Statement of Jeffrey A. Friedman

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I. Introduction

Chairman Max Baucus (D-MT), Ranking Member Charles Grassley (R-IA), and distinguished members of the Senate Finance Committee, thank you for inviting me to speak at today's hearing on Internet taxation. The views I will express today are my own, and do not necessarily represent the views of KPMG LLP or its clients.

In my remarks today I am going to discuss some of the international tax developments in Europe and the OECD that could affect U.S.-based businesses conducting business over the Internet.

International issues are relevant to our domestic discussions for at least three reasons. First, there are similar tax policy discussions taking place overseas, and as a result it is helpful to consider and perhaps benefit from those ongoing discussions. Second, as US-based multinational companies are often subject to both foreign consumption taxes and US sales and use taxes, many business representatives would like to see governments make similar tax policy decisions in the hope of simplifying today's taxes. Finally, some of the difficult issues that have prevented an international compromise on tax reform are also relevant to the domestic sales and use tax debate.

By way of background, discussions concerning how to adapt consumption taxes to electronic commerce are taking place at the Organization for Economic Cooperation and Development (OECD) and the European Commission (EC). These discussions are focused on how to apply value added taxes (VAT) and similar taxes to sales of digitized goods and services, such as music, software, and information services.

There are several parallels between what is happening overseas and the domestic debate. For instance, the OECD and the EU are grappling with issues such as:

- Which jurisdiction will have the right to impose consumption taxes and what will be the resulting tax rate?
- What are the appropriate enforcement mechanisms if a remote vendor refuses to collect consumption taxes?
- How can consumption taxes be made simple enough to maximize the changes to compliance?

II. European VAT Imposed on Digitized Goods and Services

In June 2000, the EC released a proposal for a directive to modify the rules for applying VAT to digitized goods and services.[1] The objective of the EC was to create a level playing field between EU and non-EU vendors selling products and services delivered electronically (e.g., digitally delivered software, music, information services). It is important to note that the EC has broad authority over value added taxes imposed by its fifteen member nations.

Currently, non-EU vendors do not have to charge VAT on sales of digitized goods and services to European customers. The EC's proposal would change this treatment so that all sellers would have to charge VAT on sales to EU customers.

Specifically, the proposed directive would require non-EU vendors to register for VAT in a single EU member state, and to collect VAT on all sales within the EU based on the VAT rate in the chosen state of registration. VAT would be remitted only to the state of registration and there would be no obligation on the part of the state of registration to share revenue with other EU member states. Thus, non-EU sellers would be able to select which European country receives tax revenue for all of its European sales.

In the fall of 2000, EU member states began expressing concern with the proposed directive. VAT rates vary substantially in the EU, ranging from 15-25%. EU member states with high VAT rates were concerned that because non-EU vendors would be able to select one country in which to register for all European sales they would be tempted to register in the member state with the lowest applicable tax rate, *i.e.*, Luxembourg.

Several EU member states suggested changes to this part of the directive. France suggested that registration for VAT be required in every member state in which sales were made. The EC reportedly opposed that effort because it would result in too heavy a compliance burden on non-EU vendors and, as a result, non-EU vendors would not comply with the directive.[2] The EC's concern is similar to the concern of certain lawmakers here in the United States that a prerequisite to efforts to expand sales and use tax collection should be the adoption of a simplified collection system that does not impose unreasonable burdens on remote vendors.

A revised proposed directive was prepared by EC staff in March of this year. The revised proposed directive would continue to permit non-EU vendors to register in only one member state and to pay VAT only to that member state (the "member state of identification"). However, unlike the original proposed directive, non-EU vendors would be required to charge VAT based on the tax rate in the customer's jurisdiction.

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[1] Proposal for a Council Directive Amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means, COM(2000) 349, http://europa.eu.int/comm/taxation_customs/proposals/taxation/tax_prop.htm, June 7, 2000.

[2] Joe Kirwin, French Compromise VAT Plan on Digital Products Meets EC Rebuff, Daily Tax Report, 192 DTR G-1, October 3, 2000.

The revised proposed directive must be unanimously approved by the EU member states in order to go into effect. The revised proposal has received the endorsement of all but one EU member state – the United Kingdom. The new EU president has said that the Commission will press ahead on trying to obtain EU-wide agreement on the proposal.[3]

A. Technical Issues Raised by Proposed Directive

Some U.S. businesses have expressed concern that the revised proposed directive could create new competitive distortions and place U.S. business at a disadvantage vis-à-vis EU vendors.

For instance, under current law, an EU vendor located in one member state (*e.g.*, Luxembourg) selling digital goods and services to an individual consumer located in a different EU member state (*e.g.*, France) is permitted to charge VAT based on where the seller is located as opposed to where the customer is located (assuming the vendor's sales do not exceed certain thresholds). By contrast, under the revised proposed directive, a non-EU vendor would be required to charge and remit VAT based on where its customers are located. Therefore, an EU vendor located in an EU member state with a low VAT rate could enjoy a competitive advantage over non-EU vendors.

The revised proposed directive also would presumably require non-EU sellers to verify where the customer is located at the time each sale takes place. Many business representatives have said that they often do not know or cannot verify where their customers are located at the time of a sale. Therefore, this part of the proposed directive is of great concern to non-EU vendors that would be required to collect VAT.

The revised proposed directive also does not provide a de minimis sale threshold for collection. Under current law, when goods are sold by U.S. companies to European consumers and shipped by common carrier, individual shipments under a certain threshold -- generally around $25 -- may be exempt from VAT in certain circumstances. The revised proposal directive does not provide a similar exemption for digitized goods and therefore treats them more harshly than traditional sales.

Finally, the revised proposed directive would be applicable even to very small vendors. The original proposed directive would have exempted companies that had less than 100,000 euros in sales in Europe, but the revised proposed directive includes no such threshold.

[3] Belgium to Press for EU E-Commerce Tax This Year, National Journal's Technology Daily, July 17, 2001.

B. U.S. Treasury Response

In July of last year, the prior Administration publicly criticized the EC's original proposed directive.[4] While acknowledging that the proposed directive seeks to address what is perceived to be an uneven playing field between EU and non-EU vendors of digitally-delivered goods, the Administration raised several of the issues discussed earlier.

Additionally, Treasury expressed the view that the issue of imposing VAT on digital goods and services should be handled within the OECD and that OECD member countries or groups of countries should not act unilaterally. The United States, the EC, the EU member states and other interested stakeholders (including the private sector) have been working within the OECD on the very complex substantive and administrative issues associated with e-commerce taxation.

C. OECD and Consumption Taxes

The OECD -- through a subsidiary body of the Committee on Fiscal Affairs called Working Party No. 9 -- has also been examining some of the technical issues that are raised by requiring VAT to be collected on sales of digital goods and services. In general, the OECD process is comprehensive and solicits the views of member countries, non-member countries and business representatives. As a result, the OECD process is broadly supported but is not as far along as the EC process. In addition, unlike the EC, the OECD's role in developing solutions is advisory and not binding on the thirty member countries of the organization. Ultimately, each OECD member country is free to make its own decisions on VAT collection.

Working Party No. 9 issued a report in February in which it reiterated its support for requiring VAT collection on sales of digital goods and services, but it also remarked on some of the technical problems raised by implementing such a system.[5] In particular, the report discussed the issue of collection mechanisms. It recommended:

- a reverse charge or "self-assessment" mechanism for business -to-business transactions, and
- a simplified registration and remittance system for business-to-consumer transactions.

In the case of business-to-consumer transactions, the recommended system would oblige non-resident businesses to register for value-added taxes and to charge, collect and remit such taxes based on the VAT rate in the jurisdiction where the consumer has his usual place of residence.

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[4] See Remarks of Deputy Treasury Secretary Stuart E. Eizenstat before the Coalition of Service Industries and Tax Council, http://www.treas.gov/press/releases/00arch.htm#, July 26, 2000.
[5] Working Party No. 9 on Consumption Taxes, Consumption Tax Aspects of Electronic Commerce, http://www.oecd.org/daf/fa/e_com/public_release.htm#Consumption_tax_issues, February 2001.

The report goes on to state that current technology does not permit the vendor to verify accurately the purchaser's stated place of residence. It further states that the available options for collecting consumption taxes on business to consumer transactions present serious difficulties, either because they impose significant burdens on non-resident sellers, or because they are costly for revenue authorities to administer.

In sum, although the report sets forth certain preliminary conclusions with respect to collection, it appears that the Working Party has a great deal more work to do in developing administrable recommendations that can be implemented by OECD member countries.

III. Tariffs

Turning for just a moment to tariffs, recent developments have been limited. As part of the Internet Tax Freedom Act enacted in 1998, Congress expressed its view that the United States should seek to assure that electronic commerce is free from tariffs.[6] Member governments of the World Trade Organization adopted a temporary moratorium on customs duties on electronic transmissions in May 1998.[7] WTO members may consider an extension of this moratorium at their ministerial conference later this year.

IV. Direct Tax Issues

A. The OECD

I would like to touch briefly on some of the developments with respect to income taxes. The OECD has been the primary forum for discussions on how to adapt our current system of income tax treaties to electronic commerce. Tax professionals from both member governments and the business community have been working with the OECD on these difficult issues and have been doing very good work.

In December 2000, the OECD's Committee on Fiscal Affairs adopted amendments to the commentary of the OECD Model Tax Convention which clarify what types of contacts with a jurisdiction constitute a permanent establishment.[8] The amendments provide that an Internet web site alone will not generally constitute a permanent establishment. The amendments further provide that an Internet Service Provider (ISP) will not, except in very unusual circumstances, constitute an agent of another enterprise so as to create a permanent establishment.

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[6] Pub. L. 105-277, Sec. 1203.

[7] Declaration on Global Electronic Commerce, Geneva WTO Ministerial Conference, adopted May 20, 1998, http://www.wto.org/english/thewto_e/minist_e/min98_e/ecom_e.htm, ("… we also declare that Members will continue their current practice of not imposing customs duties on electronic transmissions.").

[8] OECD Committee on Fiscal Affairs, Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5, http://www.oecd.org/daf/fa/e_com/ec_1_PE_Eng.pdf, December 22, 2000.

The OECD Model Tax Convention commentary also discusses whether an enterprise that has a server at its disposal has a permanent establishment. In order for a server or other computer equipment owned or leased by a business to constitute a permanent establishment, it must be in a fixed location, the business must be wholly or partly carried on in the jurisdiction where the server or equipment is located, and the activities carried out through the server or equipment must be core functions.

The work of the OECD and their associated technical advisory groups is continuing. To date, their work has been based on the premise that existing tax principles should be adapted to electronic commerce. Whether they will re-examine foundational income tax principles (such as the taxation of business profits based on the existence of a permanent establishment) remains to be determined. Meanwhile, however, countries that are not members of the OECD have signaled that they may follow their own separate path in determining how to tax electronic commerce.

B. Non-OECD Countries

According to press reports, tax authorities in India are proposing to amend the income tax regime so they can tax the activities of foreign companies that lack a physical presence in India.[9] In general, the tax authorities there have expressed concern that existing concepts of permanent establishment are too narrow and allow companies that sell their products and services through e-commerce to avoid taxes even though they conduct substantial business in the country.

If India follows through with its proposal, it could have significant consequences for the tax treatment of transactions between U.S. businesses and Indian customers, and, conceivably, could have adverse consequences on US-Indian trade. It could also set a precedent that could be followed by other developing nations.

In addition to abandoning settled concepts such as permanent establishment, non-OECD countries may attempt to re-characterize payments that should be treated as business profits as royalty payments. In general, payments that represent business profits are often not subject to withholding taxes, but payments that represent royalties are often subject to withholding taxes. In 1999, India's Authority for Advance Ruling issued a ruling in a case involving a credit card and travelers' check processing business in which it found that payments by the company's Indian subsidiary for the use of the U.S. parent's computer systems located in the United States and in Hong Kong constituted royalty income, rather than business profits.[10] Such a position has dramatic tax consequences as it leads to taxation of a business that only has "electronic" contacts with India. The U.S. Treasury will need to continue to monitor how its existing treaty network is being applied to electronic commerce.

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[9] Parveen Nagree, Indian Tax Authorities Propose e-Commerce Income Tax Amendments, Worldwide Tax Daily, 2001 WTD 142-6, July 24, 2001; Aziz Nishtar, India Mulls Taxation of Foreign Companies' E-Commerce Income, Worldwide Tax Daily, 2001 WTD 141-1, July 23, 2001.

[10] Shreya Pandit and Shefali Goradia, Indian AAR Issues Landmark Ruling on e-Commerce Taxation under U.S.-India Tax Treaty, Worldwide Tax Daily, 1999 WTD 128-5, July 6, 1999.

V. **Conclusion**

In conclusion, international tax developments demonstrate that many nations are grappling with how to adapt their taxation systems to electronic commerce and that there are many competing concerns. Policymakers here and abroad are correctly seeking input from various stakeholders including government representatives, the business community, and tax practitioners. Their work will continue, and answers to some of the most difficult tax policy issues do not appear imminent. Thank you for the opportunity to address these issues today.