and e-commerce

In various papers published on e-commerce and taxation, the OECD has come to a number of conclusions that should assist enterprises carrying out cross-border internet transactions. The conclusions include the following:

- A website on a server located outside a jurisdiction but capable of being accessed by persons in that jurisdiction does not give the website owner a PE or taxable presence in that location.
- A website located in a jurisdiction which is non-interactive and merely displays advertising or other preliminary information will not usually constitute a PE.
- An interactive website which allows for the placing and fulfilment of orders may constitute a PE. However, if the server is moved about within the same country it will not constitute a fixed place of business and will not be a PE.
- A website in itself does not constitute a fixed place of business as it does not involve any tangible property. However, where the enterprise has control of the server by virtue of either ownership or rental of the server, the website could constitute a PE. See

examples B and C in Part 2, section 4 of the IRD guide.

• A website is not an "agent" of the enterprise and therefore does not give the enterprise a PE.

• The use of an ISP does not constitute a PE. See example D in Pt 2, s 4 of the IRD guide.

• A primary issue which is central to the notion of a PE is the concept of a "business". Whether a business exists is dependent on the activities of the enterprises in the foreign jurisdiction. Spasmodic activity which is not specifically targeted at the jurisdiction is not likely to constitute a business in that jurisdiction.

WITHHOLDING TAXES

¶34-035 Withholding taxes

IT04 subpart NG; IT(WP) reg 2(1), 4, Sch 1, Pt E; IT07 subpart RF, RD 8, Sch 4

The two sorts of withholding tax particularly relevant to e-commerce transactions are non-resident withholding tax (NRWT) and non-resident contractors withholding tax (NRCWT).

Non-resident withholding tax

Non-resident withholding tax is imposed on royalties sourced in New Zealand. The rules governing NRWT are discussed at ¶26-240 – ¶26-330. Many e-commerce transactions potentially involve the payment of royalties to non-residents. The OECD technical advisory group (TAG) on the "Treaty Clarification of Issues arising from E-commerce" published its final report in February 2001. The report identifies a number of typical e-commerce transactions and analyses them in terms of being either business profits or royalties. If the products are provided by an offshore party and income is classified as business profits, that offshore party will generally not be subject to income tax in the purchaser's jurisdiction unless it has a permanent establishment (PE) there — see ¶34-030. If income from the products is classified as a royalty, it will be subject to NRWT.

The TAG report is considered to be favourable towards online vendors because the majority of the receipts have been classified as business profits. Therefore, unless the vendor has a PE in the foreign jurisdiction, it will escape tax in that jurisdiction. Income from the following information products has been classified by TAG as business profits: downloading of digital products; updates and add-ons; online shopping portals; online professional services; digital products downloaded for single use; applications hosting online auctions; search and retrieval of information; advertising; data delivery services; online technical support; streaming audio and video; subscriptions to websites; data warehousing; and revenues from

affiliate programs.

In contrast, income from the following items has been classified by TAG as royalties: use of copyrighted content (ie the right to publish or display copyrighted content); access to an interactive website; downloading and commercial exploitation (ie the right to reproduce and sell a product); and use of undivulged technical information (eg trade secrets).

The January 2003 update of the OECD tax convention included changes to the commentary to Art 12 (Royalties) of the OECD Model resulting from a consideration of whether particular e-commerce payments should be characterised as payments for the sale or lease of property, for the provision of a service, or as a royalty. In 2003 the Inland Revenue Department finalised its interpretation guideline on non-resident software suppliers' payments derived from New Zealand. For discussion of the guideline, see ¶26-210.

Non-resident contractor withholding tax (NRCWT)

The rules governing NRCWT are discussed at ¶26-330. Any "contract activity" carried out by a non-resident is caught by the Income Tax (Withholding Payment) Regulations 1979. The definition of a contract activity appears to be broad enough to include the provision of services over the Internet where the non-resident providing the service uses a New Zealand server (the suggestion being that using a New Zealand server has the effect of the services being performed in New Zealand). It is not clear whether the services have to be *physically* performed in New Zealand in order to be caught by the withholding regulations. Therefore, where services are provided over the internet to a New Zealand person, it could be said that they are being provided in New Zealand. However, see Pt 2, s 8 of the IRD guide.

Nevertheless, the Inland Revenue Department's current view appears to assume that services must be physically performed in New Zealand to be caught by the Income Tax (Withholding Payments) Regulations (see Pt 2, s 8 of the IRD guide).

There is a provision in the withholding regulations for the Commissioner to issue an exemption certificate which relieves the contract payment payer from the liability to deduct withholding tax. See ¶26-330. The exemption certificate is granted in a number of circumstances, including where the Commissioner is satisfied that the payer will have no PE in New Zealand under the provisions of the relevant double tax agreement. As a practical point, exemption certificates are not granted with retrospective application. Therefore, there could be a contingent liability for NRCWT on the basis that although the person providing the service is prima facie entitled to an exemption certificate, no exemption has been applied for.

APPORTIONMENT

¶34-040 Apportionment of business profits

IT04 s FB 2; IT07 s YD 5

If internet transactions are taxed in New Zealand, apportionment becomes a material issue. This is because there may well be several jurisdictions involved in the transaction, rather than just New Zealand and one other jurisdiction. Domestic legislation in the form of s FB 2 provides for an apportionment of income and expenditure incurred in gaining it if:

- any business of a taxpayer is carried on partly in New Zealand and partly outside New Zealand, or
- a contract is made in New Zealand and is wholly or partly performed by a taxpayer outside New Zealand, or is made outside New Zealand and is wholly or partly performed by a taxpayer in New Zealand.

Various mechanisms used on the internet can result in apportionment issues because of the existence of multiple contributors to one transaction. One example of this is the use of hypertext links.

In cases where the taxpayer has a permanent establishment (PE) in New Zealand, the relevant double tax agreement (DTA) will complement the provisions of s FB 2. Article 7 of the OECD Model Convention maintains that only profits attributable to the PE may be taxed in that jurisdiction.

A discussion paper was released in January 2001 by the OECD business profits technical advisory group regarding the attribution of profit to a PE involved in electronic commerce transactions.

GOODS AND SERVICES TAX

¶34-050 Exported goods and services

GST s 11, 11A

The usual GST rules apply to taxpayers selling goods or services over the Internet to a person based offshore. See ¶32-032.

Record-keeping requirements

To satisfy the Inland Revenue Department that goods have been exported, exporters should keep a copy of the international parcel customs declaration stamped by a postal officer (or the invoice if the goods have been couriered), together with any customs export entry documentation.

The zero-rating of services provided to non-residents who are outside New Zealand when the services are performed (see s 11A(1)(k) of the *Goods and Services Tax Act 1985*) is one area where e-commerce traders will run into difficulties if they cannot provide the

Department with adequate documentation. The key elements of this provision are that:

- the services must be supplied to a non-resident, and
- the non-resident must be outside New Zealand when the services are performed.

See further at ¶32-035 under "Services supplied to non-residents". Areas of potential difficulty for those zero-rating their services under s 11A(1)(k) include:

- failing to ensure that the recipient of the goods is in fact a non-resident
- failing to ensure the non-resident is outside New Zealand when the services are performed, or
- failing to reasonably ascertain whether any person in New Zealand will receive the services for domestic consumption.

Example 1:

A New Zealand teacher runs an internet service for students wishing to learn English as a second language. The students (who are based both in New Zealand and offshore) submit their course work by email. When invoicing her students, the teacher takes an educated guess (after examining a student's email address) as to whether the fee should be zero rated or have GST added. She then emails the invoices to her students.

The Department has stated that an email address does not provide sufficient proof that a person is outside New Zealand because is relatively easy for a New Zealand resident to get an overseas domain name (maryjane@hotmail.com, for example). In this situation, the teacher should, at the very least, obtain an email certification from any student given a zero-rated invoice that he or she is not resident in New Zealand and will not be in New Zealand when receiving the teaching services.

Example 2:

A New Zealand school offers an online service for students wishing to learn English as a second language. The students submit their course work by email. A proportion of the school's students are foreign students in New Zealand on student or working visas. Some of these students do not pay the fees themselves; rather, their overseas parents are invoiced directly and they pay for their child's tuition. The school assumes that the invoices can be zero rated because it is invoicing non-residents and the invoices are sent by mail to overseas addresses.

The school should not be zero rating the invoices because the teaching services will be received by another person (the student) who is in New Zealand and does not receive the services in the course of his or taxable activity. Each time the school enrols a student, it should be inquiring as to the student's country of residence, whether the student will be in New Zealand for the duration of the course, and whether the student or some other person will be paying for the course. This information could be incorporated into the school's enrolment form so that the school retains a written record of it.

¶34-060 Imported goods and services

Imported goods

The usual GST rules apply to the importation of goods ordered via the internet. To support a claim for an input tax credit, the New Zealand Customs Service requires a customs import entry (including electronic entry) document or a deferred payment of duty statement. See further at ¶32-062.

"Imported services" — buying services over the internet from non-residents

Services provided by non-residents may be subject to GST: see ¶32-400 – ¶32-470. In respect of the provision of telecommunication services, see ¶32-066.

RECORD-KEEPING

¶34-070 Record-keeping

The *Electronic Transactions Act 2002* is intended to:

- reduce compliance and transaction costs for business and the general public
- remove legislative impediments to dealing with Government electronically
- promote consistency between New Zealand law and that of our major trading partners, particularly Australia, and
- promote the development of electronic commerce.

The Department has released standard practice statement GNL-430, "Retention of business records by electronic means", published in *Tax Information Bulletin* Vol 15, No 12, December 2003, p 57–61. For further detail see ¶1-505.

For GST record-keeping requirements in relation to certain imported services, see ¶32-460.

Inland Revenue Dept (2002) "Guide to tax consequences of trading over the internet", pp 3-6 & 14-16 http://www.ird.govt.nz/library/ecommerce/

Part 1 – General overview

1. General points about the New Zealand taxation system
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   - Permanent establishment
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   - Banner space advertising and barter
   - Timing of income

1. General points about the New Zealand taxation system

New Zealand taxes the worldwide income of its tax residents.
See our website at http://www.ird.govt.nz/.
For a definition of tax resident you can view our booklet *NZ Tax Residence (IR 292)* online at
http://www.ird.govt.nz/library/publications/generalinformation.html

Tax residents – individuals

Generally you are a New Zealand tax resident if:

- you are in New Zealand for more than 183 days in any twelve-month period, or
- you have an "enduring relationship" with New Zealand (that is, a permanent place of abode), or
- you are away from New Zealand in the service of the New Zealand Government.

Tax residents – companies

For tax purposes a company is resident in New Zealand if:

- it is incorporated in New Zealand, or
- it has its head office in New Zealand, or
- it has its centre of management in New Zealand or
- control of the company by its directors is exercised in New Zealand, whether or not decision making by its directors is confined to New Zealand.

Resident for GST purposes

In addition to the general resident explanation above for GST purposes:

- a person is a resident in New Zealand if they carry on, in New Zealand, any taxable activity, or other activity, while having any fixed or permanent place in New Zealand relating to that taxable or other activity
- a person who is an unincorporated body is resident in New Zealand if the body has its centre of administrative management in New Zealand.

Source of income

New Zealand also taxes all income sourced in New Zealand, whether it is derived by resident or non-resident taxpayers. A range of income can be derived from New Zealand. This includes generally:

- Income from any business wholly or partly carried out in New Zealand
- Income from contracts made or wholly or partly performed in New Zealand
- Income from the sale of tangible, or intangible, property situated in New Zealand
- Interest or a redemption payment, derived from or in respect of money lent in New Zealand:
- Interest or a redemption payment, derived from or in respect of money lent outside New Zealand to—

  any person who is resident in New Zealand, except where the money lent is used by the person for the purposes of a business carried on by the person outside New Zealand through a fixed establishment outside New Zealand; or

  any person who is not resident in New Zealand if the money lent is used by the person for the purposes of a business carried on by the person in New Zealand through a fixed establishment in New Zealand:
- Payments of any kind to the extent to which they are paid as consideration for the use of, or the right to use, in New Zealand, any personal property, being payments—

  by a person who is resident in New Zealand; or

  by a person who is not resident in New Zealand and are allowed as a deduction to the person for the purposes of tax in New Zealand:
- Royalties paid by a person resident in New Zealand and not for a business they carry on outside New Zealand through a fixed establishment outside New Zealand
- Royalties paid by a person not resident in New Zealand and allowed as a deduction for their tax in New Zealand
- Income derived directly or indirectly from any other source in New Zealand.

(For full details refer to Section OE 4 (1) of the Income Tax Act 1994.)

Non-residents

For an explanation of non-residents' tax liabilities see page 11 of our booklet *New Zealand Tax Residence (IR 292)*.

Double tax agreements (DTAs)
New Zealand has DTAs in place with a number of countries. These generally modify the tax treatment of income flows between the two countries.

E-commerce
Inland Revenue applies the principle of neutrality when dealing with e-commerce—that is, there should be no tax advantage or disadvantage for individuals or entities conducting e-commerce in comparison to other forms of commerce.

Note: That if you are unsure about your tax obligations please phone us on 0800 377 774.

2. Getting started

If I start a new business what are my obligations to Inland Revenue?
We can provide you with help and support through our Call Centres and free tax advisory services operated by Business Tax Information officers. These officers provide advice to all types of small and medium businesses and organisations. They explain the taxes you need to know about and use a selection of booklets and worksheets to help with this.
We also provide a Maori Community tax service that provides advice for Maori small and medium businesses and organisations.

If I start a new business and trade only on the internet what are my obligations to Inland Revenue?
We prefer that you contact the Business Tax Information Officers located at most sites. They can provide help and support for you. They will explain Inland Revenue requirements for GST, income tax and payroll and help with these.

If you want to meet with one of our staff call us on 0800 377 774.
Alternatively if you haven't registered for GST, or as a new employer, you can ask for an advisory visit by simply ticking the box on the registration form.

I am already trading but haven't previously used the internet. Do I need to let Inland Revenue know that I have started trading electronically?
No, as the electronic trading will be an extension of your existing business.

3. What do I need to do?

What business records do I need to keep of my transactions if I trade electronically?
You are required to keep sufficient records to make complete and correct tax returns. You also need to be able to demonstrate in response to our enquiries that this is the case. The precise nature and extent of the records to be kept will depend on the type and size of your business and the systems you operate.

Note: All records must be retained in New Zealand—unless, after written application, authorisation is given by the Commissioner of Inland Revenue to hold them outside New Zealand.

For legislative detail refer to Section 22 of the Tax Administration Act 1994 and Section 75 of the GST Act 1985.

Do I need to keep special records of sales and purchases made electronically?
All records relating to the trading activities of the business must be retained to enable the correct gross income, allowable deductions and tax positions to be confirmed. This includes records of sales and purchases made electronically.

Do I have to retain electronic records on hard copy also?
No. As long as all information contained in the original transactions can be recovered and re-presented.

How long do I have to keep records?
Generally business records must be kept for at least seven years, after the end of the year to which they relate. This includes electronic records.
Payroll records for employee wages and costs must also be retained for seven years.

Can I use encryption to safeguard my records?
Yes, but you must make sure that you can recover the original information in an unencrypted form so that you can make a complete and correct tax return.
You also need to be able to demonstrate in response to our enquiries that this is the case, and if we need to check your records they should be unencrypted.

What if I change my computer or software?
If you make hardware or software changes:

- facilities for retrieving electronic records that have been stored on the former system must be retained, or
- the electronic records must be converted to a compatible system and both sets of files retained complete with documentation showing the method of transfer and controls in place to ensure the transfer was complete and accurate.

Is there a particular commercial software package I should use?
No. You are free to use whatever package suits your business so long as it can produce information from which you can make a complete and correct tax return.

Note: Inland Revenue has produced an exposure draft ED0026 Retention of Business Records by Taxpayers about electronic record keeping. It was issued for consultation and is expected to be released soon in its final form.

Part 2 – Income tax and electronic commerce

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6. Companies – residence, centre of management
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1. Introduction

This part of the guide provides further information to help understand the income tax treatment of e-commerce transactions. It is intended to provide a broad understanding of how the current income tax law and principles apply to taxing income from e-commerce.

2. Income tax overview

There are no separate provisions within the income tax laws that deal only with e-commerce. Where relevant, current tax laws and interpretations will be applied to e-commerce transactions.

The current bases of income taxation are:

- "residence"–New Zealand residents are liable for taxation on their worldwide income, and
- "source"—with non-residents taxed on income sourced from New Zealand.

For companies the broad principles of incorporation, physical presence, and the place of central management and control, are used to determine whether the income is derived in New Zealand and therefore liable for tax in New Zealand.

If business operations are carried out in New Zealand, income derived from those operations is usually said to be sourced in New Zealand and liable to tax here.

Where business operations are carried out is a question of fact and degree. Under New Zealand tax laws a non-New Zealand incorporated company will be treated as resident in New Zealand if:

- its head office is in New Zealand or,
- its centre of management is in New Zealand, or
- control of the company by its directors is exercised in New Zealand.

Where Double Taxation Agreements (DTAs) apply, consideration is given to the place of effective management. If residency arises under both treaty countries domestic legislation there may be dual residence and a "tie breaker" test may be applied

Permanent establishment (DTAs) and e-commerce

The OECD recently concluded that generally a website in itself does not constitute a permanent establishment, nor does a web hosting arrangement through an internet service provider (ISP).

The OECD report dealing with this "Clarification on the Application of the Permanent Establishment Definition in E-Commerce" can be accessed on the link www.oecd.org/daf/fa/e_com/public_release.htm. (The department supports this position.)

Note that the presence or absence of a permanent establishment is relevant only where there is a DTA between New Zealand and the jurisdiction concerned.

This report considers human intervention is not a requirement for the existence of a permanent establishment. It also states that whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through the equipment exceed the "preparatory or auxiliary" threshold—and this can only be decided on a case by case basis.

In the OECD Model Tax Convention, paragraph 4 (e) of Article 5 on Permanent Establishment states generally that the term "Permanent Establishment" shall be deemed not to include "the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary nature."

The Commentary to Article 5 states in paragraph 24 "It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole."

Examples given in the report of preparatory or auxiliary activities include:

- providing a communications link
- advertising goods or services
- relaying information through a mirror server
- gathering market data for the enterprise
- supplying information.

It is suggested in the report that if the location is used to operate a server that hosts a website that is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers the location will not constitute a permanent establishment.

If however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products), and are performed automatically through the equipment located there, these activities cannot be considered to be merely preparatory or auxiliary. In the latter situation, there may be a need to attribute profits to the permanent establishment.

The OECD has also released a draft report "Attribution of Profit To a Permanent Establishment Involved in Electronic Commerce Transactions" which provides examples of some methods of attributing profits.
Refer www.oecd.org/daf/fa/e_com/public_release.htm. (As this is a draft report only the department has not published a position on it.)

New Zealand businesses using their own servers which are based in other countries may need to consider possible tax implications if their internet business activities on their website are complete and fully automated. This could amount to a permanent establishment in that country.

For a non-resident the mere presence of its website hosted on an ISP in New Zealand is unlikely to amount to a tax liability in New Zealand. However, if the non-resident owns the server located in New Zealand, this may constitute a "fixed place of business" that is, a permanent establishment—creating a liability for tax in New Zealand. Whether or not the taxpayer has a permanent establishment in the country of source may be irrelevant to determining whether that country will impose tax on the income. The presence or absence of a permanent establishment is relevant only where there is a DTA in place between New Zealand and the other jurisdiction concerned.

3. Double taxation issues

Where the business operations are in New Zealand but the website is hosted in a foreign country, double taxation may arise if the same income is also subject to tax in the host country of the website. This would depend on the tax rules (with respect to source and income) of the foreign country. Double taxation can be mitigated by the existence of a Double Taxation Agreement (DTA) between New Zealand and the foreign country and the terms of the agreement.

If the country has a DTA with New Zealand, although the total worldwide income must be returned in New Zealand, a credit will be allowed against New Zealand tax for the tax paid in the overseas country. It will be limited to the lesser of the tax paid overseas or the New Zealand tax payable on that income.

If the overseas country does not have a DTA with New Zealand there is a possibility of double taxation occurring.

In the absence of a DTA between New Zealand and the foreign country, a unilateral tax credit may be allowed for foreign tax paid on foreign sourced income.

GST Guidelines for Recipients of Imported Services (October 2004) Policy Advice Division of Inland Revenue Department pp1-6

The new rules

1. The Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 amended the Goods and Services Tax Act 1985 (the GST Act) to introduce a "reverse charge" mechanism to tax certain imports of services – for example, management, legal and accounting services, a new software installation (and after-sales service) or products downloaded via the internet.

2. From 1 January 2005 GST-registered recipients of supplies of imported services are required to add GST to the price of the services and include the tax in the normal GST return and pay it to Inland Revenue if:

- the services would be subject to GST if supplied in New Zealand; and
- the recipient makes more than a minimal level of exempt or other non-taxable supplies.

3. These guidelines explain how the reverse charge affects these supplies of imported services.

New definitions

4. The following definitions have been included in the Act as part of the introduction of the reverse charge:

- "Goods" means all kinds of personal or real property, but does not include choses in action, money or a product that is transmitted by a non-resident to a resident by means of a wire, cable, radio, optical or other electromagnetic system or by means of a similar technical system.
- "Non-resident" means a person to the extent that the person is not resident in New Zealand.

Application

5. These guidelines apply to a deemed supplier required to self-assess GST on the value of a supply of imported services. For the purposes of GST, a service is anything which is not goods or money. Any business which receives a supply of imported services, or any other person who receives a substantial supply of imported services, is potentially liable to pay GST on the supply.

Supply of imported services

6. A supply of imported services is subject to GST if:

- the services are supplied by a non-resident supplier to a recipient who is a New Zealand resident;
- the services are acquired by a person who has not in the last 12 months made (and does not expect in the next 12 months to make) supplies of which at least 95 percent in total are taxable supplies; and
- the supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity;[1]

The 95 percent threshold is consistent with the 5 percent threshold in the change-in-use adjustment rules. Therefore if a registered person is required to account for the reverse charge, it is likely that the person is already required to make change-in-use adjustments.

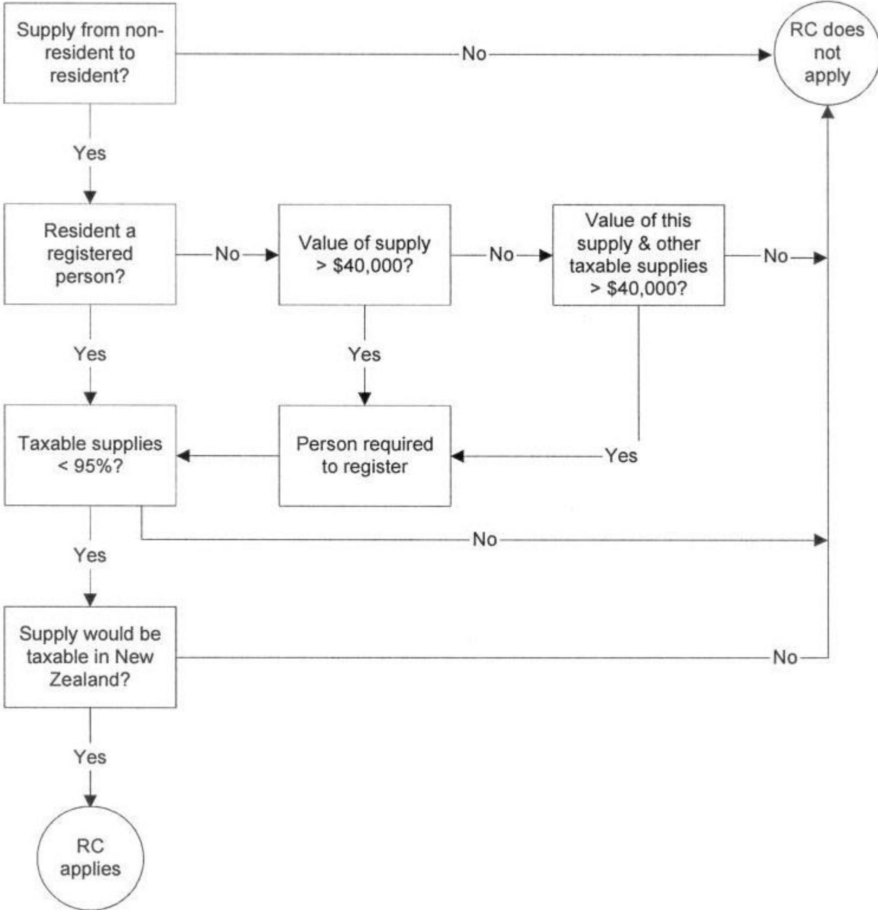
7. Supplies of services that would be exempt supplies if made in New Zealand, such as certain financial services, are not subject to the reverse charge. Also, services that would otherwise be subject to GST at 12.5% under the reverse charge can, in most circumstances, be zero-rated under section 11A if they would have been zero-rated had they been supplied in New Zealand.

8. A person required to pay GST under the reverse charge is treated as the supplier of the services for the following purposes:

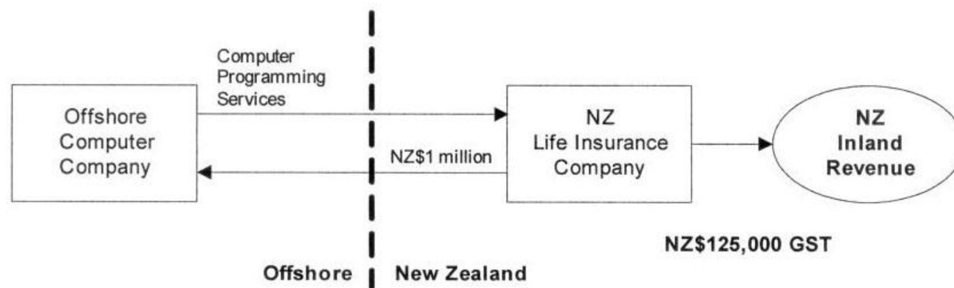
- registration;
- payment of output tax;
- record keeping; and
- avoidance.

9. For all other GST purposes the person is the recipient of services.

[1] See section 8(4B) of the Act.


Application of the reverse charge
Supply from non-resident to resident?
No
RC does not apply
Yes
Resident a registered person?
No
Value of supply > $40,000?
No
Value of this supply & other taxable supplies > $40,000?
No
Yes
Yes
Taxable supplies < 95%?
Person required to register
Yes
No
Yes
Supply would be taxable in New Zealand?
No
Yes
RC applies

Example 1: The operation of the reverse charge



An offshore computer company makes a supply of programming services to a New Zealand life insurance company. The life insurance company makes solely exempt supplies of services. It is charged $1 million for the programming services, which it pays on receipt of the services. An invoice is provided after payment is made. The two companies are not associated persons.

In this situation:

- The services are supplied by a non-resident supplier to a resident recipient.
- The services are acquired by a person who has not in the last 12 months made (and does not expect in the next 12 months to make) supplies of which at least 95 percent in total are taxable supplies.
- The supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

The New Zealand insurer is required to register for GST if it is not already registered. It is required to account for GST on the value of the supply. The value of the supply is $1 million (the consideration for the supply), so the output tax is $125,000.

Example 2: When the reverse charge does not apply

An offshore computer company makes a supply of programming services to a GST-registered New Zealand retail company. The retail company makes a mix of 98 percent taxable supplies of goods and services and 2 percent exempt supplies of financial services, such as hire purchase, to non-registered consumers. It is charged $1 million for the programming services, which it pays on receipt of the services. An invoice is provided after payment is made. The two companies are not associated persons.

In this situation:

- The services are supplied by a non-resident supplier to a resident recipient.
- The services are acquired by a person who **has**, in the last 12 months made (and **does** expect in the next 12 months to make) supplies of which at least 95 percent in total are taxable supplies.

Therefore the supply is not subject to the reverse charge because the New Zealand retailer makes taxable supplies in excess of the 95 percent threshold.

Registration requirements

10. Because imported services are treated as having been supplied by the recipient in the course or furtherance of a taxable activity carried on by the recipient, the value of imported services supplied to that person is included in the total value of supplies made by that person for the purposes of determining liability to register for GST under section 51. Although many businesses making supplies in New Zealand are currently registered for GST, the reverse charge may require others to register – in particular, any person importing services as a private consumer.

11. A person must register for GST if:

- the total value of supplies made in any month and the 11 preceding months exceeds $40,000, or
- the total value of supplies made in any month and the 11 following months exceeds $40,000.

12. Therefore a person who makes no other taxable supplies in New Zealand may be required to register as a result of importing in excess of $40,000 of services in any 12-month period. Persons who do make other taxable supplies but fall below the $40,000 threshold may be required to register if they import services which, together with other taxable supplies, exceed the threshold.

Example 3: Requirement to register for GST – importing significant amount of services

A wealthy retired businesswoman who is not registered for GST has commissioned the building of a substantial property on the outskirts of Auckland. She contracts Italian architects, designers and landscapers for the project. Plans and drawings are sent to her electronically. She is required to register for GST and pay output tax on the value of those services if, together with any other services she has imported in the same 12-month period, the value exceeds $40,000.

Example 4: Requirement to register for GST – registration threshold exceeded

A business that is not currently required to register for GST makes $39,000 of supplies that would be taxable if the business were GST-registered. It purchases an international franchise licence for $10,000. As the value of the supplies made by the business is now $49,000, the business is required to register for GST.

13. Further details on registration requirements are in the Inland Revenue booklet *GST – do you need to register? (IR 365),* which is available on the Inland Revenue website – www.ird.govt.nz.

Inland Revenue Department E-commerce and Tax Online Trading downloaded from http://www.ird.govt.nz/ecommerce-tax/onlinetrading.html on 25 March 2009.

Skip to Content

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E-commerce and tax
Te tauhokohoko a-rorohiko me te take

E-commerce and tax

Online trading

If you sell goods through online auction or sales sites, for example TradeMe or eBay, your tax obligations are exactly the same as for buying and selling goods in a shop.

Many people sell things they no longer want or need. Usually, there are no tax consequences. However, people who sell things on a regular basis may be regarded as being in business and should be declaring the sales for income tax purposes.

As a general guide, you are regarded as being in business and should be declaring sales from online (or any other) trading, if:

- you acquired the goods with the purpose of on-selling
- the purpose of the activity is to make a profit, or
- your business involves dealing in these goods.

A key factor that we would consider when deciding whether someone is in business is the frequency or regularity of their trading.

As well as income tax, businesses with online sales of over $40,000 a year are required to register for GST.

Like any other business, sufficient records must be kept for seven years to substantiate your income and expenses.

If you have been trading online for some time and think that you might have tax obligations that you have overlooked, contact us as soon as possible. See **Contact us >** for details.

Other pages in: E-commerce and tax

- New Zealand and the Organisation for Economic Cooperation and Development (OECD)

OECD Committee on Fiscal Affairs (2003) "Implementation of the Ottawa Taxation Framework Conditions", The 2003 Report, pp 7-14 & 18-23. http://www.oecd/org/ taxation

Overview of work on e-commerce

The 1998 Post-Ottawa Agenda highlighted a number of items for further work. This box lists some of the achievements since 1998:

Taxpayer Service

Member countries are encouraged to develop systems for accepting tax returns through new technologies and for receiving automated payments of social security, payroll taxes and similar deductions;

Member countries are encouraged to develop interactive telephone answering systems for standard enquiries.

Development of simplified registration procedures and processes for non-resident suppliers required to account for VAT/GST.

Creation of a dedicated OECD group to take forward, through exchange of experiences and information, successful practices in developing taxpayer service.

Tax Administration, Identification and Information Needs

International consensus reached and Guidance issued on

- requirements for Internet business identification
- transaction information, record-keeping and accountability of electronic payment systems.
- verification requirements for customer status and jurisdiction

Tax Collection and Control

Voluntary compliance encouraged through development of simplified registration for non-resident suppliers required to collect VAT/GST.

Work on automated collection of cross-border VAT/GST well advanced

Consumption Taxes

Place of taxation issues including definitions of place of consumption for B2B and B2C agreed and published.

Guidance issued on methods for verifying jurisdiction and status of customer.

Recommended approaches to effective administration and collection of tax published

International Tax Arrangements and Co-operation

Clarification in the OECD Model Tax Convention of the application of the permanent establishment definition in e-commerce.

Clarification in the OECD Model Tax Convention of the treaty characterisation of various types of e-commerce payments

Proposals on refining the concept of place of effective management as a tie-breaker rule

Work well advanced on examining how the current treaty rules for the taxation of business profits apply in the context of e-commerce and on examining proposals for alternative rules.

Electronic Commerce

1. As the digital revolution of the 1990s developed so governments around the world became aware of the potential for electronic commerce to transform the way businesses and citizens operate. New ways of doing business emerged creating a new commercial environment in which, amongst other things, businesses suddenly found themselves with access to markets around the globe. For large and small firms the physical constraints of bricks and mortar were less important, start up costs were significantly reduced, and a new entrepreneurial environment blossomed. As both businesses and consumers acquired the hardware necessary to access the Internet so e-commerce grew rapidly.

2. But at the turn of the millennium the dot.com bubble burst and a new economic structure of the Internet emerged. Although many small vendors exist, the market is now dominated by a comparatively small number of larger well-recognised companies with established international names and brands that, in the main, existed before the Internet or were built up very rapidly from the early stages of the Internet boom. The e-commerce landscape has evolved, with the majority of businesses integrating e-commerce into their mainstream activities. Larger firms are more likely to use e-commerce for end-to-end advertising procurement, ordering, payment, selling and even delivery of digitised products as they develop integrated internal and external "e-business" strategies, while most smaller firms restrict their e-commerce activities to advertising and e-mail. Business-to-consumer transactions in the main are less well-developed than business-to-business and all firms are more likely to buy and procure than sell over the Internet[1]. All these activities are encompassed under the umbrella of "electronic commerce". But in many cases the use of the Internet and other networks are another extension of "normal" business activity – with major transforming power, but within established market and firm structures. Figure 1 illustrates that growth in the general Information and Communications Technologies (ICT) sector is still comparatively strong.

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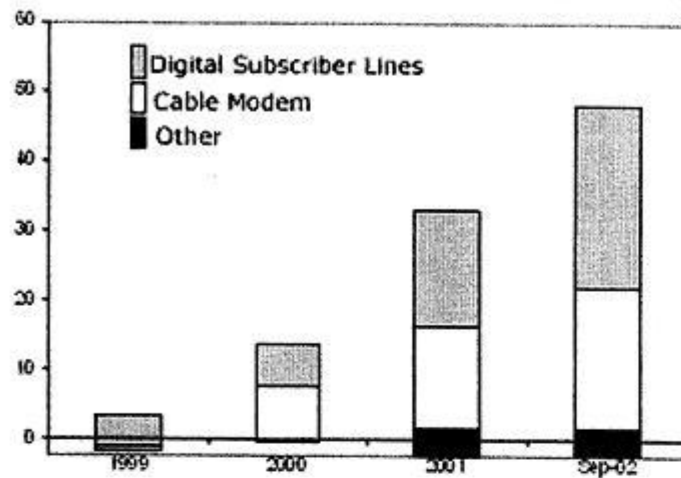
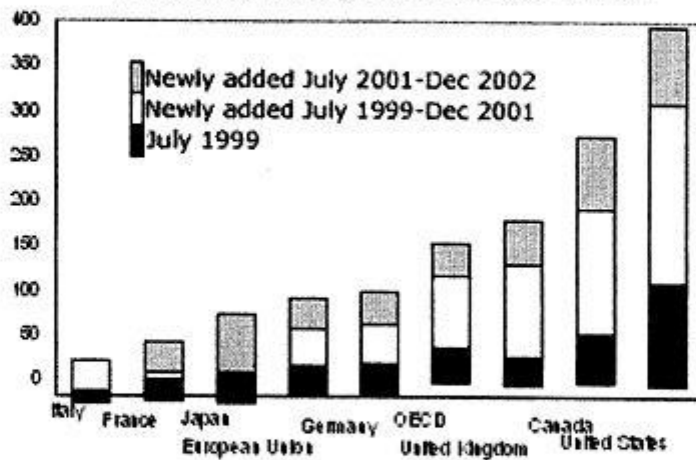
[1] B2C has been much slower to take off than optimists predicted due, in part, to vendor-side costs and brand establishment, and consumer-side worries about security of transactions, fraud, delivery problems and privacy issues

Broadband connections in the OECD area (millions)



Secure servers per million inhabitants



Source: Broadband connections in the OECD area, OECD (2003), Communications Outlook, Paris
Secure Servers per million inhabitants, OECD (www.oecd.org/sti/telecom) based on Netcraft (www.netcraft.com)

The Challenges to Individual Governments

3. As the Internet moved from its origins as primarily a means of communicating across networks to a medium supporting commercial activities tensions emerged between those who saw the Internet as a new commercial frontier and those who saw a need for governments to provide a regulatory framework within which commerce on the Internet could operate. The opportunities provided by the technology to sell products in circumstances that would formerly have required a degree of physical presence appeared to challenge the application of tax concepts developed for a physical, rather than virtual, world. Some commentators called for the Internet to become a tax-free zone in order to encourage its development. Other commentators saw the Internet offering governments a new source of revenue and advocated a "bit tax" as a means of raising such revenues

4. Governments also saw ICTs as an opportunity to improve the business of government. The potential for enabling the interface between government and citizens to develop was clear. One of the key areas identified in this respect was that of tax and, specifically, the use of the technology as a means of simplifying the interface between tax administrations and taxpayers. On-line tax returns were inevitably highlighted as an area for development that could reduce administrative burdens on both sides. Many governments use tax administration to lead the e-government revolution.

The OECD Response

5. In November 1997 the OECD organised a joint government and business conference in Turku, Finland entitled "Dismantling the Barriers to Global Electronic Commerce", the title of which underscored the OECD's overall approach. A key principle overlaying all the OECD's work on electronic commerce is the creation of an environment in which electronic commerce can develop its full potential. For tax this has required a fiscal environment that strikes a balance between development of electronic commerce and the need to secure the revenue base on which so much government expenditure is based. The Ottawa OECD Ministerial Conference in 1998 "A Borderless World – Realising the Potential of Electronic Commerce", which brought together OECD and non-OECD governments and the business community, furthered this through the adoption of the Ottawa Taxation Framework Conditions, which included a set of broad taxation principles that should apply to e-commerce (see Box 1).

Box 1: Ottawa Taxation Framework Conditions – Principles

Neutrality

i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency

ii) Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and simplicity

iii) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and fairness

iv) Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

Flexibility

v) The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

6. The links with business that had been established at the Turku conference remained one of the keys to the OECD's approach to e-commerce work. The Committee on Fiscal Affairs (CFA), from the inception of its work, required that business and non-OECD economies must continue to be involved in the implementation of the Ottawa Taxation Framework Conditions. Business had both the knowledge of the technology, and its commercial application, and was more acutely aware of the rapidly changing environment. The global reach of e-

commerce also dictated that the Committee should include key non-OECD economies in its post-Ottawa work.

7. The Committee therefore established an inclusive process through the formation of a number of Technical Advisory Groups (TAGs) comprising representatives from member governments, non-member governments and business. Box 2 sets out the post-Ottawa work structure.

Box 2: Post-Ottawa Work Structure

Direct Taxes:	*Treaty Characterisation TAG* *Business Profits TAG*
Consumption Taxes:	*Consumption Tax TAG*
Tax Administration:	*Professional Data Assessment TAG*

A Technology TAG was also created to provide expert technological input into the work of the other TAGs

2001 Progress Report

8. Following the adoption of the Ottawa Taxation Framework Conditions work progressed on their implementation and in 2001 the Committee on Fiscal Affairs (CFA) published a report, "Taxation and Electronic Commerce – Implementing the Ottawa Taxation Framework Conditions". The report summarised the considerable progress on aspects of direct taxes, consumption taxes and tax administration and went on to identify further work.

9. The report covered the full range of taxation issues noting that work since Ottawa had shown that neither of the two extremes – a tax-free environment for e-commerce nor special e-commerce taxes (such as a Bit Tax) – were acceptable to governments. The 2001 Report confirmed that the principles that apply to taxation of conventional commerce should equally apply to e-commerce.

Direct Taxes

10. The 2001 Report covered four issues related to direct taxes. The first was the clarification of the application of the permanent establishment (PE) definition in e-commerce. The Committee issued two drafts for public comments and on 22 December 2000, approved the proposed changes to the OECD Model Tax Convention. These changes clarify in what circumstances computer equipment at a given location can constitute a permanent establishment. The second issue was related to the first one: a discussion draft was produced by the Business Profits TAG on the attribution of profits to a permanent establishment constituted by a server at a given location The third issue was dealt with in the report by the Treaty Characterisation TAG which made recommendations on the characterisation of various types of e-commerce payments under the OECD Model Tax Convention and suggested some clarifications to the OECD Model Tax Convention. The fourth issue concerned the impact of e-commerce on the application of the place of effective management as a tie breaker rule. This was the subject of a Discussion Draft by the Business Profits TAG.

Consumption Taxes

11. Following the publication of the Ottawa Taxation Framework Conditions the Committee on Fiscal Affairs agreed a work programme on consumption taxes. Key issues in that programme included the development of Guidelines on the definition of the place of consumption. The Guidelines affirmed that for business-to-business (B2B) supplies tax should accrue in the jurisdiction in which the recipient has located its business presence. For business-to-consumer (B2C) supplies the place of consumption should be the jurisdiction in which the recipient has his or her usual residence.

12. The 2001 Report went on to set out a number of Recommended Approaches to tax collection mechanisms for cross-border supplies ("Recommended Approaches to the Practical Application of the Guidelines on the Definition of the Place of Consumption"). For B2B supplies the recommended approach underscored the Ottawa conclusion that reverse charge (or self-assessment) was the most appropriate. For B2C supplies the report recognised that there was no one simple solution, but suggested, in the interim, and where this fitted national systems, a simplified registration system that reduced the compliance burdens that full registration would impose.

22. The e-commerce environment has changed significantly over the last three years but many of the issues identified in both 1998 and 2001 continue to preoccupy governments and business. And the twin OECD approach of providing a fiscal environment that enables e-commerce to grow whilst ensuring integrity in revenue policies and collection is as appropriate today as it was in 1998.

Direct Taxes

23. Work has continued in a number of areas. The report from the Treaty Characterisation TAG led to clarifications to the Model Commentary being published in the 2003 Update to the OECD Model Tax Convention. That update also included the changes to the Commentary on Article 5 in relation to the circumstances in which a location where computer equipment is used might constitute a permanent establishment (PE). The Business Profit TAG released in June 2003 a revised version of its draft on place of effective management including proposed amendments to the Model Commentary. This draft and the public comments on it will be considered with a view to deciding what, if any, amendments to the OECD Model Tax Convention are needed.

24. The Business Profits TAG is in the process of finalising a discussion draft on whether the current treaty rules for taxing business profits are appropriate for e-commerce for release for public comment later in 2003. The BP TAG draft on the attribution of profit to a server PE and the public comments thereon were made available to the Committee to assist in the revision of its discussion draft on attributing profits to PEs in general. Once this has been revised the BP TAG will consider whether it is necessary to revise its own draft.

25. On transfer pricing, the Committee concluded that having monitored developments in the area of e-commerce since 1998, no new or pressing issues have been identified in relation to transfer pricing aspects of e-commerce. Further, the analysis of fact patterns of different e-commerce business models showed that the existing guidance of the Transfer Pricing Guidelines appears capable of dealing with the issues. The Committee may return to this in case the normal monitoring procedures identify developments in electronic commerce. It is intended to publish the report on the impact of e-commerce on the application of the Transfer Pricing Guidelines in the OECD Tax Policy Studies series.

Consumption Taxes

26. Under consumption taxes such as Value Added Tax (VAT) – referred to by some jurisdictions as Goods and Services Tax (GST) - the supplier is responsible for the correct application of tax on each transaction. In an e-commerce environment this means that systems must be able to apply the correct rate of tax, and in the correct jurisdiction, automatically and at the time the transaction is being made. From a business perspective it is essential to ensure that VAT/GST is applied correctly at the time the transaction takes place as there is little chance to correct errors later, especially in the B2C environment. Most e-commerce operates with the minimum of human intervention in processes so it is important that accurate information on the application of these taxes is provided so that systems operators can operate in a fiscal environment that provides certainty.

27. The 2001 Report recognised that there was further work to be undertaken to develop fully the Ottawa Taxation Framework Conditions as augmented by the Guidelines and Recommended Approaches. This work included:

- Verification of the jurisdiction and the status of the customer
- Analysis of registration thresholds in the context of simplification
- Review of technology-based and technology-facilitated collection mechanisms
- Development of international administrative co-operation
- Simplification options and initiatives.

28. In developing the post-2001 report work the Committee on Fiscal Affairs decided to create a "Consumption Tax Guidance Series". Unlike some aspects of the Committee's work on direct taxes there is no obvious OECD publication in which to present a comprehensive and coherent set of papers on consumption taxes. Whilst initially the new Guidance Series will focus on electronic commerce issues, over time it will develop into a more comprehensive series on a range of consumption tax issues. In recognition that all countries have different environments in which they operate a caveat that has been agreed by member countries features on all the papers in the Series (see Box 4).

Box 4: Consumption Tax Guidance Series Caveat

Consumption Tax Guidance is a means of developing greater awareness of both policy and administrative issues. On policy issues the Guidance contains recommendations to member governments that are aimed at removing conflicts, distortions and disincentives to international trade. The section on administrative issues has been developed as a result of sharing experiences between member countries. The OECD's Committee on Fiscal Affairs has approved the contents and countries are encouraged to apply the guidance wherever possible. Nothing contained herein binds member countries, although where there is clear consensus amongst the member countries, administrations should consider the guidance in the light of their existing taxation systems and their legislative approaches.

The first papers in that Series are, therefore, the outputs from the Committee's work on electronic commerce. These papers are summarised in the following paragraphs but the complete papers can be found on the OECD's web site (www.oecd.org/taxation).

Electronic Commerce – Verification of Customer Status and Jurisdiction

29. The guidance paper on this issue provides practical guidance on mechanisms that may be used to establish the status (business or private) and jurisdiction of the customer for low value electronic commerce transactions where the vendor does not have an established relationship with the customer. The intangible nature of many e-commerce transactions (such as a supply of a digitised product) means that in order to deliver the product it is not essential for the supplier to have the customer's physical address. So the question arises as to how a supplier can be sure of the customer's location in order to apply the correct tax decision. At the same time the supplier will need to know whether or not the customer is registered for VAT/GST (a VAT/GST-registered customer will account for tax under reverse charge/self-assessment). The guidance concludes that the status and jurisdiction of a customer should be based on customer self-identification, supported by a range of other criteria including payment information, tracking/geolocation software, nature of the supply and digital certificates. It will be important to monitor the application of these recommendations as technology develops and the means of determining customer location improve.

Electronic Commerce – Commentary on Place of Consumption for Business-to-Business Supplies (Business Presence)

30. The Guideline on the Definition of the Place of Consumption for the Taxation of Cross Border Services and Intangible Property in the Context of E-commerce provides that for cross border business-to-business supplies of services and intangibles:

- The main criterion for determining the place of consumption (and therefore the place of taxation) for the supply is the jurisdiction in which the recipient has located its business presence.
- Countries may use a different criterion where the application of the main criterion results in a distortion of competition or avoidance of tax, (*e.g.* resulting from the routing of services through establishments in non-tax or low-tax jurisdictions)

31. The commentary builds on the main criterion by stating that in cases where a customer has multiple locations, the terms of the contract (*e.g.* invoicing, terms of payment, use of intellectual property) should normally provide sufficient indicative evidence to assist both business and revenue administrations in determining the jurisdiction of consumption. It then develops an override to this by suggesting that where supplies are routed through low-tax or no-tax jurisdictions in order to avoid or minimise taxation of consumption, a country may choose to require a business presence in its jurisdiction to account for tax to the extent – but only to the extent - that consumption takes place in that jurisdiction. In addition, and in order to avoid double taxation, the host country of the business location may choose to provide a correction proportionately equivalent to the tax collected by the country under the application of this test.

Electronic Commerce – Commentary to the Recommended Approaches to the Practical Application of the Guidelines on the Place of Consumption – Simplified Registration Systems

32. This guidance explores registration and declaration procedures and record keeping requirements in the context of simplified registration systems for e-commerce B2C cross border transactions. It suggests that governments that implement simplified registration systems consider using electronic registration and declaration and encourages tax administrations to review and develop a legal basis to allow for the use of electronic record keeping systems.

Other Consumption Tax Issues

Registration Thresholds

33. The 2001 Report highlighted the role that registration thresholds might have to play in minimising compliance requirements for non-resident suppliers and identified that this was an area for further clarification. As can be seen from the full version of the report (available at www.oecd.org/taxation) a number of complex issues have arisen, partly from the fact that there is a variety of thresholds across OECD countries.

34. Variations on the theme of thresholds can be seen in the relevant tables published in the OECD's "Consumption Tax Trends" [2]. Countries approach the issue of thresholds from a number of different perspectives:

- Equivalent registration and collection threshold
- No registration threshold but a separate collection threshold
- Separate thresholds for suppliers of services
- Separate thresholds for the charitable sector
- Differing thresholds for non-resident suppliers as opposed to domestic suppliers
- Absence of thresholds

35. In addition to these variations in approach there is also a wide range of annual turnover limits from nil up to a top value of over €200,000. The report acknowledges that against this background developing a consistent approach across all countries was not feasible. The discussion was focused on the application of thresholds to non-resident e-commerce suppliers utilising the simplified interim approach. However, the fact that many countries do not currently grant thresholds to non-resident suppliers has raised issues over neutrality, compliance burdens and practical application. The report concludes that countries should carefully consider these features as part of the development of simplified registration systems. This is an issue that the Committee will keep under review.

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[2] see also Table 8 at http://www.oecd.org/EN/document/0,,EN-document-22-nodirectorate-no-1-32519-22,00.html