Annex A

Prior work on the digital economy

This annex summarises the content and output of the previous work on electronic commerce. Specifically, it presents the work that led to the 1998 Ministerial Conference on Electronic Commerce in Ottawa (Ottawa Conference) and its main outcomes. It then describes the follow-up work carried out in relation to tax treaty issues and to consumption tax issues.

A.1 1996-98: Work leading to the Ottawa Ministerial Conference on Electronic Commerce

At its June 1996 meeting, the Committee on Fiscal Affairs (CFA) discussed the tax implications of the development of communications technologies. After a conference on electronic commerce organised by the Organisation for Economic Co-operation and Development (OECD) and the government of Finland in co-operation with the European Community (EC) Commission, the government of Japan and the Business and Industry Advisory Committee to the OECD (BIAC) in Turku in November 1997, the CFA adopted a series of proposals for the preparation of a Ministerial meeting on electronic commerce to be organised in Ottawa in October 1998. In preparation for that meeting, the CFA adopted the report: "Electronic Commerce: Taxation Framework Conditions" (OECD, 2001b), which drew the following main conclusions:

- The widely accepted general tax principles that guide governments in relation to conventional commerce should also guide them in relation to electronic commerce.
- Existing taxation rules can implement these principles.
- This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.
- The application of these principles to electronic commerce should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double and unintentional non-taxation.
- The process of implementing these principles should involve an intensified dialogue with business and with non-member economies.

A.2 1998: The Ottawa Ministerial Conference on Electronic Commerce

At the Ottawa Ministerial Conference on Electronic Commerce, leaders from governments (29 member countries and 11 non-member countries), heads of major international organisations, industry leaders, and representatives of consumer, labour and social interests discussed plans to promote the development of global electronic commerce. Ministers welcomed the 1998 CFA Report "Electronic Commerce: Taxation Framework Conditions" (OECD, 2001b), and endorsed a set of taxation principles (listed in Box A.1) which should apply to electronic commerce:

Box A.1. **Ottawa taxation framework conditions – Principles**

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

Certainty and Simplicity: 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: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

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

A.3 Post-Ottawa: CFA work and technical advisory groups

At its January 1999 meeting, the CFA decided that the work programme on electronic commerce would be taken forward by the Committee's existing subsidiary bodies, in their respective areas of responsibility. It also endorsed the establishment of the following "technical advisory groups" (TAGs), comprising representatives from OECD governments, non-OECD governments, business and science, thus comprising a broad range of interests and expertise:

- A **consumption tax TAG,** to advise on the practical implementation of the Ottawa principle of taxation in the place of consumption.
- A **technology TAG,** to provide expert technological input to the other TAGs.
- A p**rofessional data assessment TAG,** to advise the feasibility and practicality of developing internationally compatible information and record-keeping requirements and tax collection arrangements.
- A b**usiness profits (BP) TAG**, to advise on how the current tax treaty rules for the taxation of business profits apply in the context of electronic commerce and to examine proposals for alternative rules.

- A **treaty characterisation TAG,** to advise on the characterisation of various types of electronic commerce payments under tax treaties with a view to providing necessary clarifications in the Commentary.

Given the relevance for the current work on the tax challenges of the digital economy, the sections below describe the main output of the work conducted by the BP TAG and by the Treaty Characterisation TAG.

A.3.1. The work of the business profits TAG

The work of the BP TAG produced discussion drafts on "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" (OECD, 2001a), released in February 2001, and "Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention" (OECD, 2003c), released in May 2003.

The TAG also produced a report, "Treaty Rules and E-Commerce: Taxing Business Profits in the New Economy" (OECD, 2005), which was released in 2005. In that report, the BP TAG recognised that some aspects of existing international tax rules presented concerns. The report first examined a number of relatively restricted approaches to address those concerns in a manner that would not require fundamental changes to international tax rules, and made recommendations with respect to those alternatives. The report also discussed more fundamental changes. After summarising the existing treaty rules for taxing business profits (liability to tax, permanent establishment (PE) concept, computation of profits, allocation of the tax base between countries), the report presented a critical evaluation of these rules against a number of specific criteria, which were derived from the Ottawa framework conditions. In assessing the current principles for taxing business profits against these criteria, the report highlighted a number of pros and cons of the current rules. For example, with respect to the important question where business profits originate ("the source issue") the report concluded that business profits should be viewed as originating from the location of the factors that allow the enterprise to realise business profits. The report therefore rejected the suggestion that the mere fact that a country provides the market where an enterprise's goods and services are supplied should allow that country to consider that a share of the profits of the enterprise is derived therefrom.

The BP TAG could, however, not agree on the related issue whether a supplier which is not physically present in a country may be considered to be using that country's legal and economic infrastructure and, if that is the case, whether and to what extent, such use of a country's legal and economic infrastructure should be considered to be one factor which would allow that country to claim source taxing rights on a share of the enterprise's profits. In addition, since the most "traditional" of business enterprises continue to

incorporate electronic commerce business models, it was found not to be appropriate, nor possible, to design one set of nexus rules for "electronic commerce" companies, and another for non-electronic commerce companies. The final report also gave an overview of the various alternatives to the current treaty rules for taxing business profits that were discussed. These alternatives ranged from relatively minor changes to the existing rules to the adoption of complete new ones.

The following alternatives were found to entail relatively minor changes:

- *Modification of the PE definition to exclude activities that do not involve human intervention by personnel, including dependent agents*: This option would modify the PE definition to expressly exclude the maintenance of a fixed place of business used solely for the carrying on of activities that do not involve human intervention by personnel, including dependent agents.
- *Modification of the PE definition to provide that a server cannot, in itself, constitute a PE*: According to this alternative, the PE definition would not cover situations where a fixed place of business is used merely to carry on automated functions through equipment, data and software such as a server and website.
- *Modification of the PE definition/interpretation to exclude functions attributable to software*: paragraph 4 of Article 5 of the OECD Model Tax Convention provides a list of functions that are specifically excluded from the definition of a PE (the Article 5, paragraph 4 exceptions). This option would indirectly expand this list by excluding functions attributable to software when applying the Article 5, paragraph 4 exceptions.
- *Elimination of the existing exceptions in paragraph 4 of Article 5 or making these exceptions subject to the overall condition that they be preparatory or auxiliary*: One option would be to eliminate all the exceptions included in paragraph 4 of the definition of PE. A less radical option would be to make all the activities referred to in the existing exceptions subject to the overall limitation that they be of a preparatory or auxiliary nature.
- *Elimination of the exceptions for storage, display or delivery in paragraph 4 of Article 5*: This option suggested that paragraph 4 of Article 5 be amended so that the use of facilities solely for purpose of storage, display or delivery should no longer be considered not to constitute a PE.
- *Modification of the existing rules to add a force-of-attraction rule dealing with electronic commerce*: According to this alternative,

paragraph 1 of Article 7 of the OECD Model Tax Convention would be amended to include a so-called "force-of-attraction" rule which would deal with electronic commerce operations. The aim would be to ensure that a country may tax profits derived from selling in that country, through an enterprise's website, products similar to those sold through a PE that the enterprise has in the country.

- *Adopting supplementary nexus rules for purposes of taxing profits arising from the provision of services*: The option would be to modify the OECD Model to include a provision, similar to that already found in the UN Model, that would allow for the taxation of income from services if the enterprise that provides such services is present in the other country for that purpose during a certain period of time. The rationale for the proposal was that service providers are very mobile and that the income-producing functions take place in foreign countries without the need to set up a physical facility or use a fixed base of operations.

After having examined these alternatives in light of the comments received, the report reached the following conclusions:

- The option to *modify the PE definition to exclude activities that do not involve human intervention by personnel, including dependent agents* would be unlikely to be adopted and did not need further consideration.
- As regards the options to *modify the PE definition to provide that a server cannot, in itself, constitute a PE* or to *exclude functions attributable to software when applying the preparatory or auxiliary exception*, the BP TAG concluded that while these options should not be pursued at that time, the application of the current rules to functions performed with the use of servers and software should be monitored to determine whether it raises practical difficulties or concerns, which could lead to further study of these alternatives or combinations or variants thereof.
- With respect to the option to *eliminate all the existing exceptions in paragraph 4 of Article 5*, the BP TAG concluded that this option should not be pursued.
- As regards the options to *make all the existing exceptions in paragraph 4 of Article 5 subject to the overall condition that they be preparatory or auxiliary* and to *eliminate the exceptions for storage, display and delivery in paragraph 4 of Article 5*, the BP TAG concluded the application of these exceptions should continue to be monitored to determine whether practical difficulties or concerns warrant any such changes.

- With respect to the option to *modify the existing rules to add a force-of-attraction rule dealing with electronic commerce*, the BP TAG concluded that it should not be pursued.
- As regards the option to *adopt supplementary nexus rules for purposes of taxing profits arising from the provision of services*, the BP TAG noted that this option would be examined in the context of the work that the OECD was to undertake on the application of tax treaties to services.

The following alternatives were found to require a fundamental modification of the existing rules:

- *Adopting rules similar to those concerning taxation of passive income to allow source taxation of payments related to some forms of electronic commerce (so as to subject them to source withholding tax)*: This alternative encompassed various approaches under which a withholding tax would be applied on all or certain cross-border payments related to electronic commerce. The discussion in the BP TAG focused on a general option under which a final withholding tax would be applied to electronic commerce payments made from a country, whether or not the recipient has personnel or electronic equipment in that country.
- *A new nexus*: *base eroding payments arising in a country*: This option contained a nexus rule that focuses only on whether the foreign enterprise is receiving a payment from an in-country payor that the payor may deduct for domestic tax purposes rather than on where the activities giving rise to the product or service are located. Under this nexus rule, the source state would be entitled to impose a withholding tax on all such cross-border payments.
- *Replacing separate entity accounting and arm's length by formulary apportionment of profits of a common group*: According to this alternative, the separate entity and arm's length principles would be replaced by a system based on formulary apportionment as the international method of allocating and measuring business profits that countries may tax. Under such formulary apportionment system, a formula would be used to divide the net profits of a company, or a group of related companies, doing business in more than one country among the countries where the corporation (or group) operates.
- *Adding a new nexus of "electronic (virtual)PE":* This concept of "virtual PE" was a suggestion of an alternative nexus that would apply to electronic commerce operations. This could be done in various ways, such as extending the definition to cover so-called "virtual fixed places of business", "virtual agencies" or "on-site

business presences." All of them would require a modification of the PE definition (or the addition of a new nexus rule in treaties).

The report concluded that it would not be appropriate to embark on any such changes at that time. Electronic commerce and other business models resulting from new communication technologies were not perceived by the BP TAG to justify, by themselves, a dramatic departure from the current rules. There did not seem to be actual evidence that the communications efficiencies of the Internet had caused any significant decrease to the tax revenues of capital importing countries. Also, it was considered that fundamental changes should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that had been suggested appeared to meet that condition. It was recognised, however, that there was a need to continue to monitor how direct tax revenues are affected by changes to business models resulting from new communication technologies and that some aspects of the existing international rules for taxing business profits raised concerns. More generally, the report noted that the effect of many of these alternatives would extend far beyond electronic commerce it would therefore be important to take account of their impact on all types of business activities when considering them.

A.3.2 CFA work in the area of tax treaties

In addition to the work of the TAGs, the CFA directed its Working Parties to discuss and propose solutions with respect to the issues that had been raised by the TAGs. This led to some changes to the OECD Model Tax Convention and its Commentary which were incorporated in the 2003 update. The changes related to the definition of PE and to the characterisation of payments in particular under the definition of royalties contained in the Model Tax Convention.

A.3.2.1 Treaty rules for taxing business profits

The main content of the changes to the Commentary on Article 5 was to provide that the definition of PE, which is typically defined as a "fixed place of business through which business is conducted," could, under certain conditions, cover servers. In contrast, the changes to the Commentary rejected the view that a website could be regarded as a PE. Paragraphs (shown in Box A.2) were added to the OECD Commentary on Article 5 of the OECD Model Tax Convention in 2003 and are also included in the Commentary to the UN Model Tax Convention (see paragraphs 36-37 of the Commentary on Article 5 of the UN Model Tax Convention).

Box A.2. **Commentary on Article 5 of the OECD Model Tax Convention**

"42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 While a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet website, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that website is concerned. On the other hand, the server on which the website is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

42.3 The distinction between a website and the server on which the website is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the website. For example, it is common for the website through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the website, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its website should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the website is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a website has the server at its own disposal, for example it owns (or leases) and operates the server on which the website is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

Box A.2. **Commentary on Article 5 of the OECD Model Tax Convention** *(continued)*

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5 Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. *automatic pumping equipment used in the exploitation of natural resources.*

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

– providing a communications link – much like a telephone line – between suppliers and customers;

– advertising of goods or services;

– relaying information through a mirror server for security and efficiency purposes;

– gathering market data for the enterprise;

– supplying information.

Box A.2. **Commentary on Article 5 of the OECD Model Tax Convention** *(continued)*

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting websites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an "e-tailer") that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a website which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and 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 are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the websites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through websites operated through the servers owned and operated by these ISPs. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the websites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will

Box A.2. **Commentary on Article 5 of the OECD Model Tax Convention** *(continued)*

constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the websites of many different enterprises. It is also clear that since the website through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the website being an agent of the enterprise for purposes of that paragraph."

A.3.2.2 Treaty characterisation issues

Amendments to the Commentary on Article 12 of the OECD Model Tax Convention were also made to clarify the delimitation between the application of Articles 12 and 7 in the context of new business models in electronic commerce. These clarifications were included in the 2013 update and deal with *(i)* payment for the use of, or the right to use, a copyright, *(ii)* payments for know-how, *(iii)* mixed payments. These paragraphs are also included in the UN Model Tax Convention (see paragraphs 12-16 of the Commentary on Article 12 of the UN Model Tax Convention), although it was noted that some members disagreed with the conclusions reached regarding the character of several types of payment.

Box A.3. **Commentary on Article 12 – Payment for the use of, or the right to use, a copyright**

The following paragraphs 17.1 to 17.4 are included immediately after paragraph 17 of the Commentary on Article 12:

"17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.

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

Box A.3. **Commentary on Article 12 – Payment for the use of, or the right to use, a copyright** *(continued)*

is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content."

Box A.4. **Change to the Commentary on Article 12 – Payments for know-how**

Paragraph 11 of the Commentary on Article 12 was replaced by the following paragraphs 11 to 11.5 (additions to the existing text of paragraph 11 appear ***in bold italics***):

"11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the "Association des Bureaux pour la Protection de la Propriété Industrielle" (ANBPPI), states that 'know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique'.

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.

11.2** This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party.* ***Payments made under the latter contracts generally fall under Article 7.

11.3 The need to distinguish these two types of payments, i.e. ***payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:***

– Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.

– In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.

Box A.4. **Change to the Commentary on Article 12 – Payments for know-how** *(continued)*

– In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to subcontractors for the performance of similar services*.*

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

– payments obtained as consideration for after-sales service,

– payments for services rendered by a seller to the purchaser under a guarantee,

– payments for pure technical assistance,

– payments for an opinion given by an engineer, an advocate or an accountant, and

– payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently*.*

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection*.*

11.6 *In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial*

Box A.4. **Change to the Commentary on Article 12 – Payments for know-how** *(continued)*

assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part." [*paragraph 45 below includes suggested changes to this last sentence*]

Box A.5. **Commentary on Article 12 – Mixed payments**

The last sentence of paragraph 11 of the Commentary on Article 12 was replaced by the following (deletions appear in ~~*strikethrough*~~ and additions in ***bold italics***):

"If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, ***then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.*** ~~*then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.*~~*"*

A.3.3 CFA work in the area of consumption taxes

This section first looks at the elements of the 1998 Ottawa Taxation Framework Conditions (OECD, 2001b) specifically related to consumption taxes and discusses the E-commerce Guidelines (OECD, 2003b) and the Consumption tax guidance papers (OECD 2003c-e-f) that were developed to implement these conditions.

The need for an international co-ordination of the application of domestic value added tax (VAT) systems to international trade first became apparent following the emergence and strong growth of e-commerce. In the field of consumption taxes, the core elements of the *Taxation Framework Conditions* (OECD, 2001b) can be summarised as follows:

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.
- For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.
- Where business and other organisations within a country acquire services and intangibles from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

These framework conditions were broad statements of general principle which required further elaboration to facilitate their practical application. As a follow-up to this work, in 2003 the CFA released its E-commerce Guidelines (2003b). The CFA also released the Consumption Tax Guidance Series (OECD 2003c-e-f) along with these Guidelines, consisting of three papers providing guidance on the implementation of the Guidelines in practice. These Guidelines and Guidance papers are summarised in the following sections.

A.3.3.1. The E-commerce Guidelines

Destination based taxation of cross-border e-business was the governing principle of the E-commerce Guidelines (2003b) Under the destination principle, tax is ultimately levied only on the final consumption within the jurisdiction where such consumption is deemed to occur. Exports are not subject to tax with refund of input taxes (that is, "free of VAT" or "zero-rated"), and imports are taxed on the same basis and at the same rates as domestic supplies. The E-commerce Guidelines (2003b)provide that:

- *For business-to-business transactions*, the place of consumption for cross-border supplies of services and intangibles that are capable of delivery from a remote location made to a non-resident business recipient should be the jurisdiction in which the recipient has located its business presence. This was referred to as the "main criterion". The Guidelines (2003b) indicated that countries may, in certain circumstances, use a different criterion to determine the actual place of consumption, where the application of the main criterion "would lead to a distortion of competition or avoidance of tax." This was referred to as the "override criterion".
- *For business-to-consumer transactions*, the place of consumption for cross-border supplies of services and intangibles that are capable of delivery from a remote location made to a non-resident private recipient should be the jurisdiction in which the recipient has its usual residence.

These Guidelines (2003b) were explicitly not applicable to *(i)* sub-national consumption taxes, *(ii)* suppliers who were registered or required to be registered in the customer's jurisdiction, *(iii)* services that are not capable of direct delivery from a remote location (such as hotel accommodation, transportation or vehicle rental), *(iv)* services for which the place of consumption could be readily identified, *(v)* services for which the place of consumption could be more appropriately determined by other criteria, *(vi)* specific types of services for which more specific approaches might be needed.

A.3.3.2 The consumption tax guidance papers

The CFA released three *Consumption Tax Guidance* (OECD, 2003c-e-f) papers along with the E-commerce Guidelines, to support their implementation in practice. These Guidance papers deal with: *(i)* Identifying place of taxation for business-to-business supplies by reference to the customer's business presence (OECD, 2003c); *(ii)* Simplified registration guidance (OECD, 2003e); and *(iii)* Verification of customer status and jurisdiction (OECD, 2003f). These papers are briefly summarised below:

- *Guidance paper on identifying place of taxation by reference to the customer's business presence:* the *Guidelines on the Definition of Place of Consumption* (OECD, 2003c) described "business presence" as, "in principle, the establishment (for example, headquarters, registered office, or a branch of the business) of the recipient to which the supply is made." The Guidance paper on business presence underlined the importance of contracts in determining the business presence to which the supply is made. Normal commercial practices as evidenced in the terms of contracts (e.g. invoicing, terms of payment, use of intellectual property rights), should normally provide sufficient indicative evidence to assist both business and revenue administrations in determining the jurisdiction of consumption. The Guidance paper also discussed the "override criterion". It considered the case where a customer with branches in several jurisdictions that are not entitled to recover the input tax on a transaction, routed this transaction through branches in jurisdictions with no or a low VAT, "thus avoiding a significant amount of tax." The Guidance Paper suggested that a pure place of consumption override could be applied in such a case, according to which a country may require "a business presence" in its jurisdiction to account for tax to the extent that the supply is used in that jurisdiction. In addition, and in order to avoid double taxation, the country of the business presence that has acquired the supply may then choose to provide a correction proportionately equivalent to the tax collected by the other country under the application of this test.

- *Guidance paper on simplified registration systems* (OECD, 2003e): This guidance paper explored the possible implementation of a system for taxing e-commerce business-to-consumer (B2C) cross-border transactions in the customer's jurisdiction, based on vendor collection. It considered registration and declaration procedures and record-keeping requirements and recommended the use of simplified registration regimes and registration thresholds to minimise the potential compliance burden. It suggested 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.
- *Guidance paper on Verification of Customer Status and Jurisdiction* (OECD, 2003f): This Guidance Paper provided practical guidance on mechanisms that may be used to establish the status (business or private) and jurisdiction of customers, for low value electronic commerce transactions where vendors do not have an established relationship with the customer. It does not apply to high value B2B transactions where the vendor and the customer were assumed to have an established relationship. In these cases the supplier was assumed to be normally aware of the customer's status and jurisdiction and no additional verification process of the customer's declaration was considered necessary. The Paper concluded 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 and geo-location software, the nature of the supply and digital certificates.

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