

# Electronic Commerce: *The UK's Taxation Agenda*





# Foreword



E-commerce is already having a major impact on the life and economy of the nation and will have an increasing role in the next Millennium. Its main tool is the Internet and, whether actively participating in it or not, few people will be unaffected by a means of global communication that is so powerful in operation, yet so simple to use. The Internet offers consumer choice, business efficiency and recreation. Other developments in trade and communications have probably been as revolutionary but none has grown and changed at such a phenomenal pace.

The UK is well placed to take advantage of e-commerce. We have a world-class telecommunications infrastructure, open and competitive markets, and we also have English, the main language of the World Wide Web. But we must not be complacent that all the benefits of e-commerce will naturally fall to us, or that some of the potential drawbacks will pass us by.

E-commerce is a challenge to the business community. For Government, there is a need to ensure that there is a climate in which e-commerce can flourish. The economic stability that we are currently enjoying and the measures we have introduced to boost competitiveness and enterprise are all parts of setting that climate.

They are reflected in the seven point plan for Britain to lead the next stage of the Internet revolution, set out by the Chancellor in his recent speech to the UK Internet Summit<sup>1</sup>. And measures outlined in this paper to maintain the fairness of the taxation system, foster innovation, provide better access to computers and to make use of electronic methods to improve the administration of tax affairs are all in line with that plan.

I commend this paper to you, and thank all those in the business community and elsewhere who have contributed to the work so far. We need you to continue working with us as we take this forward – helping to build in Britain the best environment in the world for e-commerce.

A handwritten signature in blue ink that reads "Stephen Timms".

**Stephen Timms**  
Financial Secretary to the Treasury

<sup>1</sup> HM Treasury News Releases 173/99 and 175/99 available at [www.hm-treasury.gov.uk/press/1999/index.html](http://www.hm-treasury.gov.uk/press/1999/index.html)



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# Executive Summary

- 1 E-commerce is revolutionising the way in which business and Government is conducted, a revolution that is happening at an unprecedented pace. The Government is committed to ensuring that business in the UK is able to benefit from the changes taking place and to achieving the Government's goal of "creating in the UK the best environment in the world in which to trade electronically by 2002"<sup>2</sup>.
- 2 The Government has set out clear aims for e-commerce and for e-government in the UK. And it has drawn up strategies to achieve them. Its broad policies on the taxation of e-commerce and the principles which should be applied to it have been supported by business. This paper details the work the Inland Revenue and HM Customs and Excise are doing to meet the Government's objectives.

## CREATING THE CLIMATE FOR GROWTH

- 3 The Government is committed to making sure that taxation is not a barrier to the growth of e-commerce, but rather fosters a climate in which e-commerce can grow. A package of measures has been introduced, and more are proposed, which demonstrates the strength of this commitment and ensures that enterprise, growth and investment are encouraged in the UK. These play a vital part in working towards the Government's goal.

## INTERNATIONAL CO-OPERATION

- 4 But e-commerce is a truly global phenomenon, and international debate and co-operation have been crucial to the progress which has been made on finding global solutions to the taxation issues thrown up by e-commerce. The Government recognises that international consensus is needed to give business certainty and avoid double taxation and unintentional non-taxation. To this end it has been playing a leading role in work in international fora.

## MODERNISING TAX ADMINISTRATION

- 5 The Inland Revenue and Customs are in the forefront of the move to Information Age Government outlined in the *Modernising Government* White Paper. Along with making greater use of technology to help deliver the Government's vision of services available 24 hours a day seven days a week where there is demand, they are acutely conscious of the need to improve the content of the information and services they deliver, as well as the channels through which it is delivered. And the plans for the introduction of contact centres – providing customers with interactive, multi-media access to Government – are a clear illustration of this drive.

<sup>2</sup> *Benchmarking the Digital Economy*, published alongside the White Paper *Our Competitive Future: Building the Knowledge Driven Economy* (Dec 1998); available at [www.dti.gov.uk/comp/competitive](http://www.dti.gov.uk/comp/competitive)

- 6 Both the Inland Revenue and Customs are introducing Internet filing of customers' returns, and the first electronic submissions will be possible during 2000/2001. And the Government intends to offer a discount on tax returns filed over the Internet as announced in Budget 1999. Further details will be announced in Budget 2000.
- 7 The pilot partnership represented by Business in Government aims to provide a 'one-stop-shop' for people setting up in business. This interactive, web-based service provides step by step guidance through customer's obligations and entitlements; making government more user-friendly. It is only one example of the close co-operation between the Inland Revenue and Customs in the development of electronic services and demonstrates joined-up government in action; a way of making it easier for their customers to do business with them – saving everyone time and money.

## CHALLENGES TO TAX COMPLIANCE

- 8 The development of e-commerce does not just present opportunities for governments and business - there are also challenges. And the Government recognises that e-commerce poses risks to tax administration and compliance.
- 9 The Government will continue to work on these issues to ensure that a robust compliance regime can be applied to the e-commerce environment. And more positively, the use of developing technology will make it easier for taxpayers to comply with their tax obligations, complementing the Government's view that encouraging and assisting taxpayers is the most effective way of maximising voluntary compliance.
- 10 The risks to compliance are not solely a concern of the Government. Business too has an interest in ensuring a level playing field, where all are aware of their rights and at the same time comply with their obligations. The role of business in consultation with the Government has been important in tackling the issues raised by e-commerce.

## THE TAX RULES

- 11 A consistent message from business has been that clarity of the tax rules for e-commerce is a top priority, and businesses that trade internationally need to be certain what rules will apply and how they will be applied. At the same time the Government needs to ensure the rules work in a way that protects tax revenues. But the globalisation of trade brought about by e-commerce, and the question of achieving effective application of the tax rules to international e-commerce mean that it is not possible for any country to act unilaterally to provide this certainty.
- 12 The Government is working with its international partners to provide clarification in a number of areas by the end of 2000. It is, for example, playing a leading role in work with them to agree a clear definition for place of consumption – a key concept in the operation of VAT – to ensure consistency in treatment of electronic and conventionally delivered services; and to clarify the interpretation of the "permanent establishment" concept in an electronic environment and how certain income should be classified for direct tax purposes.
- 13 The business community has indicated that some of these issues need speedy clarification but in other areas the Government should not act too hastily to change long standing and widely accepted concepts, since changes brought in too rapidly might work inappropriately as technology develops. The Government agrees with this analysis and is continuing to work to resolve immediate issues while monitoring closely how developments in technology will affect the international tax rules and UK tax

revenues, so as to be ready to adapt any of the rules in the future should this become necessary.

## SUMMARY

- 14 The Government recognises that e-commerce presents both challenges and huge opportunities for taxation and tax administration. It is actively exploring and introducing ways in which the tools and techniques of e-commerce can assist taxpayers in their dealings with government, while also contributing fully to the targets for digital government. At the same time the Government has developed its policy for the taxation of e-commerce and is working, with business and its international partners, to resolve and clarify particular issues and establish consensus on those of international significance. This work is playing an important part in achieving the Government's strategy for the success of e-commerce in the UK.



# Introduction

The development of e-commerce presents both opportunities and challenges for governments and business. The opportunities for those exploiting it include the trade it can generate and the efficiency with which business can be conducted. One of the challenges for business and government is the truly global marketplace, where a supplier's competitors or customers may be on the other side of the world.

The Prime Minister, in *e-commerce@its.best.uk*<sup>3</sup> – said:

"There is no doubt that e-commerce is going to have a profound effect on business, Government and consumers and on the way people live and work. E-commerce presents enormous challenges. Countries that wholeheartedly embrace e-commerce will benefit from improved economic performance. Those that do not, risk seeing trade ebb away to low-cost competitors elsewhere in the world."

In the face of this, the challenge for the Inland Revenue and Customs is threefold:

- to give confidence to those involved in e-commerce – buyers and sellers – that the tax rules are clear and fair, while maintaining revenue to the public purse;
- to contribute to a climate in which e-commerce in the UK can flourish; and
- to make use of the tools and techniques of e-commerce to improve the services we offer customers, both businesses and individuals.

E-commerce has to be incorporated into what is undoubtedly a complex taxation system, albeit one we are working to simplify. But we see it not as a hindrance, more a huge opportunity to contribute further to the wealth and competitiveness of the nation.

Taxation must not be a barrier to the growth of e-commerce and other commercial benefits. The Government has undertaken to ensure that tax rules and tax compliance are neutral between e-commerce and more traditional forms of commerce. It is equally important that tax revenue remains secure, so that public services can be adequately funded.

Our departments are working together to achieve these aims. And as e-commerce is a global phenomenon, international co-operation between governments is essential. We are actively participating in the work programmes of the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) on the taxation of e-commerce.

As technology has developed we have sought to improve many aspects of the services we offer our customers. The *Modernising Government*<sup>4</sup> White Paper endorses these initiatives and has been a catalyst in taking this work forward.

E-commerce is beginning to affect all areas of our lives, from ordering shopping through a computer at home to interacting with Inland Revenue and Customs on tax affairs. It will have an increasing role as we go into the next Millennium. The

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<sup>3</sup> available at [www.cabinet-office.gov.uk/innovation](http://www.cabinet-office.gov.uk/innovation)

Government is committed to creating the conditions under which it will flourish.

This paper sets out the background to the opportunities and challenges we face and where we are in meeting them. As you will see, we are working in co-operation and consultation with business and other interests. While this is not a consultation document, we would greatly welcome any views from readers. Contact details can be found at the end of the paper.



**Nick Montagu CB**  
Chairman of the Board of  
Inland Revenue



**Dame Valerie Strachan DCB**  
Chairman of the Board of  
Her Majesty's Customs and Excise



# Encouraging the growth of e-commerce

- 1.1 Taxation policy has an important role to play in the promotion of innovation and enterprise in general and of e-commerce in particular. The Government has taken a number of steps to reward enterprise and risk taking, stimulate investment and encourage innovation and economic growth.
- 1.2 This chapter reviews the growth of e-commerce and describes the measures the Government has and is taking to foster a climate in which business can exploit the benefits and rewards that this growth phenomenon can bring.

## WHAT IS E-COMMERCE?

- 1.3 Whilst there is no internationally accepted definition of e-commerce, the Department of Trade and Industry have proposed this working definition to the OECD:

“using an electronic network to simplify and speed up all stages of the business process, from design and making to buying, selling and delivery e-commerce is the exchange of information across electronic networks, at any stage in the supply chain, whether within an organisation, between businesses, between businesses and consumers, or between the public and private sectors, whether paid or unpaid”.

- 1.4 E-commerce is most simply described as doing business electronically, whether communicating by PC, interactive television, console gaming machine or through high street kiosks. It includes Electronic Data Interchange (EDI), the exchange of documents in structured or coded form between business computers, which began over a decade ago.

## A GROWTH PHENOMENON

- 1.5 Without a global definition, quantifying e-commerce and predicting its growth are inexact. In 1998 it is estimated that \$43 billion of business-to-business e-commerce was transacted world-wide, and it is predicted that this will increase to \$300 billion by 2002<sup>5</sup>.
- 1.6 E-commerce between businesses and consumers is less significant at present, with an estimated \$7 billion world-wide in 1998, but expected to grow to perhaps \$80 billion in 2002<sup>6</sup>.

<sup>5</sup> Trade and Industry Select Committee 10th Report (July 1999)

<sup>6</sup> International Data Corporation 1998

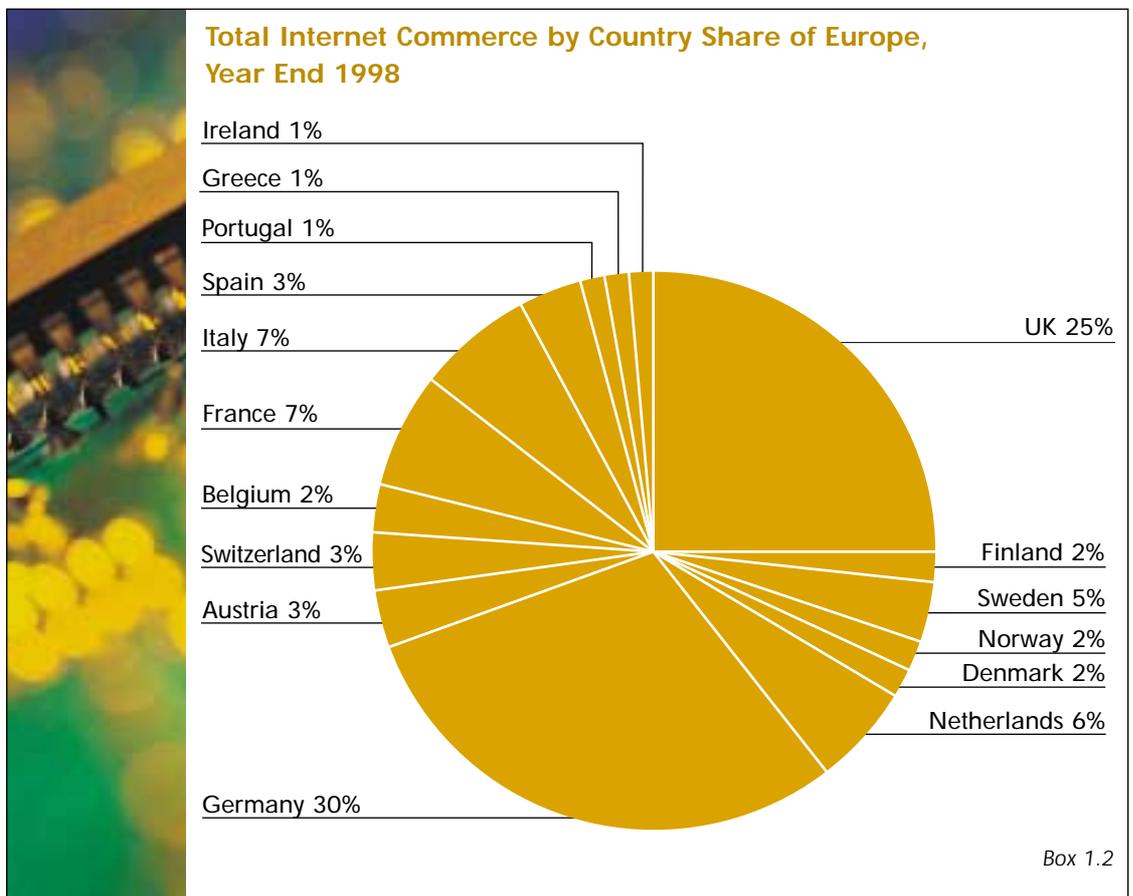
1.7 The figures in Box 1.1 show that e-commerce is growing rapidly in the UK.

#### Growth of e-commerce in the UK

- The proportion of UK companies with their own web site has increased from 37 per cent in 1998 to over 50 per cent in 1999<sup>7</sup>;
- The number of small and medium UK businesses making frequent use of e-mail, web sites and EDI rose by 70 per cent in 1999 from 350,000 in 1998 to 600,000 in 1999<sup>8</sup>; and
- UK e-commerce revenue is expected to reach \$4.5 billion in 1999, rising to \$47 billion by 2002<sup>9</sup>.

Box 1.1

1.8 As can be seen in Box 1.2<sup>9</sup>, the UK is a leader in Europe's Internet market.



Box 1.2

1.9 Currently the vast majority of e-commerce takes place between businesses, but it is predicted that e-commerce sales to private consumers will grow rapidly as more individuals gain access, experience and confidence in its use. While both are expected to grow, business to business transactions are anticipated to maintain their predominance.

<sup>7</sup> Moving into the information age: an international benchmarking study DTI, 1999, available at [www.dti.gov.uk/comp/competitive](http://www.dti.gov.uk/comp/competitive)

<sup>8</sup> Moving into the information age: an international benchmarking study DTI, 1999, available at [www.dti.gov.uk/comp/competitive](http://www.dti.gov.uk/comp/competitive)

<sup>9</sup> International Data Corporation 1998

## CREATING THE RIGHT CLIMATE

- 1.10 The Government has set the goal of “creating in the UK the best environment in the world in which to trade electronically by 2002”<sup>10</sup>. The Prime Minister commissioned the Performance and Innovation Unit (PIU) to lead a review to define the detailed, comprehensive and cross-departmental strategy needed to ensure the Government achieves this goal. The report – *e-commerce@its.best.uk*<sup>11</sup> – recognises that the UK needs a competitive and innovative environment if it is to exploit the opportunities offered by e-commerce. A tax system which rewards enterprise and risk taking will help to encourage this.
- 1.11 But such a tax system is only one element in the promotion of innovation and enterprise. In the 1998 Pre-Budget Report, the Chancellor of the Exchequer identified that, in order to meet the productivity challenge facing the nation, the Government, in partnership with business, needed to address the lack of a culture of enterprise, ambition and growth. A package of tax measures for legislation and consultation was announced, further measures were announced in the Chancellor’s 1999 Budget speech and progress was reported in the 1999 Pre-Budget Report. These measures built on what the Government had already done to stimulate investment, particularly for new SMEs which are likely to provide the engine for radical exploitation of e-commerce.

## SMALLER AND NEW BUSINESSES

### Discounts for e-filing

- 1.12 The Government intends to offer a discount on tax returns filed over the Internet as announced in Budget 1999. Further details will be announced in Budget 2000. (See also 4.8, 4.17 and 4.43)

### Corporation tax rates

- 1.13 Corporation tax rates for SMEs have been considerably reduced since 1997, and further changes have already been announced. The rates are:
- a starter rate of ten per cent for profits up to £10,000, rising gradually to twenty per cent at the point where profits reach £50,000. This applies from April 2000 and will benefit an estimated 270,000 companies; and
  - a small companies rate of 20 per cent for profits up to £300,000, rising gradually to 30 per cent where profits reach £1,500,000. This benefits a further 95,000 companies. The small companies’ rate has been reduced by three per cent since 1997.

### Capital Allowances (tax depreciation)

- 1.14 Capital allowances reduce taxable profits for all businesses and are given in lieu of depreciation. Enhanced first year capital allowances of 40 per cent (normal rate 25 per cent) are available for assets purchased up to 1 July 2000 by both incorporated and unincorporated SMEs. This gives a cash flow advantage over commercial depreciation. An enhanced rate of 50 per cent was introduced in the July 1997 Budget for assets bought between 2 July 1997 and 1 July 1998. A 40 per cent first year allowance was introduced in 1998 and was extended for a further year in 1999.

<sup>10</sup> *Benchmarking the Digital Economy*, published alongside the White Paper *Our Competitive Future: Building the Knowledge Driven Economy* (Dec 1998); available at [www.dti.gov.uk/comp/competitive](http://www.dti.gov.uk/comp/competitive)

<sup>11</sup> published Sep 99; available at [www.cabinet-office.gov.uk/innovation](http://www.cabinet-office.gov.uk/innovation)

### **Research and Development tax credits**

- 1.15 A new research and development (R&D) tax credit will be introduced next year. This is intended to benefit particularly the sorts of new businesses which are at the cutting edge of innovation in their field – those working to expand the horizons of e-commerce will be typical.
- 1.16 Businesses already benefit from an immediate deduction for capital invested in R&D (under the Scientific Research Allowance). The new tax credit will increase relief on most current R&D spending for SME companies from 100 per cent to 150 per cent. SMEs not yet in taxable profit will be able to take the relief up front in the form of a cash payment equal to the discounted cost of the R&D.

### **Reform of Intellectual Property**

- 1.17 Consultation on reforming the tax treatment of intellectual property ended on 31 July 1999. The intention is to create simpler and more cohesive tax treatment for intellectual property and to ensure that expenditure on it qualifies for tax relief. The Government is using the results of this exercise to work up detailed proposals on which it will consult further.

### **Practical measures**

- 1.18 Smaller employers can benefit from a cashflow advantage by paying over the tax deducted from employees' wages every quarter instead of monthly. The limit at which this can be done was raised in the last Budget so that potentially over 60 per cent of employers can benefit.

### **Support for new businesses**

- 1.19 A new Small Business Service was announced in Budget 1999. It aims to simplify and improve the quality and coherence of all Government support for small, new businesses. The Inland Revenue and Customs offer extensive guidance and support for new businesses. The Government recently announced the expansion of the Revenue's dedicated helpline for new employers and a nationwide network of Business Support teams which offer face to face help.

## **THE INVESTOR AND ENTREPRENEUR**

- 1.20 The vital roles of the investor and entrepreneur are recognised by the Government, and various measures have been introduced to encourage their activities.

### **Capital Gains Tax taper relief**

- 1.21 In 1998, the Government introduced capital gains tax (CGT) taper relief to create incentives for investment in assets generating sustained growth with particular support for entrepreneurial investment. The CGT rates are effectively lowered, by reducing the amount of the capital gain brought into charge, the longer an asset has been held after 5 April 1998. The taper leads to an equivalent, maximum tax rate of 10 per cent for assets held for longer than ten years; for other assets the equivalent maximum tax rate is 24 per cent. Business assets include shareholdings in a trading company in which the shareholder can exercise voting rights of at least 5 per cent (if the shareholder works full-time in the company's business) or 25 per cent (otherwise).
- 1.22 The Chancellor announced in the 1999 Pre-Budget Report that subject to detailed consultation, he will be considering the case for shortening the business assets taper from 10 years to 5 years to bring the timing of CGT incentives more into line with evolving entrepreneurial investment patterns. The Government will also be assessing the case for broadening the scope of what can qualify as a business asset.

- 1.23 This relief is particularly attractive for people who start up their own businesses with a view to taking forward an idea which, once fully developed, can be sold to a much larger concern or floated.

### **Special investment schemes**

- 1.24 The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) provide a range of tax incentives for individuals to invest in small higher risk unquoted trading companies. The EIS caters for direct investment in such companies, and VCTs for indirect investment in them through a quoted investment fund.

#### ***Enterprise Investment Scheme***

- 1.25 Under the EIS income tax relief is available at 20 per cent on investment up to an annual limit in new shares provided they are held for five years. Payment of tax on a previous capital gain is deferred if it is invested in such shares. Gains when shares which qualify for income tax relief are sold are exempt and any losses can be offset against income if there are no gains that year.

#### ***Venture Capital Trusts***

- 1.26 Investors in a VCT which subscribes for shares in small higher risk unquoted trading companies can obtain income tax relief at 20 per cent on investment in new shares up to an annual limit of £100,000. They can also defer tax on a previous capital gain if the proceeds are invested in shares which attract income tax relief. For investments up to £100,000 a year, dividends on those shares and gains when the shares are sold are exempt from tax.

#### ***Changes in Venture Capital Schemes (EIS and VCTs) since 1997***

- 1.27 In 1998 the EIS and CGT reinvestment relief were merged in a new unified, and better targeted, scheme. The annual limit on investment in EIS qualifying for income tax relief was raised from £100,000 to £150,000 and the size of company benefiting from both schemes was increased. Companies with gross assets of no more than £15 million before the investment and £16 million afterwards can now qualify.
- 1.28 In 1999 the CGT rules were changed so that individuals making successive investments in EIS companies (serial investors) benefit from taper relief on a cumulative basis when they reinvest the gain arising from one EIS investment in another EIS company.

#### ***Corporate venturing***

- 1.29 Corporate venturing is an umbrella term for a range of mutually beneficial relationships which may be established between companies. They commonly occur between a larger company and a smaller one in the same line of business. The larger company may be able to bring particular skills, knowledge or facilities to the relationship, for example in management or marketing. It may also offer financial assistance. The small company may provide a window onto new technology in which the larger company is interested but in which it does not wish to participate directly.
- 1.30 The Government is convinced that corporate venturing has enormous potential for helping early stage companies. Experience in the United States, for instance in Silicon Valley, has shown what can be achieved when large companies work with and support smaller ones.
- 1.31 To encourage corporate venturing in the UK, the Government confirmed in the 1999 Pre-Budget Report that provision for corporation tax relief at 20 per cent for companies taking minority shareholdings in small, unquoted higher risk trading

companies is to be included in the next Finance Bill. The Government announced in response to consultation, that companies will also be able to defer tax on any gain made on corporate venturing investments where that gain is invested in another shareholding under the scheme, and to claim relief against income for capital losses – net of corporation tax relief – on disposals of shares. Other changes include a reduction, from 5 years to 3 years, in the period for which investors must retain shares if they are to qualify for relief on them. Draft legislation will be published by the end of the year.

## MANAGERS AND EMPLOYEES

- 1.32 Incentives to encourage greater involvement of managers and employees in the enterprise and growth culture have also been announced.

### Enterprise Management Incentive (EMI)

- 1.33 In his last Budget (1999) the Chancellor announced his intention to introduce in 2000 a new targeted tax break for equity remuneration. This will be available to up to 10 key individuals who are prepared to share in the risks and rewards of working in a small higher-risk trading company to enable it to succeed and grow. EMIs will offer key employees considerably more tax-advantaged equity remuneration (up to £100,000 of options valued at the date of grant) than is available under existing approved option schemes. The measure will be broadly targeted on the same companies as the EIS/VCT schemes.

### New all-employee share schemes

- 1.34 The Chancellor also announced his intention to introduce a new all-employee share scheme in 2000 with a view to encouraging more employees to take a stake in their companies. This new scheme is to play an important part in reaching the Government's target of doubling the number of companies which offer shares to all their employees, as part of the drive to close Britain's productivity gap. Sustained employee ownership, especially when combined with a participative management culture, can harness the ambition of employees to see the company in which they work succeed. Research evidence indicates that in these cases employee share ownership has a positive effect on productivity. This will be the most tax-advantaged all-employee share scheme ever introduced in the UK.

### Provision of computers for home use

- 1.35 The Government has taken a number of steps to provide better access to computers. In the 1999 Finance Act, the Government introduced an exemption for up to £500 worth of benefit which would otherwise be chargeable on an employee when his or her employer provides a computer for home use either free or at low cost. Only benefits in excess of £500 will remain chargeable.
- 1.36 This means that an employer can lend computer equipment with a value of up to £2,500 to an employee free of tax (since the annual benefit is normally based on 20 per cent of the value of the asset). The exemption should encourage employees to use computers more and to acquire additional skills.
- 1.37 And in October 1999 the Chancellor announced a scheme through which low income individuals will be able to lease computers and software<sup>12</sup>.

## CONCLUSION

- 1.38 The Government is committed to making sure that taxation is not a barrier to the growth of e-commerce and to ensure that enterprise, growth and investment are encouraged in the UK. The measures and issues that have been outlined in this chapter demonstrate the strength of this commitment. These play a vital part in working towards the Government's goal of creating in the UK the best environment in which to trade electronically by 2002.





# Shaping the future

2.1 During the last 2 years, the Government has developed and set out:

- its strategy for the UK and its citizens to benefit from the opportunities of the digital revolution – its vision of using new technologies to make significant improvements to public services; and
- its policy on the taxation of e-commerce.

2.2 This chapter outlines the Government's strategies and policies as they affect taxation and the tax system.

## ELECTRONIC GOVERNMENT

2.3 The Government has set out a programme to reform the way in which government works<sup>13</sup>. Box 2.1 sets out some of the important elements of the package that are of particular relevance to the delivery of electronic services by the Inland Revenue and Customs.

### Commitments and priorities

- to deliver public services to meet the needs of citizens, not the convenience of service providers;
- to use new technology to meet the needs of citizens and business, and not trail behind technological developments;
- development of public services that are available 24 hours a day, seven days a week where there is a demand;
- joined-up government in action – including a clear commitment for people to be able to notify different parts of government of details such as a change of address simply and electronically in one transaction; and
- development of an IT strategy which will establish cross-government co-ordination, machinery and frameworks on such issues as use of digital signatures and smart cards, web sites and call centres.

Box 2.1

2.4 In developing electronic services, the Government pledged to increase the choice for citizens and businesses as to how they receive services, not restrict it. New technologies will take their place alongside the telephone, the call centre, the paper document and face to face contact, not replace them.

# chapter 2

<sup>13</sup> *Modernising Government* White paper (March 1999); available at [www.cabinet-office.gov.uk/moderngov](http://www.cabinet-office.gov.uk/moderngov)

- 2.5 The PIU in its report stressed the role of the Government in promoting e-commerce and its potential to act both as exemplar and an engine for change. Procurement was seen as a key issue. The report recognised that work being done by the Inland Revenue and Customs on document filing and payment systems was a good example of electronic service delivery. It recommended that organisation of and navigation around Government web sites should be improved.

### Government targets

- 2.6 To drive its agenda forward across departments, the Government has set a number of important targets which are shown in Box 2.2.

**Targets:**

- by March 2001, 90 per cent by volume of routine procurement of goods by central government will be conducted electronically<sup>14</sup>;
- by 2002, 25 per cent of government services will be accessible electronically<sup>15</sup>. The Government will publish details of Departments' performance against this target from Spring 1999<sup>16</sup>. It will also review whether the target is sufficiently challenging to ensure that the UK is at the forefront of international best practice<sup>17</sup>; and
- by 2008, all dealings with government will be capable of delivery electronically<sup>18</sup>.

Box 2.2

### Electronic Communications Bill

- 2.7 An Electronic Communications (previously Commerce) Bill was announced in the Queen's speech in November 1998 to remove legal barriers to on-line trading. The draft Bill<sup>19</sup> was published for consultation in July 1999 and includes provisions to ensure legal equivalence between electronic and paper and pen signatures and methods of communication. The Government will introduce the Bill in the current session of Parliament.

## TAXATION POLICY

- 2.8 Policy on the taxation of electronic commerce is an important element in achieving the Government's vision for e-commerce in the UK.
- 2.9 In October 1998, following discussion with business, the Government set out its policy on the taxation of e-commerce<sup>20</sup>. This included a number of overarching principles which are shown in Box 2.3 below.

<sup>14</sup> *Our Competitive Future: Building the Knowledge Driven Economy* (Dec 1998); available at [www.dti.gov.uk/comp/competitive](http://www.dti.gov.uk/comp/competitive)

<sup>15</sup> *Our Information Age: the Government's vision* (April 1998); available at [www.number-10.gov.uk/public/info/index.html](http://www.number-10.gov.uk/public/info/index.html)

<sup>16</sup> available at [www.citu.gov.uk](http://www.citu.gov.uk)

<sup>17</sup> *Our Competitive Future: Building the Knowledge Driven Economy* (Dec 1998); available at [www.dti.gov.uk/comp/competitive](http://www.dti.gov.uk/comp/competitive)

<sup>18</sup> *Modernising Government White Paper* (March 1999); available at [www.cabinet-office.gov.uk/moderngov](http://www.cabinet-office.gov.uk/moderngov)

<sup>19</sup> available at [www.dti.gov.uk/cii/elec/ecbill.html](http://www.dti.gov.uk/cii/elec/ecbill.html)

<sup>20</sup> *Electronic Commerce: UK Taxation Policy*; available with a Press Release dated 6 October 1998 at [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk) or [www.hmce.gov.uk](http://www.hmce.gov.uk). This was published alongside *Net Benefit: the electronic commerce agenda for the UK*; available at [www.dti.gov.uk/cii/electronic.html](http://www.dti.gov.uk/cii/electronic.html)

### *Principles for the taxation of e-commerce*

- *Neutrality* – the taxation of e-commerce should seek to be technology neutral so that no particular form of commerce is advantaged or disadvantaged;
- *Certainty and transparency* – the rules for the taxation of e-commerce should be clear and simple so that businesses can anticipate, so far as possible, the tax consequences of the transactions they enter into;
- *Effectiveness* – the tax rules should not result in either double or unintentional non-taxation, and risks from increased evasion and avoidance should be kept to a minimum. The overriding aim should be that the right amount of tax is paid at the right time and in the right country; and
- *Efficiency* – the tax rules should be efficient, keeping the compliance costs of business and the administration costs of government to the minimum compatible with effective tax administration. Measures to counter evasion or avoidance should be proportionate to the risks which they seek to address.

Box 2.3

2.10 The Government took the view that it did not believe it necessary at this stage to make any major changes to existing tax legislation and regulations, or to introduce new taxes. But, as technology develops, it might be possible that some changes would become necessary to existing domestic rules to ensure that they continue to work effectively.

2.11 The policy paper outlined in broad terms the work of the Inland Revenue and Customs in the following areas:

- customer service opportunities
- tax administration and compliance
- royalties (characterisation of income)
- permanent establishment (threshold for taxing non-residents)
- transfer pricing and attribution of income to permanent establishments
- VAT
- customs duties
- betting and gaming duties

These issues are explored in greater depth in Chapters 4-8.

### **The Trade and Industry Select Committee report**

2.12 The Select Committee on Trade and Industry reviewed the work on taxation as part of its wide-ranging inquiry into e-commerce. In its report<sup>21</sup> the Committee noted that rapid progress in reaching agreement on how the international tax system should be adjusted to take account of e-commerce is unlikely. Ongoing policy development

<sup>21</sup> Tenth Report (July 1999) available at [www.parliament.uk/commons/selcom/t&ihome.htm](http://www.parliament.uk/commons/selcom/t&ihome.htm)

should take account of technological developments and consumer trends. Early compromises could have unintended and unwelcome effects.

- 2.13 The Select Committee also reported that witnesses supported the Government's principles (Box 2.3), and the view that there is no need for major changes to existing rules, or for the introduction of new taxes.
- 2.14 The Government has welcomed the Committee's comments and supports and agrees with its analysis. The Government has also told the Committee that it is working with its international partners to progress and provide clarification on a number of issues by the end of 2000 (see 8.40).

### **The Performance and Innovation Unit study**

- 2.15 The PIU also looked closely at the Government's policy on the taxation of e-commerce as part of its study. The report<sup>22</sup> recognised that e-commerce poses a number of challenges for tax policy and administration, and concluded that an internationally agreed tax framework was one of the foundations of a successful e-commerce strategy. It also recognised the leading role the UK has been playing in the international work to achieve this, though the speed of development of e-commerce has outstripped the normal international processes.
- 2.16 Box 2.4 sets out the PIU recommendations on taxation. The Government has accepted all the recommendations in the report.

#### ***Overall strategy***

- the Inland Revenue and Customs and Excise should publish a comprehensive Information Paper in the Autumn (1999) updating the Government's strategy for the tax treatment of e-commerce.

#### ***Safeguarding the tax base***

- the UK should continue to aim for international agreement on the direct tax treatment of payments for electronic goods and services by end 2000;
- the UK should continue to seek international agreement on the application of the "permanent establishment" principle to web sites by March 2000;
- the UK should continue to play a leading role in OECD work to review the application of transfer pricing rules to e-commerce and to develop rules for attributing income to permanent establishments;
- the UK should identify effective mechanisms for VAT collection in respect of consumer purchases of on-line items [digitised products] from outside the EU; and
- the tax authorities need to remain vigilant in ensuring e-commerce does not lead to increased tax evasion and avoidance.

#### ***Simplifying and communicating the tax rules to business***

- the UK should work with the EU, the World Customs Organisation and other international bodies to improve and streamline procedures for the collection of VAT and customs duties on small consignments of imports; and

cont. ➔

- the Inland Revenue and Customs and Excise should publish improved guidance for e-businesses, targeted at small and medium sized enterprises, explaining their tax obligations and how the tax system will treat cross-border transactions.

***International coherence and agreement***

- the UK should continue to play a leading role in the OECD and in other international organisations to achieve an internationally agreed implementation of the framework for the taxation of e-commerce agreed at the 1998 Ottawa Ministerial conference; and
- the UK should seek an international examination of the implications of e-commerce betting and gaming for the tax yield from this sector.

Box 2.4

## CONSULTATION

- 2.17 The Government is committed to involving the public and business in the debate on its policies on e-commerce. Their contribution is important in achieving the Government's objectives – service delivery initiatives should meet the needs of customers and taxation policy should meet the principles outlined in box 2.3.
- 2.18 The Inland Revenue and Customs have set up an Electronic Commerce Consultation Forum<sup>23</sup> to widen their consultation with business on the taxation issues. The aim of the Forum is to ensure that the Government is aware of the needs and concerns of UK business. This will inform the debate both domestically and internationally.
- 2.19 The Forum consists of the relevant officials from both departments and a number of representative bodies and associations in the UK with an interest in the subject. Also taking part are some of the UK business participants in the Technical Advisory Groups that have been set up by the OECD to look at the issues (see 3.12).
- 2.20 The first meeting of the Forum was held in June 1999. Sub-groups were set up to consider taxpayer service, consumption tax, business profits, characterisation of income and tax administration and compliance. More detail of their work is given later in the paper. The contribution of the participants is already proving valuable to the Government in understanding the needs and concerns of UK business.

## APPOINTMENT OF AN E-ENVOY AND AN E-MINISTER

- 2.21 To spearhead the Government's drive to make its vision a reality, the Secretary of State for Trade and Industry announced in November 1998 that the Government would appoint a Special Representative on the Digital Economy – the UK's e-envoy.
- 2.22 In July 1999, Patricia Hewitt MP was appointed as the Minister for Small Businesses and E-commerce at the DTI, bringing together all the Government's work on e-commerce and taking forward the overall strategy.
- 2.23 In September 1999, the Prime Minister launched the PIU report and announced the appointment of Alex Allan as e-envoy. He said that the challenge for government is to "act faster and co-ordinate better. We've been too slow here – as have most governments around the world. So we've reorganised the way we work with a single lead Minister and a single lead official".

<sup>23</sup> Press Release 22 June 1999; available at [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk) and [www.hmce.gov.uk](http://www.hmce.gov.uk)

2.24 The Inland Revenue and Customs will be working closely with both the e-Minister and the e-envoy.

## CONCLUSION

2.25 The Government has set out clear aims for e-commerce and for e-government in the UK. And it has drawn up strategies to achieve them. Its broad policies on the taxation of e-commerce and the principles which should be applied to it have been supported by business. Chapters 4 – 8 go on to detail the work the Inland Revenue and Customs are doing to meet the Government's aims.

# The international scene

- 3.1 The international nature of e-commerce brings with it the need to find global solutions to the taxation issues that it raises. If international trading is to be encouraged, business needs certainty and clarity over how international tax rules will work. At the same time, the Government needs to ensure that the rules work in a way that does not lead to a loss of tax revenue. Working with other governments and business to achieve these aims is essential. If countries take different approaches or act unilaterally, there could be:
- double taxation or unintentional non-taxation;
  - excessive compliance burdens for business; and
  - opportunities for the dishonest to evade or avoid taxes.
- 3.2 International co-operation can also contribute to the ways in which the Government can use developments in technology to improve the service it offers. Sharing experiences and expertise will help ensure the UK puts in place the best systems and products.
- 3.3 This chapter outlines the international aspects of this work in which the UK has been actively participating.

## ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

- 3.4 The OECD has been taking forward the tax issues raised by e-commerce. The UK has played – and continues to play – a major role in this work.

### Turku Conference

- 3.5 In November 1997, the OECD held an international conference in Turku, Finland at which government and business representatives from around the world met to review and debate OECD work on the impact of e-commerce on business. The OECD was mandated to prepare a framework for the taxation of e-commerce and an undertaking was given to engage the business sector in a series of working dialogues on the issues.

- 3.6 It was agreed that the criteria to guide the development of the tax framework would be:

*Guiding criteria*

- neutrality;
- fairness;
- certainty, and
- the need to avoid excessive taxation.

Box 3.1

- 3.7 OECD member countries held a series of meetings with business in the course of drawing up the framework. These were essential in reaching broad understanding of the issues and opportunities.

## OTTAWA CONFERENCE

- 3.8 The framework was presented to Ministers at a conference held by the OECD in Ottawa in October 1998. Tax was one of four topics addressed, the others being consumer protection, authentication and privacy. Business representatives, governments from OECD member countries and a number of non-OECD member countries attended. Ministers endorsed a number of important conclusions<sup>24</sup>, including that:

- the technologies which underlie e-commerce offer revenue authorities significant opportunities to improve taxpayer service and member countries are committed to exploiting fully these opportunities;
- the taxation principles which guide governments in relation to conventional commerce should also guide them in relation to e-commerce. .... [A]t this stage of development in the technological and commercial environment, existing taxation rules can implement these principles; and
- any arrangements for the application of these principles to e-commerce adopted domestically – and any adaptation of existing taxation principles – should be structured to maintain fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double taxation and unintentional non taxation.

- 3.9 A number of broad principles applying to the taxation of e-commerce (Box 3.2) were agreed, which also covered a number of more specific elements and options on taxpayer service opportunities and the taxation of e-commerce. Governments undertook to work through the OECD and in consultation with business to implement and extend the framework.

## **Framework conditions: broad taxation 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 counter-acting measures proportionate to the risks involved.

### **Flexibility**

The systems for the taxation of electronic commerce should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Box 3.2

3.10 The Government believes that Ottawa was a very important milestone. The taxation framework – in the development of which the UK played a leading role – was a significant achievement and laid the foundation on which detailed work is being built. The commitment by OECD countries to work together on the issues – with business and developing their contacts with non-OECD member countries – is vital to arriving at workable tax rules and administrative systems.

## **Post Ottawa Work Programme**

3.11 Following the Ottawa conference, the OECD consulted with business on what it saw as the priority areas and drew up a detailed agenda for its work to the end of 2000. The work programme is covering:

- characterisation of income (royalties/sales of goods and services);
- permanent establishments;
- transfer pricing and attribution of profits to permanent establishments;
- consumption taxes (such as VAT); and
- tax administration and compliance.

3.12 As part of that programme five Technical Advisory Groups (TAGs) have been established. These include participants from member countries, non-OECD member countries and businesses from a wide range of sectors and jurisdictions. Their role is to advise the member country working parties on the specific issues within the work programme. This is a unique development in the work of the OECD and reflects the

importance placed by the member countries in achieving international solutions in partnership with business.

3.13 The five TAGs<sup>25</sup> are:

- Income Characterisation
- Business Profits
- Consumption Taxes
- Technology
- Professional Data Assessment

3.14 The UK is playing a major role in this work and is chairing the member country working parties looking at transfer pricing and attribution of profits to permanent establishments; tax administration and compliance; and the Business Profits TAG.

3.15 As the work programme progresses, the OECD is posting various papers to a publicly accessible web site<sup>26</sup>. And in October 1999, it held a conference in Paris to take stock of progress. On tax, it was reported that work is progressing well in all five TAGs. It is feeding into the work of the member country working parties that are due to report their findings at the end of 2000.

#### **Knowledge Exchange Web site**

3.16 The OECD is facilitating the setting up of a web site by member countries to share knowledge and experience. It will be available to the public as well as officials and will contain information about member country tax administrations, their systems, operational improvements, policy documents and will contain links to their existing web sites. The Government is supporting this project which will assist exchange of best practice and electronic interaction between tax administrations.

### **THE 1998 G8 SUMMIT**

3.17 The G8 Foreign and Finance Ministers met in Birmingham in May 1998 under the Presidency of the UK and with e-commerce as one of the major items on the agenda. In their conclusions<sup>27</sup> – set out in Box 3.3 – they supported the view that taxation should be technology-neutral and stated that a framework on taxation was a priority. They also encouraged public administration to use electronic means to deliver services wherever possible.

#### ***Conclusions of the joint meeting of the G8 Foreign and Finance Ministers: 9 May 1998***

... We will work with the international institutions and the private sector to offer the best opportunities for the future: a predictable and stable environment and a seamless, decentralised global market place where competition and consumer choice drive economic activity. In particular, we welcome the work of the WTO, OECD, and other appropriate international fora and the private sector, and encourage:

- removal of inappropriate and unnecessary legal barriers to the electronic conduct of business;

cont. ➔

<sup>25</sup> the mandates and participants of these groups are available at [www.oecd.org/daf/fa/e\\_com/tag.htm](http://www.oecd.org/daf/fa/e_com/tag.htm)

<sup>26</sup> available at [www.oecd.org/daf/fa/e\\_com/e\\_rego.htm](http://www.oecd.org/daf/fa/e_com/e_rego.htm)

<sup>27</sup> available at <http://birmingham.g8summit.gov.uk/forfin/joint.shtml>

- taxation to be technology-neutral. It should neither stifle commercial opportunities by creating unnecessary barriers nor provide increased scope for tax avoidance and evasion. International co-operation through the OECD is essential;
- public administration to use electronic means to deliver programmes and services, promoting progress in the WTO Working Group on Transparency In Government Procurement and the reform of the WTO Government Procurement Agreement, and pushing forward the work on trade facilitation in the WTO and elsewhere; and
- governments to involve business and consumers in this work to ensure that any proposals are practical and take into account the demands of the market place.

We look forward to progress at the Ottawa OECD ministerial conference in October and in other international fora. A framework on taxation is a priority.

Box 3.3

## EUROPE

### The EU-US statement on e-commerce

- 3.18 At their December 1997 summit, the EU and the United States of America issued a joint declaration on e-commerce<sup>28</sup>. They agreed to “work towards the development of a global market place where competition and consumer choice drive economic activity, on the basis of [a number of] guidelines, including, that taxes on electronic commerce should be clear, consistent, neutral and non discriminatory”. To achieve the goals it was agreed to continue discussions in appropriate multilateral fora, including the OECD.
- 3.19 At the following summit in May 1998, there was agreement to the development of an internationally agreed framework for e-commerce.

### Meeting of European Finance Ministers (ECOFIN)

- 3.20 The EU first looked at the impact of e-commerce on VAT and customs duties in June 1997. Since that time the Member States have been involved in three separate sets of groups considering a variety of distinct facets in detail. The UK has made major contributions to this work. The Commission reported at the conclusion of each phase of the work.
- 3.21 The first report, in April 1998, concentrated mainly on Internet transactions that result in the supply of physical goods. The report concluded that – although an increase in the number of small packages could be anticipated – existing rules and mechanisms (that apply tax and duty in the importing country) would continue to operate effectively (see Chapter 6).
- 3.22 The Commission report at the end of phase two contained a list of guideline principles which are summarised in Box 3.4. European Economic and Finance Ministers<sup>29</sup> noted the report and endorsed similar conclusions that then formed the EU contribution to the OECD’s Ministerial conference in October 1998.

<sup>28</sup> available at [www.qlinks.net/comdocs/eu-us.htm](http://www.qlinks.net/comdocs/eu-us.htm)

<sup>29</sup> ECOFIN 5 July 1998, 9745/98

### Guidelines

- there is no need for new taxes on e-commerce at this stage – existing taxes should be adapted as necessary to meet the developments of e-commerce;
- products supplied in digital format should be treated, for VAT purposes, as a supply of services;
- services supplied for consumption within the EU should be taxed within the EU, and those supplied for consumption outside the EU should not attract EU VAT;
- compliance should be made as easy and simple as possible;
- the tax system for e-commerce must be enforceable;
- tax administration should be facilitated, for example by further development of electronic invoicing; and
- business should be able to discharge their fiscal obligations by rendering returns and payments electronically.

Box 3.4

### European Commission paper

3.23 The Commission made a public commitment<sup>30</sup> in July 1999 that it would quickly bring forward a proposal for legislative change to the place of supply rules<sup>31</sup> for services. This will reflect the conclusions reached at Ottawa and, in particular, ensure that VAT accrues in the place of consumption, and self-assessment for business customers continues to be used.

### WTO DECLARATION ON GLOBAL E-COMMERCE

3.24 The second Ministerial conference of the World Trade Organisation (WTO) in May 1998 agreed on a declaration<sup>32</sup> establishing a comprehensive work programme for all trade-related issues of e-commerce. It was also decided that all WTO members would continue the current practice of not imposing customs duties on electronic transmissions.

### THE UK-US STATEMENT ON E-COMMERCE

3.25 In January 1999, the Prime Minister and the Vice President of the United States issued a joint statement on e-commerce<sup>33</sup>. The agreement committed the governments of the UK and the US to work together on a wide range of issues to support the development of global e-commerce in the future. On taxes they supported and endorsed the following principles and policies:

“Any taxation of e-commerce should be clear, consistent, neutral and non-discriminatory. We will actively participate within the OECD and work toward achieving the application of the framework principles for the taxation of electronic commerce agreed by member countries at the Ministerial conference at Ottawa in October 1998. Close co-operation and mutual assistance between the UK and the US tax authorities is necessary to ensure effective tax administration and to prevent tax evasion and avoidance.”

<sup>30</sup> *Indirect Taxes and E-commerce – Commission Paper XXI/99/1201-EN*

<sup>31</sup> Article 9 Sixth VAT Directive 77/388, (UK related provisions contained in Sections 7(10), 7(11), 8(1) 9 and Schedule 5 Value Added Tax Act 1994, VAT (Place of Supply of Services) Order 1992 (as amended))

<sup>32</sup> available at [www.wto.org/anniv/ecom.htm](http://www.wto.org/anniv/ecom.htm)

<sup>33</sup> available at [www.number-10.gov.uk/public/news/index.html](http://www.number-10.gov.uk/public/news/index.html)

## CONCLUSION

- 3.26 International debate and co-operation have been crucial to the progress which has been made on the taxation issues which are explored in more depth in Chapters 4-8. The Government continues to believe that the OECD, and for VAT the European Union, are the most appropriate fora for this and the UK has played, and continues to play, a leading role in the work of both.



# Harnessing the technology: modernising tax administration

- 4.1 The Government has been providing services electronically to taxpayers for many years and is expanding these services all the time. The expectations of taxpayers are changing fast too. The Government recognises this and, as shown in Chapter 2, has set targets, aims and objectives for modernising government. The benefits of technology must be used to make things easier for citizens, business and government, and to help get things right first time so that everyone saves time and money.
- 4.2 The development of electronic services and their take-up by taxpayers, depend on a number of factors. In particular, the Government sees it as essential to put in place the legislative framework and remove barriers to electronic interaction with taxpayers. It must ensure security and customer confidence.
- 4.3 The 1999 Finance Act introduced legislation to facilitate the use of electronic communications between taxpayers and the Inland Revenue and Customs. For instance, it changed legislation that made it difficult to accept documents which do not have a signature in the traditional sense. The Electronic Communications Bill will bring legal equivalence between electronic and written signatures generally. Solutions to security issues are being found with market developments such as Public Key Infrastructure (PKI).
- 4.4 This chapter shows how technology is being used to modernise the Inland Revenue and Customs – what has been achieved, what is being done and what will be possible in the future.

## COMMUNICATION

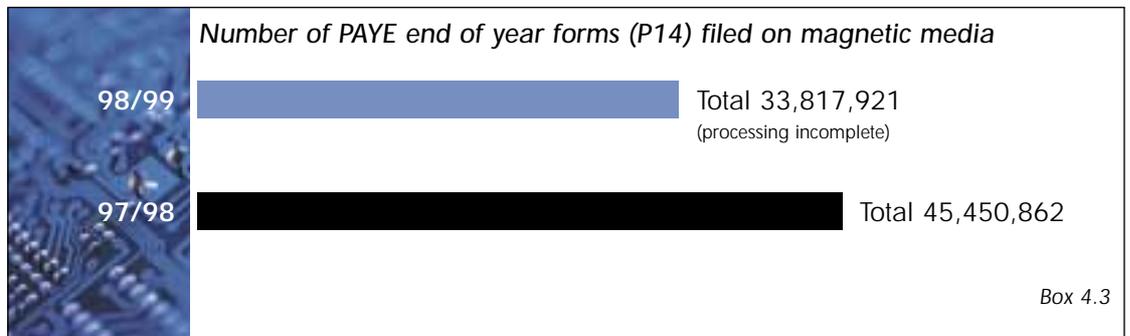
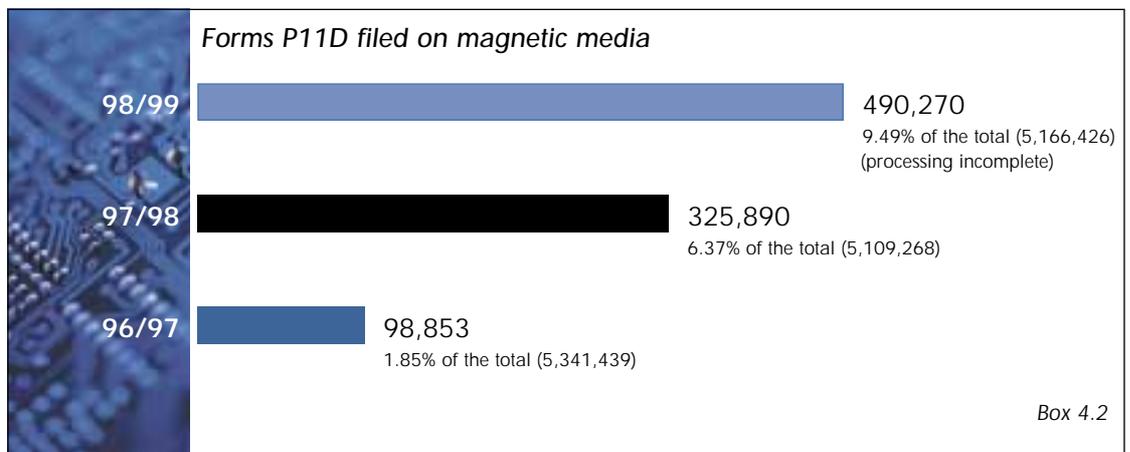
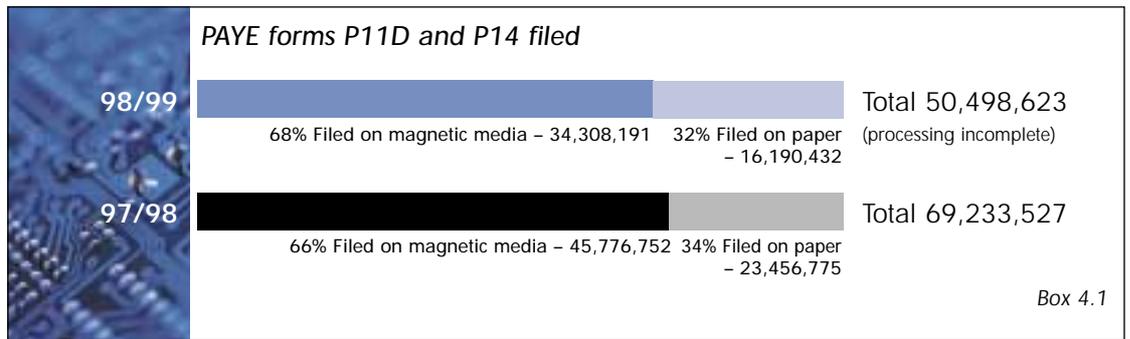
### Communication with employers

- 4.5 Various means of electronic communication are available.

### *Magnetic media*

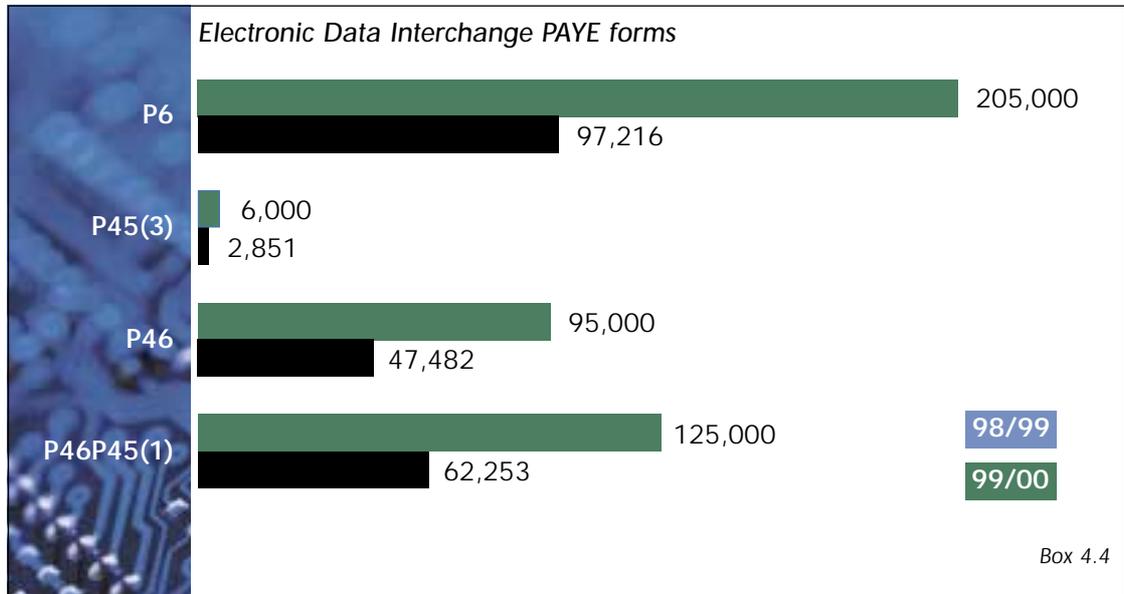
- 4.6 For many years facilities have been offered to employers to exchange a wide range of forms on magnetic media such as tapes, disks and cartridges. These include end-of-year pay and tax

details, returns of employee benefits and expenses, details of personal and contracted-out pensions, and notices of budget coding changes. The employer's annual pack, which contains forms, tax tables and guidance for employers, is made available on CD-ROM. As Boxes 4.1 – 4.3 show, the volumes involved are very substantial.



**Electronic Data Interchange (EDI)**

4.7 EDI services over commercial networks remove the need for physical exchanges of data. Because of high set up costs, these are mainly suitable for those exchanging large volumes of information. An EDI service for forms that can currently be submitted via magnetic media, as well as other 'employer' forms, is being introduced in stages between April 1999 and April 2000. The full range and volumes can be seen in Box 4.4.



#### *PAYE forms over the Internet*

- 4.8 The Government plans to introduce a service during 2000/2001 to enable employers to send and receive a wide range of PAYE forms over the Internet. And it intends to offer discount on returns filed over the Internet (see 1.12). The forms will be broadly those which are currently covered by magnetic media and/or EDI services. This will be a major step forward in helping smaller employers, who cannot afford the setting up costs of EDI, to benefit from using cheaper and simpler Internet technology. The Government will work closely with the payroll software industry to incorporate Internet transmission of forms into their products.
- 4.9 There needs to be a secure system for these Internet exchanges. The strategy, in line with government generally, is to use the emerging Public Key Infrastructure (PKI) which is likely to mean customers will need a smart card from one of a range of providers. But other ways of ensuring security and customer confidence in the shorter term will be necessary to make the services available on a large scale, while the structure of the PKI market place matures and a significant customer base is established. The Government is also looking at how best to send secure messages to employers both to meet short-term needs and to provide potential for a value added cross-governmental service.

#### **Construction Industry Scheme**

- 4.10 This service enables contractors or software houses acting on their behalf to send in the required vouchers for payments to subcontractors using an EDI service. It went live on 1 August 1999.

#### **Communication with pension scheme providers**

- 4.11 In 1997, an EDI link was introduced for pension scheme providers to submit forms to the Inland Revenue to register and cancel personal pensions, which attract rebates on National Insurance Contributions because they are contracted out of SERPS. This removes the handling and checking of clerical forms and so speeds up the process.
- 4.12 The Government is considering extending the facility to Contracted Out Salary Related (COSR) schemes and Contracted Out Money Purchase (COMP) schemes.
- 4.13 Pension schemes currently provide information (mainly on paper) to the Inland Revenue and the Occupational Pensions Regulatory Authority for the purposes of

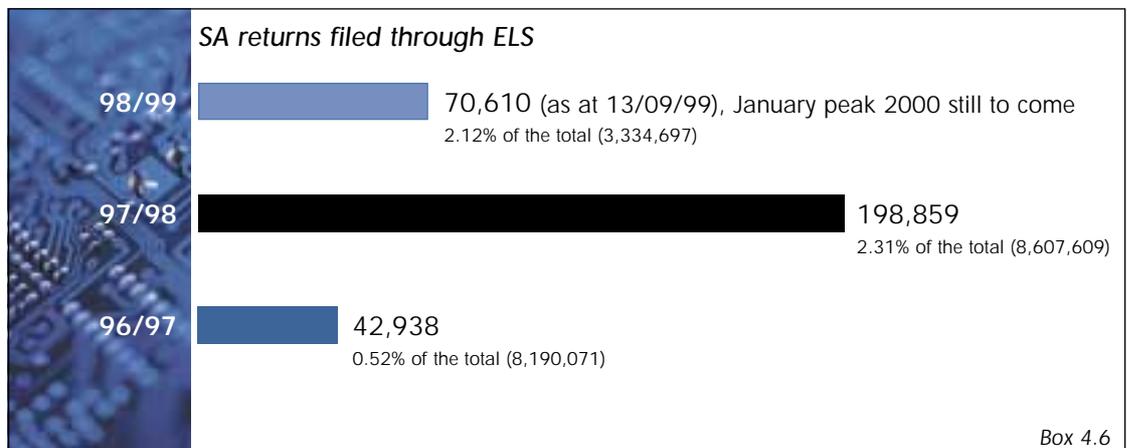
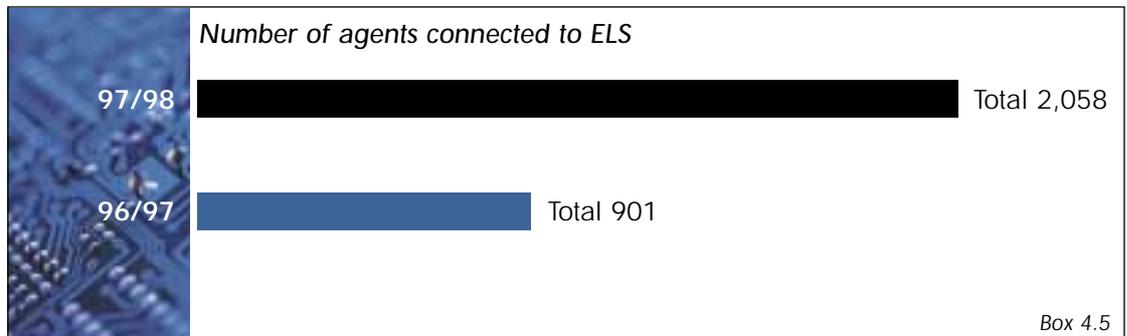
registration and approval. A study is currently underway to consider rationalisation of the process and the use of electronic means of transmission.

- 4.14 The forms that pension scheme providers need will soon be available on the Inland Revenue's web site. The possibility of them being able to be completed and submitted on-line is being investigated.
- 4.15 The Government is also investigating the possibility of one electronic application/registration form for pension schemes across various parts of the Inland Revenue (Financial Intermediaries and Claims Office, Pensions Schemes Office, Contracted Out Employers' Group) and the Occupational Pensions Regulatory Authority (OPRA). The form would be automatically checked and the system would automatically maintain records for all the organisations concerned.

**Self assessment returns**

*Electronic Lodgement Service*

4.16 The Electronic Lodgement Service (ELS), introduced in April 1997, enables agents to send their clients' self assessment tax returns electronically using the EDI format. Any agent wishing to use it registers with the Inland Revenue's Electronic Business Unit, which provides support if needed. As Boxes 4.5 - 4.7 show, both the number of agents using the service and the number of returns they send in has increased dramatically in its second year of operation. Current expectations are for over 400,000 returns to be filed in the third year of operation, more than doubling the previous year's figure.



	<b>% shift</b>
Number of agents	128%
Number of returns filed electronically	323%
Number of 'phone calls made to the Electronic Business Unit	25%

Box 4.7

#### ***Self assessment returns over the Internet***

- 4.17 The Government plans to introduce a service in April 2000 to allow most individuals to send in their self assessment tax return over the Internet with no need to produce or keep a paper copy. This major new development will build on, but not replace, the successful ELS for agents. Many details have still to be settled and a programme of continuous improvement after April is planned. The Government also intends to offer a discount on tax returns filed over the Internet (see 1.12).
- 4.18 The electronic self assessment returns available from the Revenue web site will provide help, guidance and data validation. The Government has been and will continue to work with the private sector to support the inclusion of the tax return in commercial products as well.
- 4.19 The security solutions detailed in paragraph 4.9 above will also apply to filing of self assessment returns via the Internet.

#### ***Payment***

- 4.20 An Internet payment service will be introduced during 2000.

#### ***Company filing***

- 4.21 The Government will be exploring the use of Internet technology for an on-line service for companies to file their tax returns, and will look to extend the service with other government departments.

#### ***WinLife***

- 4.22 WinLife is an application that has been in use in the Inland Revenue for some years to help check the tax computations of life insurance companies. It adopts an innovative approach to the presentation of complex tax rules in an easily accessible format with comprehensive on-line help. It has now been developed to the stage where it is attracting commercial interest and the Government is exploring the possibility of a joint venture with a software house to maintain and market the application. This would help companies comply more easily with their tax obligations and would pave the way for the electronic submission of their computations at some future time.

#### ***National Insurance Contributions***

- 4.23 A review of business processes is underway within the National Insurance Contributions Office to identify those suitable for electronic delivery.

#### **Communication with freight handlers**

##### **CHIEF**

- 4.24 CHIEF (Customs Handling of Import & Export Freight) is the Customs and Excise declaration processing system which currently handles in excess of 99 per cent of the country's import declarations (5.4 million declarations during the twelve months to April 1999).

4.25 CHIEF provides:

- direct trader access to the electronic processing of imports and exports – including the calculation of duties, currency and quantity conversions – and the automatic clearance of consignments;
- identification of imported goods which require documentary or physical examination, making use of a highly sophisticated risk-profiling system; and
- fast and flexible on-line information retrieval of up to four years' import and export data. As well as managing information, this facility supports the investigation of fraud and the management of Customs operations.

4.26 CHIEF enables the collection of billions of pounds of revenue each year, the accurate collection of international trade and transport statistics, and the protection of society by controlling the import and export of restricted goods, as well as detecting the smuggling of prohibited goods.

#### ***Freight Business Programme***

4.27 The continued requirement to submit paper frontier declarations and supporting documents for the international movement of freight is an issue which has been widely debated in recent years. The Government has believed for some time that a more advanced approach to handling entry requirements, using electronic means, would give distinct benefits to both government and business. This led to one of the main recommendations in the 1997 Customs Long Term Freight Policy document<sup>34</sup> being to pursue a fully electronic environment within the customs business.

4.28 At the same time, the European Commission's Customs 2000 (now Customs 2002) initiative has proposed a number of simplification projects including a move towards the removal of all paper-based procedures by 2002. The reform of the Single Administrative Document (SAD), which is the standard form used to declare goods to customs, and development of the Single Administrative Message (SAM), which is the electronic equivalent, flow from this initiative.

4.29 UK Customs' Freight Business Programme contains a number of initiatives that support the move to an electronic environment. These projects are described below.

#### ***Customs Freight Simplified Procedures***

4.30 Customs Freight Simplified Procedures (CFSP) were introduced in 1998 and, in many cases, removed the need for a customs declaration and supporting documentation to be submitted in paper format at the frontier. Authorised traders are instead allowed to supply full details of the goods to Customs, at a later date, by means of EDI.

4.31 CFSP also allows for supporting documents to be retained at a trader's commercial premises to be checked on an audit basis.

#### ***Single European Authorisations***

4.32 Building on the messaging systems developed for CFSP, the Government is also participating in an EU-wide Single European Authorisation (SEA) project to facilitate multi-national business. This will allow a business to appoint a single centre of administration within the EU for the operation of their simplified import and export procedures. Customs duty and import VAT in respect of imports into the EU would be paid to the EU Member State where the authorisation is held.

### ***International Trade Prototype***

- 4.33 The UK is working in partnership with the US and multi-national companies to develop prototype systems designed to reduce procedural barriers to international trade, standardise customs procedures and enhance mutual assistance between customs services. By simplifying and standardising customs procedures, goods will be able to move across international borders much more quickly and efficiently.
- 4.34 The International Trade Prototype (ITP) project will make use of both secure Internet services and EDIFACT<sup>35</sup> messaging for the exchange of data relating to the importation/exportation of goods.
- 4.35 A seamless transaction will be created with the electronic export declaration becoming the import declaration in the importing country. This will cut down the amount of administration and amount of paperwork involved with international trade, thereby reducing burdens on business.

### ***G7 initiative***

- 4.36 The Government is working with counterparts from the G7 countries to standardise electronic customs declarations across the G7 countries. This will reduce the costs of customs processing, promote trade, help governments collect taxes and statistics and help prevent fraud and corruption.
- 4.37 The G7 countries are working to develop a standardised set of data elements for both import and export which will be universally applicable. Work is also being carried out in conjunction with ITP to develop an EDIFACT message to cater for these data sets.

### ***Export Review***

- 4.38 The Government is developing an electronic system for dealing with export declarations which will facilitate the move to an inland system of audit-based control. This effectively means that customs controls will mainly be carried out inland at the business premises.
- 4.39 The new export system will allow for the presentation of a minimal amount of information about the goods prior to their shipment, but sufficient to allow Customs to carry out its checks. Once the goods receive customs clearance inland, they can be shipped in the knowledge that they will receive speedy and almost certain frontier clearance.
- 4.40 There will also be an option for a fully electronic system of clearance for exports at the frontier for those businesses that do not wish the customs checks to be carried out at their premises. All options are likely to be introduced by 2002.

### ***Paperless customs declarations***

- 4.41 As well as the work already carried out on simplified procedures, the Government is looking at extending the use of paperless systems to normal import procedures. There are a number of legal and procedural issues which need to be resolved before this can be accomplished. One of the main areas to be addressed concerns the acceptance of electronic authentication for customs declarations. Customs currently rely on a hand-written signature on a paper customs declaration to determine who was responsible for the importation/exportation of the goods in question. If the paper version of the entry is to be removed, then a way of replacing this signature in an electronic environment will need to be found.

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<sup>35</sup> a globally-used standard form of electronic transmission

4.42 Another area which needs to be addressed is how, in an electronic environment, Customs will deal with documentation which currently supports the paper declaration. Negotiations are underway to resolve this matter in Europe with the aim of allowing traders to retain supporting documents at their commercial premises for Customs to view at a later date if required. The Government is participating in these negotiations and is actively supporting an amendment to current legislation to make retention of supporting documentation possible.

#### VAT returns and forms over the Internet

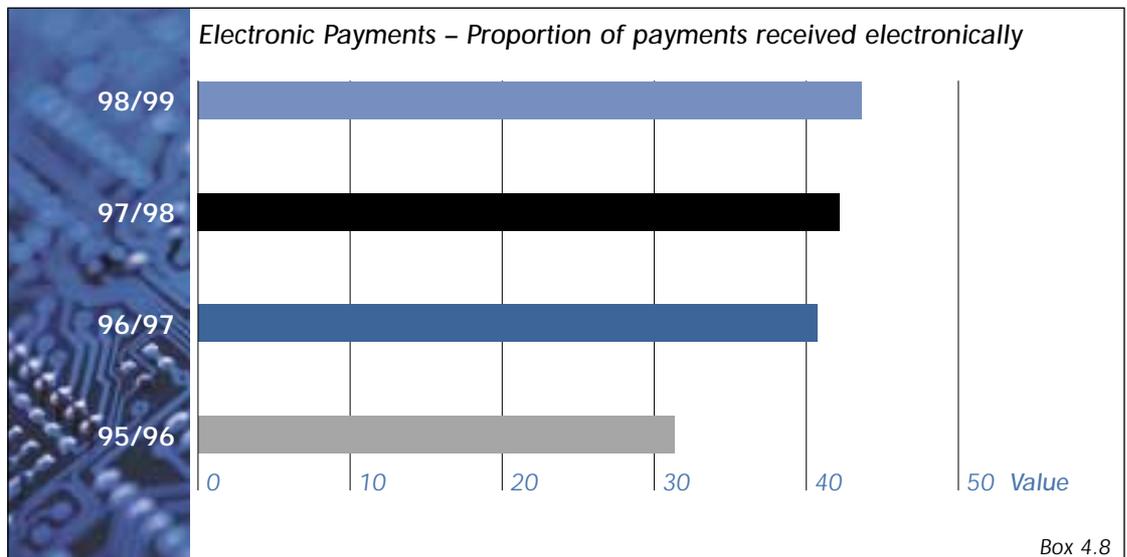
4.43 An Internet trial of VAT returns has already begun, which involves approximately 100 VAT registered businesses. These businesses will submit VAT return information electronically via the Internet, but will continue, for the period of the trial, to submit a paper return as well. If this is successful a live Internet pilot will be introduced in March 2000. The Internet based form for electronic VAT returns will be interactive with guidance, help messages and in-built validation of data. And the Government intends to offer a discount on returns filed over the Internet. (see 1.12).

4.44 In line with the Government White Paper on *Modernising Government* a target of 25% take-up (400,000 businesses) by 2002 has been set. Initial indications suggest that businesses welcome the option of Internet filing.

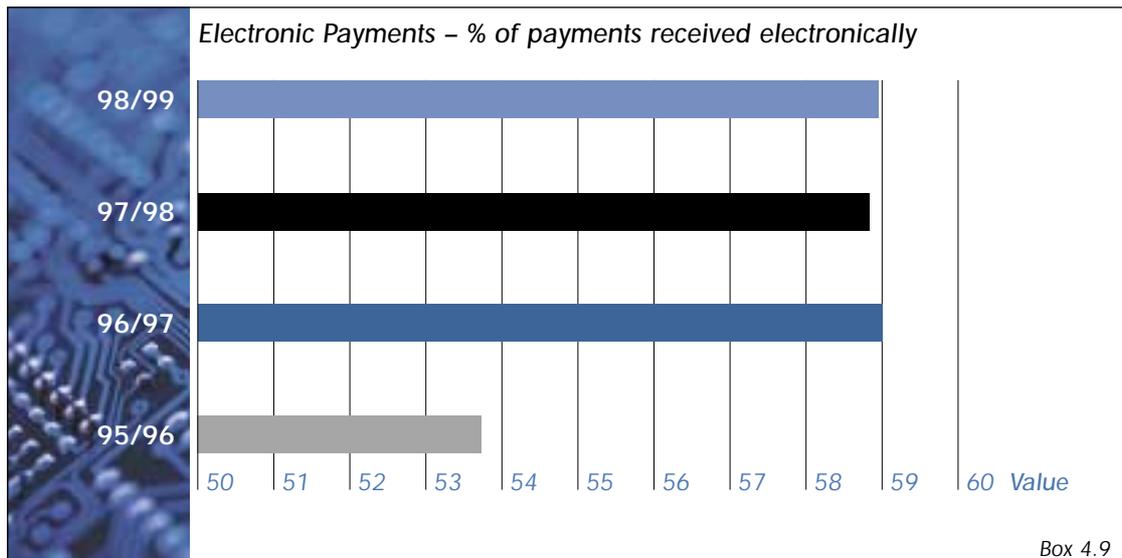
4.45 The Government is also working with software developers to incorporate Internet filing applications for VAT into business accounting software.

4.46 As part of the strategy to enable electronic transmission of all VAT forms, the Government also plans to introduce an Internet trial of VAT registrations in April 2000.

4.47 The following information gives an outline of electronic payments received. Boxes 4.8 – 4.9 show the value of VAT received in £ billions.



4.48 Box 4.9 shows the percentage of payments received.



4.49 The security solutions detailed in paragraph 4.9 above will also apply to filing of VAT returns via the Internet.

#### E-form for Intrastat declarations

4.50 Customs has developed an electronic form that can be used to return statistics over the Internet. Businesses have the option of local input of data which has proved popular as the system allows bulk uploads of data without the need to re-key. The Government has been encouraged by the positive response by business to this initiative.

4.51 Customs' computer system automatically validates the data by identifying basic keying errors and reduces the possibility of transmitting incorrect data. The system automatically acknowledges its receipt – a facility not available to businesses that submit their data in hard copy.

#### EC Sales Lists

4.52 A business which makes a supply of goods to a VAT registered customer in another European Member State can zero rate the supply, provided they obtain their customer's VAT identity number and can provide documentary evidence of the "export". The declaration is made to Customs on an EC Sales List which is then sent electronically to the tax authority in the other Member State. The information helps to provide a level playing field for UK businesses by ensuring that competitors account for the tax in the Member State of destination, and provides an effective anti-fraud measure for the authorities. Customs are committed to reducing administrative burdens on businesses by providing a variety of transmission methods to send sales lists electronically. In addition to the methods currently available under EDI, Customs are developing options to submit the lists via the Internet.

#### Information and education

4.53 Both the Inland Revenue and Customs use their web sites extensively to provide information and help to customers.

4.54 The Customs web site has increased its audience from a few hundred to over 175,000 page visits per week. And the Inland Revenue web site has been redeveloped during the last year to a new design based on market research. Currently the site has

approximately 275,000 page visits per week on average, with higher seasonal peaks (Budget day and during the Self Assessment cycle).

- 4.55 New developments include adding on-line declarations to the Customs web site. This is currently being trialled for Intrastat declarations and a VAT return is now also being developed. The Inland Revenue manuals will be made available online on the Inland Revenue web site as part of the Open Government initiative and interactive questions and answers are planned.

### **Call centres**

- 4.56 The Inland Revenue and Customs use the telephone extensively. In 1998 the Inland Revenue had 37 million calls, a 23 per cent rise over the 30 million in 1997 and equivalent to 4,000 staff working full-time. Customs and Excise currently has over 30 advice points dealing with over two million calls a year. Both departments are experimenting with the use of call centres.
- 4.57 Call centres differ from telephone units, response lines and help lines because they transact business – not just provide information.
- 4.58 The Inland Revenue's experimental call centre in East Kilbride serves the two million employees and pensioners of Scottish-based businesses, and is open 8am to 8pm Monday to Friday. Callers can make claims to allowances or deductions, amend their self assessment tax returns, get help in completing their returns and other forms, and they can get answers not just to general queries but to specific questions about their own tax liability. The experimental call centre is designed to test the demand for doing more business by telephone. The experiment runs for one year until 30 November 1999. If it is successful, the Inland Revenue will extend the use of call centres across the rest of the UK. It would aim to roll out 50 per cent of call centres by 2002.
- 4.59 Customs has successfully completed a trial of virtual call centre working where incoming calls are distributed across a network of geographically remote sites linked through a telecommunications system to provide a seamless national advice service. It expects to introduce a virtual call centre with one national telephone number from April 2001.

### **Contact centres**

- 4.60 In the longer term, the Government plans to develop contact centres which will be able to respond to customers in a variety of ways, including by e-mail, telephone, video and interactive television.
- 4.61 The same infrastructure used for call centres will support the administration of Internet transactions, e-mail etc. Call centres will migrate to multi-purpose, multi-channel contact centres, for internal and external customers, offering one easily identifiable place for customers to get in touch with the organisation.
- 4.62 Customs plan to expand its call centre operation into multi-media contact centres to create an integrated customer service package. It will develop computer technology integration facilities for users to navigate its information systems. The services offered will cover not simply enquiries but processing of transactions to amend or update information held by Customs on business. These developments are planned for delivery during 2001/2002.

- 4.63 This will not end personal contact for those who want it. The contact centre can also have local outlets where staff have the same access to the support systems used by the central contact centre.

### **Inheritance Tax**

- 4.64 The Government is developing an interactive electronic return for inheritance tax. This will calculate tax and interest due based on values entered by the taxpayer. Initially the return would be available for on-line completion but would be submitted by post. In the longer term the possibility of on-line filing will be explored.

### **Stamp Duty**

- 4.65 Stamp Duty is charged on sales of UK property and of UK-registered shares. While there are some developments which will in the future allow for the electronic transfer of title to land and buildings, it is electronic settlement of share deals that has prompted developments in Stamp Duty taxation. Stamp Duty provides direct experience of a tax charged on electronic transactions which is also collected electronically.
- 4.66 In 1986 Stamp Duty Reserve Tax (SDRT) was introduced as a backup for Stamp Duty where a transaction was carried out without the execution of a legal document. At that time, SDRT did no more than fill a few gaps. The two taxes do not apply simultaneously.
- 4.67 Subsequently, in order to cater for electronic trading of shares, the Government made company law regulations relaxing the general rule that a transfer must be made by a paper document. These permit a paperless transfer of shares to be registered, provided it is made through an electronic system approved by the Treasury. SDRT regulations impose an obligation on operators of approved electronic transfer systems to collect SDRT on transfers going through their systems. The tax collected in this way, with information required for audit purposes, is conveyed electronically to the Inland Revenue.
- 4.68 'Crest' is currently the only approved operator and its system went live in 1996. The bulk of the SDRT yield – most of the total £3 billion or so of Stamp Duty/SDRT on share transactions – is now collected through this system.
- 4.69 Internet trading of shares is a more recent development. But this does not in itself affect the collection of SDRT. The tax on Internet deals, as for other deals, is typically collected when it is settled on Crest and the company registrar accepts and records a change of ownership of the shares concerned.

### **Future use of the Internet**

- 4.70 Greater exploitation of Internet technology will enable the Government to offer a greater range of services and, working with other government departments, will allow its customers greater access to and control of information about themselves across government. For instance, taxpayers could check on their payment position, make claims, and check information on previous tax returns. They could also update information that the Inland Revenue and Customs and other parts of government hold about them.

## **JOINED-UP GOVERNMENT**

- 4.71 The Government is committed to joined-up government – central and local authorities working together to provide customers with the right services for their circumstances.

## **Business with Government**

- 4.72 Business with Government is a pilot partnership between central and local government in which the Inland Revenue and Customs are participating.
- 4.73 The service is aimed at people who want to set up in business. It is an interactive web-based service. The idea is to provide people with up-to-date, consistent, step by step guidance through what they need to do, what their entitlements are, and where to get further help if they need it. Information will be tailored to the individual circumstances of the customer and (increasingly) they will have the option to send information to government automatically.
- 4.74 The aim is to encourage enterprise by giving businesses the information they need at one cheap, easy and convenient point of contact; making government more user-friendly. The system will increase the chances of customers succeeding first time and reduce the costs of doing so.
- 4.75 This pilot will enable participating authorities to explore the potential for:
- reducing the burden on citizens wishing to open up new businesses, by providing accurate, up-to-date and consistent responses from a single convenient source;
  - making it easier for customers to succeed with their obligations, by tailoring information to their circumstances and making it easier to obtain;
  - reducing government costs by increasing the chances of first time success by customers in gaining their entitlements and meeting their obligations; and
  - overcoming the difficulties of different authorities working together to provide customers with integrated information.
- 4.76 Within the funding and timescales, the pilot service will cover only a small slice of the huge amount of information possibly relevant to someone setting up a new business. The real value of the service will be that it is customer driven. It will adapt and update its database in response to the questions people ask. To launch the pilot, the project has asked a number of organisations representing small businesses to say what are the questions most frequently asked by their members.
- 4.77 The pilot service has been developed during the summer of 1999 and restricted trials are now running with a number of representative bodies of small business.

## **Business Information in Government**

- 4.78 The Inland Revenue and Customs are also working on a study in partnership with other government departments originally known as the Single Business Register but now renamed Business Information in Government (BiiG).
- 4.79 Government departments are investigating the issues associated with compiling a single register of businesses for use by government departments. The service would be made available primarily over the Internet.

4.80 The study is expected to identify the benefits as being:

- reducing the burden on businesses of supplying information to central government;
- reducing administration costs by having a single source of information; and
- assisting data sharing between departments, where legislation permits.

4.81 The study will be completed by the end of 1999 and it is hoped to develop a pilot system during 2000/01.

### Portals

4.82 It is the Government's intention, as announced in the *Modernising Government White Paper*, to develop a number of Portals as potential, single, integrated means of access to different types of government information and services. These will allow information from different sources within government to be brought together at one point, facilitating the creation of new joined-up services with a standardised presentation. In practice, it will allow citizens and businesses access to these services, with the appropriate authentication checks, via the Internet.

4.83 The first Portal to be developed will be the facility to notify a number of government departments of a change of address in a single transaction. A pilot system is expected to be operational by summer 2000 with a national roll-out by 2002. Further Portals offering other services will be developed.

## INCREASING THE EFFICIENCY OF THE DEPARTMENTS

4.84 As well as improving the service the Inland Revenue and Customs offer their customers, they are also using technology to improve internal procedures. This is a continuous process. It is not the purpose of this paper to review this in detail except for procurement, where the Government has set targets for electronic delivery.

### Procurement

4.85 The Inland Revenue and Customs have introduced integrated automated purchasing systems that facilitate end to end electronic purchasing and payment with suppliers. The systems offer 'on-line catalogues' featuring the products of most of their major suppliers, and giving purchasers an automated mechanism to select, order and pay for products.

4.86 Pilots of the Government Procurement Card (GPC) have been successfully completed and are currently being evaluated. The GPC is designed to complement the departments' systems by offering a quick and easy mechanism for ordering and paying for high volume, low value transactions which make up a high percentage of their purchases.

4.87 The Government is developing a high-level model for an electronic procurement system across government and has published a requirement in the Official Journal of the European Community for a 'government cyberstore'. The cyberstore would provide extensive electronic links to supplier catalogues established under suitable government-wide framework agreements. It is envisaged that the preferred payment method will be via the GPC.

## CONSULTATION WITH CUSTOMERS

4.88 A sub-group of the Electronic Commerce Consultation Forum (see 2.18) is looking at taxpayer service delivery. This includes a number of bodies which represent software houses, accountancy firms and their clients. Amongst the issues that the sub-group has been asked to look at are:

- the services, information and electronic access that business would like to see available;
- co-operation with private sector producers;
- how the take up of Internet filing could be encouraged; and
- business views on the challenges to tax administration and how they might be addressed, including for example, digital signatures, encryption, PKI, authentication, security.

## CONCLUSION

4.89 The Inland Revenue and Customs are in the forefront of the move to Information Age Government outlined in the *Modernising Government* White Paper. Along with making greater use of technology to help deliver the Government's vision of services available 24 hours a day seven days a week, they are acutely conscious of the need to improve the content of the information and services they deliver, as well as the channels through which it is delivered.

4.90 The close co-operation between the two departments in the development of electronic services is joined-up government in action, and makes it easier for their customers to do business with them – saving everyone time and money.



# The challenges to tax compliance

- 5.1 Taxpayers and the Government have a mutual interest in maintaining the integrity of the tax system ensuring that:
- it is as easy as possible for taxpayers to comply with their obligations and secure their entitlements;
  - compliance costs are kept to the minimum compatible with effective tax administration; and
  - tax evasion is tackled so that taxpayers who play by the rules are not disadvantaged and public services can be adequately funded.
- 5.2 The vast majority of taxpayers comply with their tax obligations. But there will inevitably be those who will see e-commerce as an opportunity to evade taxes. Electronic trading provides opportunities for fraud similar to those that exist with, for instance, cash. But it also has the potential to amplify significantly some existing areas of risk. Techniques for detecting and deterring those attempting to evade taxes must keep pace with the development of technology. And emphasis needs to be firmly placed on ensuring that compliance regimes are simple and certain, thus encouraging compliance in the first place.
- 5.3 This chapter explains the risks that e-commerce poses to tax administration and compliance and how, with the help of business, the Government can address them.

## CUSTOMER EDUCATION AND SUPPORT

- 5.4 The Government believes that encouraging and assisting taxpayers is the most effective way of enabling them to comply with their tax obligations. This applies to those taxpayers engaged in e-commerce as it does to those trading by more traditional means. Taxpayers are more likely to comply if:
- they understand and have confidence in the laws they have to observe;
  - it is easy to comply; and
  - compliance is a positive move giving certainty and reflecting good citizenship.

- 5.5 Encouraging and improving compliance is achieved by respecting taxpayers' rights and helping them recognise their obligations under the law. Publicity, taxpayer education and support are all essential to achieving these goals.
- 5.6 The Government has already put in place arrangements to rewrite tax law to make it more transparent. And e-commerce provides an opportunity for Government to interact with business in a direct way. It has the potential to provide access to structured information on demand as well as interactive services.
- 5.7 To assist in this process the Government is:
- looking at the design of income and corporation tax returns to incorporate a request for a business to give its web site and e-mail address. This could, in the future, bring the advantages of speedier communication and enable the Inland Revenue and Customs to target sector related information or guidance;
  - examining how developments in technology might be used to reduce compliance costs on business during the audit of electronic data, books and records, within acceptable risk parameters;
  - considering in particular what guidance small and medium sized enterprises (SMEs) which are starting to trade over the Internet and, perhaps, internationally for the first time, need to help them comply with their obligations; and
  - using the opportunities offered by technology to assist taxpayers to comply with the law and to help keep compliance costs for business down (see Chapter 4).

### Risks from e-commerce

- 5.8 There is a distinction between those who fail to comply through ignorance or inadequate information, and those who do so deliberately. The compliance risks for direct and indirect taxes are not new and at present there is no evidence to indicate that those engaging in e-commerce are either more or less compliant than traders using more traditional media. Arguably e-commerce is essentially a different means of trading. And as the majority of e-commerce transactions are between businesses the risks to compliance are likely to be less.
- 5.9 All businesses have an interest in the Government ensuring that everyone complies with the law. For the system to work properly there are a number of key requirements:
- *Identification* – who is doing business, whether a taxable transaction has taken place, who are the parties to a transaction, and their location;
  - *Access* – records should be readily available to auditors;
  - *Assurance* – verifying the integrity, source, completeness and accuracy of data; and
  - *Understanding* – knowledge of the sector will inform compliance strategies.

5.10 E-commerce has the potential to make it more difficult to satisfy these requirements, through:

- taxpayers exploiting the anonymity afforded by the Internet to conceal their identity, location and/or particular transactions, income or gains;
- encryption of documents and financial records – or the holding of them in other jurisdictions – to try to prevent tax administrations gaining access;
- electronic generation and filing of returns that may be based on information that exists only in electronic form, and by use of record keeping systems which allow transactions to take place without leaving an audit trail or where the trail may be easy to alter or destroy; and
- statistical information on growth rates and market penetration rapidly become out of date, making assessment of risk baselines impossible.

5.11 Additional concerns include:

- the transient nature of the Internet together with the low start-up costs which may encourage businesses to trade for a short period without notifying tax authorities;
- the ease with which taxpayers can move assets offshore and so avoid paying taxes that are due;
- the exploitation of low tax regimes to avoid UK taxes; and
- electronic money which may mirror the anonymity of cash.

## ADDRESSING THE RISKS

5.12 Information is the key to addressing the risks and to maintaining the effective administration of both direct and indirect taxes. It should be accessible to the Inland Revenue and Customs to the same extent as with more conventional means of commerce. And consultation with business will be needed to ensure that any measures considered necessary to deter, uncover or rectify non-compliance should have proper regard to the costs they may impose.

### Identification

5.13 The majority of businesses see a positive benefit in identifying themselves and their location when trading over the Internet, since consumers want to be reassured that they are dealing with legitimate concerns. Indeed, business has expressed the view that the success of e-commerce will be driven by the strong branding of the supplier and its products within a secure trading environment so as to engender confidence in the purchaser. An important element of this is the development by business of PKI, a system of verification and authentication of each party to an e-commerce transaction, including encryption and decryption of data. This should help to minimise tax compliance risks.

- 5.14 But there will be a minority of businesses in this environment who have no desire to comply or who are trading illegally. As a result, they not only put tax revenues at risk, but gain an unfair advantage over their honest competitors.
- 5.15 The Government is continuing to monitor developments, both domestically and with its international partners, by looking at the extent to which existing or developing technologies, standards and protocols can be used or modified to assist in:
- identifying taxpayers;
  - tracing or establishing their location; and
  - identifying commercial or business transactions and those transactions on which consumption taxes are due.

### Access

- 5.16 Encryption of records of financial transactions and electronic documents is perfectly legitimate and proper for reasons of commercial confidentiality. However, encryption software could be deliberately exploited by non-compliant taxpayers to make it difficult for tax authorities to access their accounting records.
- 5.17 The global nature of the Internet may also encourage those who are non-compliant to store their accounting records and documents on computers located outside their tax jurisdictions.
- 5.18 The Government is continuing to monitor developments both domestically and with its overseas partners, by:
- reviewing the adequacy and practical application of current domestic powers for information gathering in an electronic environment including the issues posed by encryption; and
  - working to improve the exchange of information between jurisdictions.

### Assurance

- 5.19 Confirming the integrity and authenticity of data provides a challenge in the electronic environment both for business and tax administrations. They have traditionally relied on audit trails based on paper – with its inherent look, feel and authenticity. Data held in electronic form does not at first glance provide these comforts. It can be corrupted, unintentionally or otherwise before presentation and it is capable of manipulation.
- 5.20 E-commerce requires levels of assurance for both business and the auditor. Historical paper audit trails are being replaced by electronic trails containing data of increasing volume and complexity. In order to secure a transaction over an open communications highway, security and integrity of the data are essential.
- 5.21 Electronic audit methods are being developed to address these problems and to give the level of assurance that businesses and tax administrations need. Business will lead the way in developing secure systems. It is in its interest to maximise performance through reliable information systems whilst, at the same time, minimising the risk of fraud. The Government will need to discuss its requirements with business and come to a view on the adequacy of assurance for tax compliance purposes.

5.22 The Government is looking, both domestically and internationally, at the development of PKI systems and associated Internet technologies to see how:

- they can be used to authenticate a taxpayer's identity, location and taxable status;
- they can satisfy the requirements of tax administrations for authenticity, non-repudiation, integrity and completeness of electronic data, books and records for tax purposes; and
- the Inland Revenue and Customs can work in partnership with business solution providers in this area to assure e-commerce systems.

5.23 The assurance of e-commerce systems will require revenue department staff to acquire and develop specific skills to audit and test these systems. They will also need to be aware of developments in this field to ensure their skills remain commensurate. This will include the adoption of computer-assisted audit tools and techniques, including the use of proprietary audit software for analysis and testing.

### Understanding

5.24 E-commerce is essentially a new means of trading. The Inland Revenue and Customs need to understand how it performs, the type of trade attracted to it and the breadth of activity. The reasons for non-compliance will not be new but there will be lessons to be learnt on the specifics.

5.25 Independent study of the rate of transaction growth varies considerably as do the predictions on market penetration. The Government will keep abreast of academic research and independent commentaries so as to ensure that they maintain an appropriate compliance strategy.

5.26 In particular they will be:

- collating evidence of e-commerce being used to take advantage of preferential tax regimes and feeding this into international work on harmful tax competition;
- examining how developments in technology might be used to trigger a bill for consumption taxes for on-line supplies by a non-resident supplier to private customers;
- monitoring the development of electronic payment systems for any compliance risks they present; and
- sharing best practice to produce guidance for tax inspectors, auditors and investigators on techniques for addressing the tax compliance risks.

### Smartcards and E-cash

5.27 The technology of smartcards continues to advance, delivering solutions to identification and applications that have historically required the use of a credit card. In terms of their use as an electronic payment system (e-cash) this presents a specific risk. To the extent that they are unaccounted they mirror the anonymity of cash but without the physical restrictions of cash.

5.28 Amounts of stored value on a card is generally capped and their application is geared towards micropayments. In the circumstances the risks may be limited. While there are e-cash experiments in progress, credit cards (where liability in case of error or theft lies with the card provider) are still the preferred payment method for most private individuals buying over the Internet. This may account for the reticence on behalf of businesses to develop the critical mass of infrastructure that would enable the system to move forward.

5.29 The Government is continuing to monitor this specific issue.

### Use of Tax Havens

5.30 The Government has legislation in place to prevent UK companies avoiding tax by diverting profits to controlled foreign companies (CFCs). A CFC is a company that is resident in a low-tax territory and controlled from the UK. An amount equal to the profits of the CFC is taxed on the UK shareholder.

5.31 There are a number of exemptions. The legislation does not apply where the CFC conducts business in a normal rate territory, unless it benefits from a listed tax break. Nor does the legislation apply if the CFC pays to the UK 90 per cent of its taxable profits (computed on UK lines) within 18 months of its year end. Additionally, it does not apply if the CFC has both sufficient staff and premises to carry out the business in its territory of residence and that business consists of certain 'exempt' activities. This is broadly a company whose main business does not fall into one of the following categories:

- dealing in goods for delivery to or from the UK, or to or from associated companies, unless the goods are delivered into the territory of the CFC;
- investment business; or
- financial or wholesale business, where at least 50 per cent of the sales are with associates.

5.32 Also, if a company fails the above tests but can demonstrate that it does not exist to avoid UK tax then no assessment on the UK shareholder will be due.

5.33 Where Internet sales or services are offered by a UK-owned subsidiary in a low-tax territory then the exemptions may not be satisfied – for example, where sales of goods are mainly with the UK and the company does not maintain a stock of those goods locally. In particular, the requirement that locally employed staff should be sufficient to manage the business will mean that companies which are little more than a brass-plate will not gain exemption. In these circumstances, the CFC rules will prevent UK companies from avoiding tax by diverting e-commerce through offshore companies.

5.34 However, the CFC legislation was introduced in 1984 and largely reflects the world before e-commerce. Whether the legislation is adequate to deal with these new developments needs careful consideration. The increasing possibility for goods and services to be offered direct to the general public from a haven company contrasts with the use of havens for intra-group arrangements for which the CFC rules were largely written. It is possible therefore that the CFC exemptions may need to be changed at some point in order to ensure that the UK tax base continues to be adequately protected and the Government is monitoring developments.

### Consultation with UK business

5.35 A sub-group of the Electronic Commerce Consultation Forum (see 2.18) is looking at administration and compliance. This subgroup includes a number of representative bodies as well as those UK businesses which participate in the Technology and Professional Data Assessment TAGs at the OECD (see 3.12).

5.36 Amongst the issues that the sub-group has been asked to look at are:

- the information and electronic access that business would like to see available;
- guidance and standards for information that business could include on a web site (tax reference number and metatags);
- business views on the challenges to tax administration and compliance and how they might be addressed including, for example, digital signatures, encryption, PKI, authentication, security;
- guidance for small and medium-sized enterprises who begin trading on the Internet;
- the advantages of web sites being notified voluntarily to the Inland Revenue and Customs by electronic means at the commencement of business enabling, for example, the targeting of sector-related information or guidance; and
- the ability of the Inland Revenue and Customs to use e-commerce technology to track payments and hence parties to a transaction in appropriate cases of suspected evasion.

5.37 Another sub-group of the Forum, the Business Profits sub-group (see also 8) is looking at the possible need to change the controlled foreign companies legislation.

### International co-operation

5.38 The above risks are essentially common to the administration of tax systems throughout the world. The Government recognises that a number of them can best be tackled in co-operation with other countries. Where tax administrations have developed expertise, the aim should be to share best practice for application both domestically and internationally.

5.39 The nature of e-commerce also means that businesses will be engaging in international trading transactions far more than ever before. To detect those intent on evading taxes on such transactions, co-operation and the exchange of information between tax administrations remains essential.

5.40 The Government is particularly interested in resolving a number of tax administration issues in the e-commerce field with its international partners. These discussions are being taken forward within the OECD. The areas include:

- adopting conventional identification practices for businesses;
- developing internationally acceptable guidelines on the levels of identification sufficient to allow digital signatures to be considered as acceptable evidence of identity in tax matters;

- developing internationally compatible information requirements. This includes requirements for the acceptance of electronic records, the format of records, access to third party information, other access arrangements, periods of retention and tax collection arrangements; and
- designing appropriate strategies and measures to improve tax compliance, including measures to improve voluntary compliance.

## CONCLUSION

- 5.41 E-commerce has the potential to amplify existing risks to tax compliance. The Government is actively working on the issues to ensure that a robust compliance regime can be applied to the e-commerce environment.
- 5.42 Business too has an interest in ensuring a level playing field, where all are aware of their rights and at the same time comply with their obligations. As the technology develops the Government will increasingly use it to make it easier for taxpayers to comply with their tax obligations.

# Modernising VAT

- 6.1 Consumption taxes are charged on the sales of goods and services. It is necessary for business to know at the time a sale is made if tax should be charged and, if so, at what rate. Value Added Tax (VAT) is the UK's major consumption tax and there has been a consistent message from business that clarity of the VAT rules for e-commerce is a top priority.
- 6.2 Being comprehensive in its nature, VAT is sufficiently robust to capture the vast majority of e-commerce transactions in its existing form. This is different from the complex web of sales taxes in the United States of America, which currently fail to tax many out-of-state sales. However, some adaptations to the VAT rules are needed in respect of international transactions in order to provide certainty, remove the potential for commercial distortion and to ensure that tax revenues are fully maintained.
- 6.3 This chapter considers these adaptations in more detail, including the implications of the European Commission's June 1999 paper (see 3.23).

## INTERNATIONAL CO-OPERATION

- 6.4 The potential for global trading means that no single country can act unilaterally. This is particularly so for consumption taxes where the risks of double taxation or unintentional non-taxation are increased without international consensus.
- 6.5 VAT is the common system of consumption tax adopted in the UK, Europe, and many other countries. In the EU, VAT is governed by VAT Directives, which provide a framework for a broadly uniform VAT system. The Government has been a key player in work co-ordinated by the European Commission and the Government has been working closely with other countries in the OECD to identify the consumption tax issues raised by e-commerce. The UK was instrumental in the development of several principles that were agreed at the OECD Ottawa Ministerial conference which took place in October 1998 and which are summarised in Box 6.1.

### *Ottawa recommendations*

- the rules for determining where tax (VAT) accrues should result in taxation in the jurisdiction of consumption – further work should be done to determine how this will operate;
- supplies of digitised products are “not goods” in respect of customs duties and VAT<sup>36</sup>; *cont.* ➔

<sup>36</sup> The treatment of digitised products as services means that customs duties are not applicable in Europe, which accords with the WTO agreement of May 1998 – see chapter 3.

- reverse charge or self-assessment should be considered by countries where this would give immediate protection to revenue and prevent distortion of competition for domestic suppliers; and
- countries should develop appropriate systems to handle the expected increase in importations of small packages in co-operation with the World Customs Organisation.

Box 6.1

6.6 The Government is continuing to take a leading role in work with its international partners to develop these principles in greater detail. The work is currently progressing along two distinct (but necessarily interrelated) strands – a clear definition for place of consumption, and effective tax collection mechanisms that do not impose undue burdens on business.

## ISSUES

6.7 The main issues for VAT revolve around international trading. E-commerce transactions fall into two categories for VAT purposes:

- physical goods ordered over the Internet delivered to both business and private customers; and
- services, including digitised products, provided on-line.

### Physical goods ordered over the Internet

6.8 The vast majority of sales over the Internet result in supplies of physical products. The existing rules ensure that tax accrues in the country into which the goods are delivered and so there are no significant new problems for VAT.

6.9 Since goods have to be delivered by conventional means, Customs will still collect VAT on goods imported from outside the EU at the time of importation (see 7.4) and the distance selling arrangements<sup>37</sup> will remain in place. Businesses will not have to make any changes to their existing accounting systems for these transactions. The very sophisticated systems being developed and operated by the fast parcels carriers should ensure that both carriers and Customs can cope with anticipated increases in volume.

### Place of taxation rules for services

6.10 The main issues are therefore in relation to the challenge which e-commerce poses in collecting VAT on international sales of services between businesses, and especially to private consumers.

6.11 Place of taxation rules determine the country in which tax is due on an international transaction. Given the intangible nature of many services, no single place of taxation rule can apply to all services. As agreed at Ottawa, consumption taxes should aim to tax services in the place where consumption takes place.

6.12 Current rules broadly achieve this aim, but e-commerce has highlighted the need to adapt existing rules to ensure consistency.

### Business-to-business transactions

6.13 The majority of e-commerce transactions are between businesses and this is likely to continue. In the case of some cross border services supplied to businesses a

<sup>37</sup> Businesses from other EU countries delivering goods to private consumers in the UK normally charge the VAT of their own country. However, if the goods delivered exceed 100,000 ECUs/Euros (around £70,000), the overseas business must register in the UK and charge the private consumer UK VAT. Overall, these arrangements prevent distortion of competition since a private consumer cannot "shop around" the EU for the lowest rate of tax. Distance selling arrangements do not apply to goods imported from outside the EU.

mechanism known as the reverse charge operates, and tax is collected from the customer. This avoids commercial distortion that would be caused by customers being able to obtain tax-free services from suppliers in other countries. However, for the services that are taxed under the basic rule, distortions have crept in.

- 6.14 During 1996 the Government became aware that existing rules for VAT on telecommunications services were resulting in distortion of competition against UK telecommunications service providers, and loss of tax revenue. VAT was due on all telecommunications services supplied by UK businesses regardless of the location of the customer. Conversely, UK customers could buy VAT-free telecommunications services merely by contracting with overseas suppliers based in for example, the United States or the Channel Islands.
- 6.15 At the time that the relevant VAT rules were introduced, only nationalised authorities supplied telecommunications services. Since then, deregulation coupled with technological innovation opened up the market to international competition with consumers being presented with a far wider choice of suppliers and types of services.
- 6.16 UK operators were being placed at a competitive disadvantage compared to suppliers who were established outside the EU because they were forced to charge VAT on all their supplies, regardless of the location of their customers.
- 6.17 It was clear that the VAT rules needed to be changed to ensure that telecommunications services were taxed where they were being used. As a result of pressure from the UK the European Commission granted identical temporary derogations to all fifteen Member States in March 1997 to give time for a permanent change to be effected. The derogations allowed each Member State to tax telecommunications services consumed within the EU, whether provided by EU or non-EU operators.
- 6.18 The Government has recently concluded negotiations and substantive changes to the relevant European VAT agreements have been agreed<sup>38</sup>. The changes will ensure that telecommunications services that are consumed in the UK continue to be taxed in the UK.
- 6.19 There is potential for the distortions that applied to telecommunications services to spread more widely to other services that are not currently taxed where they are consumed and this needs to be examined further.

#### **Business to private consumer**

- 6.20 At present, the volume of business to private consumer transactions in services over the Internet is negligible (along with the revenue involved), but the volume and value of these sales is likely to increase rapidly as technological developments facilitate transfer of data such as software, audio and video files at high speeds.
- 6.21 Unlike business to business transactions, private consumers are unlikely to be able to be held accountable for tax on purchases from overseas, not least because there would be no records or accounts in most cases from which transactions could be identified and audited. In addition consumers would be unlikely to be aware of their tax obligations.
- 6.22 The three main problems facing governments are:

- defining what is meant by the place of consumption;

<sup>38</sup> Council Directive 99/59/EC of 17 June 1999

- identifying that a transaction has taken place; and
- collecting the tax.

#### *Defining place of consumption*

6.23 The emerging international view is that the definition of place of consumption for private consumers should be their usual place of residence. This would simplify decision making for suppliers, most of whom routinely collect this information for marketing purposes.

#### *Identification of transactions*

6.24 In contrast to goods that cross borders physically and can be identified easily, digitised products can be bought and sold across borders without any obvious indication of a transaction having taken place. For businesses that are required to keep books and records, and where the Government has a right of audit, this does not present obstacles. On the other hand, sales from other countries to private consumers can cause problems. It is important to find simple and effective ways in which VAT can be self-assessed and collected on digitised products.

6.25 A further complication arises as developments in technology enable customers to obtain, and use, many on-line services while on the move between countries. Any changes to existing legislation will need to incorporate a correcting rule to ensure that these services are taxed in a non-distortive manner.

#### *Tax collection mechanisms*

6.26 The Government is working closely with international partners and business examining options for tax collection in these circumstances. Options under consideration currently include:

- requiring overseas suppliers to collect and remit tax for sales to private consumers direct to the consumers' fiscal authorities;
- suppliers collecting tax, remitting it to their local tax administration, followed by transfer to the tax administration in the country of consumption; and
- requiring intermediaries (such as financial institutions) to withhold and remit tax to the appropriate tax administration.

6.27 Longer term, the Government believes that the solution may lie in harnessing the technology to provide an automated tax charging and collection mechanism.

#### **The case for modernisation**

6.28 The place of taxation rules have a number of inherent difficulties that are highlighted by the development of e-commerce. These arise because the existing rules were developed over twenty years ago for a physical world when international trade in services was much more limited.

6.29 The authors of the rules which govern VAT could not have foreseen the rapid advances in technology that now facilitate global markets in services. Customers today can now easily obtain supplies from anywhere, rendering the current rules less effective. As a result, there is a case for bringing the rules up to date.

6.30 The basic place of taxation rule currently taxes services in the country of the supplier,

but relatively few services are taxed under this rule. A series of exceptions mean that the majority of services are already taxed in the country where they are consumed. However, the rules need to be amended for those services that are not currently taxed where consumed.

- 6.31 European Finance Ministers have already agreed that, for VAT purposes, supplies of digital products are classed as services. In line with international agreements European Ministers have also agreed that electronic commerce should be taxed in the place of consumption. The current basic rule leads to taxation in the country of the supplier, and will need to be amended to reflect this principle.
- 6.32 A number of exceptions to the basic rule already exist. Some of these lead to taxation in the country of consumption and it may be possible to add e-commerce to this list of exceptions. However, this would mean defining e-commerce in legal terms and there is a danger that the means of delivery of a service, rather than the substantive service itself, could dictate where a supply is taxed.
- 6.33 An option would be to redefine the rules in such a way that taxation in the country of consumption becomes the basic rule for services in general, not just electronic supplies. This would preserve the principle of neutrality. In practice it would not disturb the place of taxation for most services since many of the exceptions to the current basic rule already lead to taxation in the place of consumption.

#### Prospective EC legislation

- 6.34 In June 1999 the European Commission produced a paper discussing possible legislative changes to the European VAT directives (see 3.23). The Commission has indicated that it will produce proposals for legislation that reflect both the 1998 ECOFIN conclusions and the OECD agreements reached in Ottawa the same year.

## THE WAY AHEAD

- 6.35 The Government is not considering radical change. It recognises that most of the existing rules require little, if any, amendment since they are relatively simple to operate and already ensure that tax is charged in the country of consumption. Other features of the current place of taxation rules also continue to work well and are capable of being incorporated into a modernisation of the rules, albeit with a degree of adaptation in some instances. In developing these proposals further the Government will continue to consult fully with relevant business groups both in the UK through its own Electronic Commerce Consultation Forum (see 2.18) and more widely through international business consultation groups. In short, the Government's view is that a system which successfully charges VAT on electronic services, as well as other services, will involve a number of amendments, which are shown in Box 6.2:

#### *Current views on how VAT rules should be adapted*

- re-examination of the existing basic place of taxation rule for services may be needed;
- consumption defined as where the business customer is established or the private customer is resident, ensuring that the rules do not provide opportunity for tax avoidance;
- the continued use of the reverse charge mechanism for business to business sales;

cont. ➔

- the overseas supplier registering and accounting for the VAT due on sales to private customers in the UK;
- adopting rules that distinguish between services that take place with the participants in the same location and those where they are in remote locations; and
- encouraging business to develop automated solutions to collection and accounting for tax.

Box 6.2

6.36 This framework is explained in greater detail below.

- *A new basic rule:* the place of consumption principle for e-commerce is not met by the present basic rule. The solution may lie in adopting a new basic rule that taxes international services in the country in which they are consumed.

In particular such a rule would deal with the problems of convergence<sup>39</sup> where a number of services, each currently with different place of taxation rules, are provided as a single package for a single charge. Treating such a package under a single place of taxation rule would be simpler both for businesses and the Government and would ensure there is no distortion of competition caused by double taxation or unintentional non-taxation.

- *The definition of consumption:* the place of consumption for most services provided to a business customer could be the country where that business is established. In cases where consumption occurs in a different country, to overcome avoidance opportunities an additional rule would operate to ensure that tax accrued where consumption actually took place. The place of consumption for most services to private consumers may be the country where that customer has his or her permanent address or is usually resident.
- *The reverse charge:* UK business customers should continue to account for VAT on imported services. This spares overseas businesses the burden of registration and removes potential for distortion of competition against UK business.
- *Registering overseas suppliers:* to encourage compliance, suppliers could be permitted to register, account for and pay VAT on-line. Indeed, Customs is already trialling such procedures for domestic businesses. However, any such system for overseas businesses may eventually need international agreements to allow for the enforcement of the rules and the collection of tax from defaulting or non-compliant businesses.
- *Performance services:* at present services such as education and live entertainment are taxed where they are physically performed. The Internet brings the possibility of performer and audience being scattered around the globe rather than being

<sup>39</sup> Convergence is the name given to the gradual disappearance of the distinctions between telecommunications, audio visual media, the computer industry and publishing, which are merging and being transformed in the process, with information increasingly becoming a commodity. Internet users handle digital data from many sources (text, image, video, sound, fax, voice) in a "single digital space". There is, for example, no difference between information delivered via interactive television or via a web site with video, nor between voice delivered over the Internet or via the traditional telephone.

gathered in one physical location. The rules need adapting so that they distinguish between services where the participants are in the same location, and those where they are remote. The former should be taxed in the country of performance with the latter taxed in the customer's country.

- *Automated software solutions*: in order to facilitate more effective collection of taxes, business should be encouraged to develop sales order processing software that is able to cope with tax on international sales automatically. By doing so tax collection on international sales could be automated removing the need for registering overseas suppliers.

## CONSULTATION WITH UK BUSINESS

6.37 A sub-group of the Electronic Commerce Consultation Forum (see 2.18) is looking at consumption taxes, and VAT in particular. The sub-group includes a number of representative bodies as well as UK business representatives that participate in the Consumption Taxes TAG at the OECD (see 3.12). It is considering:

- how, in anticipation of forthcoming negotiations on the Commission's proposals (see 6.34), the VAT place of taxation rules for services in Europe should develop; and
- automated systems for collection of VAT on e-commerce supplies.

## CONCLUSION

6.38 The Government considers that the place of taxation rules for services require amendment in the light of international agreement that tax should accrue in the place of consumption. With the globalisation of trade brought about by e-commerce, it is not possible for any country to act unilaterally, and the Government recognises that international agreement is needed to ensure a consistent world-wide regime. As a key contributor to international debate the Government therefore intends to continue persuading other countries of the need for the framework set out above.

6.39 The Government sees it as essential that the VAT framework that is finally adopted is consistent with commercial reality. The Government will ensure that it continues to consult regularly with business to keep abreast of technological developments and to encourage its OECD and EU partners to modernise the rules as early as possible.



# Challenges for customs and excise duties

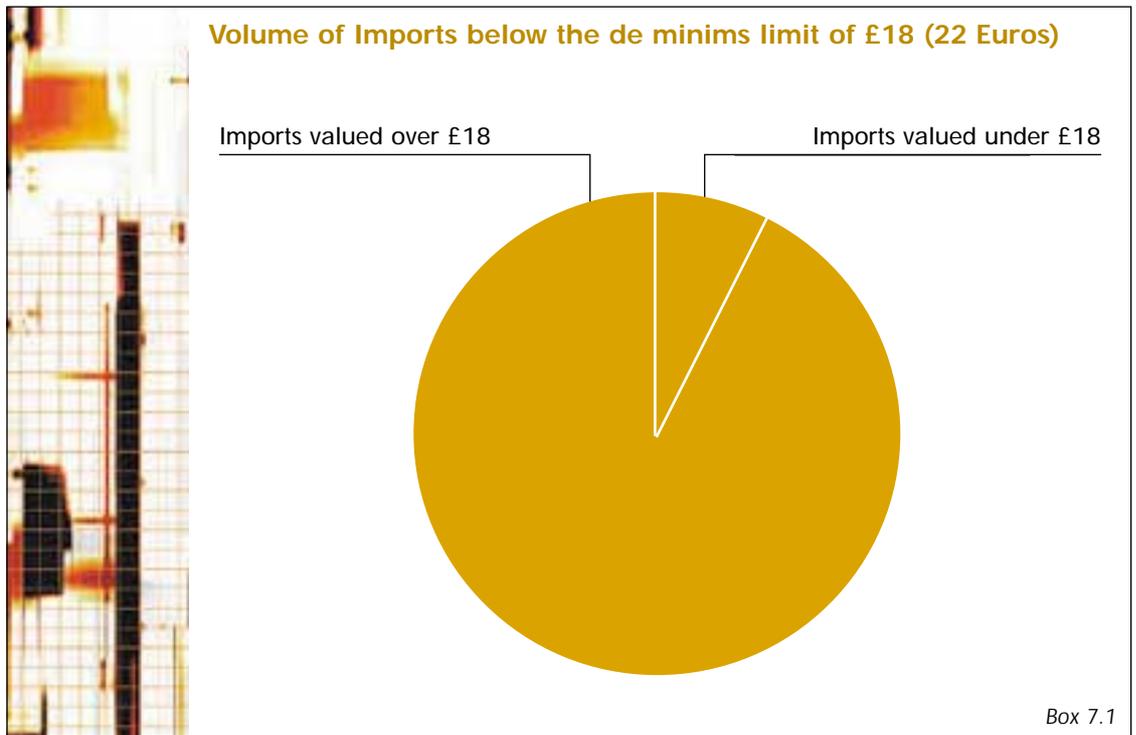
- 7.1 The potential for e-commerce to increase trade, fuelled by easier access to global markets, will lead to a significant increase in the international traffic in goods. This is especially the case for small parcels as consumers increasingly buy goods from overseas. This chapter examines the implications for customs duties.
- 7.2 Advances in technology will also facilitate the provision of a variety of services electronically - betting and gaming are an example as illustrated by the movement of UK bookmakers' Internet and telephone betting services offshore. This chapter also considers these developments and their effect on tax revenues and the industry itself.

## CUSTOMS DUTIES

- 7.3 E-commerce raises only one issue for customs duties. This results from the anticipated increase in small packages brought about by customers using the Internet to buy from abroad.
- 7.4 Goods imported into the UK from outside the EU may be subject to customs duty and import VAT with the rates being determined by the nature of the goods in question.
- 7.5 There are two exceptions to this general rule:
- if the value of a consignment does not exceed £18<sup>40</sup> it qualifies for a 'de minimis limit' relief and is admitted free of customs duty and VAT. If the value exceeds £18, customs duty and import VAT are payable on the entire value; or
  - if a consignment is sent as a gift from a private individual to a private individual and its value does not exceed £36<sup>41</sup> then it is not liable to customs duty or import VAT. Again, if the value exceeds £36, the customs duty and import VAT are payable on the full value.
- 7.6 Box 7.1 illustrates the volume of imports below the de minimus limit of £18 (22 Euros).

<sup>40</sup> 22 Euros

<sup>41</sup> 45 Euros



7.7 The Government is working closely with its international partners and with the World Customs Organisation on facilitation measures to ensure speedy customs clearance of small parcels.

## BETTING AND GAMING DUTIES

7.8 There are six betting, gaming and lottery duties and e-commerce poses risks to them. Box 7.2 below shows the total revenue yield for all these duties which represent something under one per cent of government revenues.

Regime	1998/99 Duty yield £ million	Duty rate
Lottery duty	628	12%
General betting duty	480	6.75%
Amusement machine licence duty	156	Banded duty – 3 bands
Bingo duty	105	10% (+1/9 of added prize money)
Gaming duty	91	Banded duty – 5 bands between 2.5% and 40%
Pool betting duty	70	17.5%
<b>Total</b>	<b>1530</b>	

Box 7.2

7.9 The starkest example of the impact of e-commerce in this area is in bookmaking and, from the Government's standpoint, the general betting duty charged on bets made with a bookmaker. This has traditionally been a regime dominated by cash transactions. However, an increasing percentage of bookmakers' turnover is generated by credit betting, where clients hold accounts with bookmakers and place their bets using telephone or e-mail; and by debit betting, where money is taken from customers' bank accounts immediately the bets are struck.

- 7.10 Recently, some UK bookmakers have opened up branches in other countries, which deal solely in telephone and Internet betting. Betting with offshore bookmakers is not illegal under the terms of the present law.
- 7.11 UK bookmakers with a substantial credit client base may be tempted to direct those clients towards their own offshore operations. If the major bookmakers were to transfer all their credit betting facilities offshore, the revenue at risk could be in the region of £50 million.
- 7.12 There are, however, a number of constraints to this business moving offshore:
- the law bans agents operating on behalf of overseas bookmakers and certain types of advertising;
  - the betting industry is essentially cash-based: over 90 per cent of taxable bets are made over the counter in betting offices. For many clients who wager modestly, credit betting by telephone is not an option and the existence of low-tax, offshore bookmakers will not change this;
  - many betting office clients are attracted by the immediate payment of winnings;
  - the betting office is a social outlet for many people who enjoy the excitement of watching events in a convivial environment which cannot be replicated over the telephone or on a computer screen;
  - there is a perceived increased risk for clients betting offshore that their money is not safe and that they will not be paid out on winning bets; and
  - on-course bets, such as bets placed at race tracks, have been free of duty for many years. Offshore betting is only an additional rather than a unique opportunity for those who are anxious to bet free of duty.
- 7.13 The duty yield is presently being maintained. Nonetheless, the Government takes the risk to the revenue very seriously, and continues to monitor the rapid developments in this area closely. Increasing numbers of bookmakers are opening Internet operations both within the UK and offshore. Interactive betting through digital television is imminent as is the potential use of e-cash.
- 7.14 E-commerce may create opportunities to increase turnover in the betting industry, spurred on by the increase in television coverage of sporting events around the world. The UK has the largest and most highly developed bookmaking industry in Europe. UK bookmakers and the domestic sporting events which they market enjoy a high reputation of integrity which encourages overseas clients to risk their money here.
- 7.15 The Government will work to ensure that the benefits of a growing betting market are made available to UK bookmakers, while ensuring that the industry continues to be fairly taxed. As a first step the Government will be reinforcing the present advertising ban on offshore bookmakers to prevent them targeting UK clients and diverting UK betting revenue abroad. The Government has not ruled out any further options to protect revenues and maintain thriving racing and bookmaking industries in the UK.

- 7.16 Other sectors, such as casinos and bingo, are not yet subject to the same pressures for change as bookmaking, but the potential exists. The Government will consider taking any steps necessary to protect the UK betting and gaming industry from distortive offshore competition.
- 7.17 The Government recognises the need for an agreed international response to the challenges and, in addition to bilateral contacts, is pressing for an urgent wider international discussion. At a national level, Customs is in frequent and regular contact with colleagues responsible for social regulation and for the promotion of British industry. The Government will continue to consult with industry.

## CONCLUSION

- 7.18 The Government will continue to monitor the revenue and commercial implications of the de minimis limits for customs duties. And the Government is actively exploring a range of options to protect the revenue from betting and gaming duties and encourage thriving racing and bookmaking industries in the UK. It is seeking to raise the issues internationally.

# Direct taxes: the international rules

- 8.1 The issue for income and corporation tax is how to achieve effective application of the tax rules to international e-commerce. It is important that the rules are clarified so that business has certainty about how they will work, and the Government's tax revenues are protected.
- 8.2 This chapter first explores the issues listed in Box 8.1 and then goes on to explain how the Government is dealing with them.

## *International direct tax issues*

- place of residence of companies
- quantifying business profits
  - transfer pricing
  - trading by non-residents – permanent establishments
  - attribution of profits to permanent establishments
- characterisation of income

Box 8.1

## ISSUES

### **Place of residence of companies**

- 8.3 The place of residence of a company affects the country which has taxing rights over its income and the basis on which that income is taxed. Like many countries, the UK taxes the world-wide profits of companies which are resident in the UK.
- 8.4 A company is resident in the UK if either it is incorporated here or its central management and control is here<sup>42</sup>. The place of "central management and control" is a question of fact but the place where the highest level of key business decisions are taken is a crucial factor. This is usually the place where the Board of Directors meets.
- 8.5 Technological advances mean that it may become more common for central management and control to be exercised in more than one country. Businesses may increasingly have a presence in many different locations. The Board of Directors and other key managers

# chapter 8

<sup>42</sup> Until 1988 there was no general statutory definition of "residence" for companies in UK law. The meaning was derived from case law which broadly established that a company is tax resident in the UK if its place of central management and control is in the UK.

may hold virtual rather than physical meetings (by video conference links or e-mail/discussion groups). The issue here is that this could lead to double taxation.

## Quantifying business profits

### *Transfer pricing*

- 8.6 Transfer pricing is the term used to describe the process whereby prices are set by enterprises which are related to or “associated with” each other, in respect of dealings between them. Such dealings may include sales or transfers of goods or assets, both tangible and intangible, and the provision of services, including finance.
- 8.7 It is important to both taxpayers and tax administrations as it can have a considerable effect on the taxable profits of such associated enterprises. Where the transactions in question are between associated enterprises which are resident in different countries, the transfer prices affect more than one tax jurisdiction. If both jurisdictions do not agree on the appropriate transfer prices and thus the sharing of taxing rights, there is a risk of double taxation or of less than single taxation. These considerations apply to transactions conducted electronically as they do to transactions conducted by more conventional means.
- 8.8 The OECD published updated guidance on transfer pricing in 1995<sup>43</sup>, reflecting an international consensus reached by OECD member countries. This confirmed that the “arm’s length principle” should be used to determine transfer prices for tax purposes. This principle states that the transfer prices for dealings between associated enterprises should be those which would have been agreed between them, for comparable transactions in comparable circumstances, had they been independent entities acting at arm’s length. In 1998, the Government modernised its own domestic transfer pricing legislation to bring its rules into line with the international consensus.
- 8.9 Business and tax administrations generally consider that e-commerce poses no new fundamental problems for transfer pricing. The arm’s length principle is still appropriate. However, some of the factors relevant to its application may be more difficult to take into account for e-commerce, in particular the need to:
- apply the principle on a transaction by transaction basis;
  - determine what relevant functions are performed – including assets used and risks assumed – by which enterprise, in particular when a trade is conducted amongst different enterprises on an integrated basis; and
  - more generally, find comparable transactions between independents by reference to which the principle can be applied.
- 8.10 E-commerce opens up cross-border trading opportunities, in particular, for small to medium sized enterprises. Transfer pricing issues may therefore occur more frequently. It also gives rise to increasing integration and co-operation in trading activities which add to the complexity of transfer pricing.

### *Trading by non-residents*

#### Domestic law

- 8.11 The UK taxes the world-wide profits of a trader resident in the UK. It also taxes the profits of non-residents who trade here. Non-residents are chargeable to income tax unless the non-resident is a company trading here through a branch or agency, in

which case the charge is to corporation tax. The taxable profits in both instances are those that arise from that part of the trade exercised in the UK. In the case of companies trading through a branch or agency, profits that arise outside the UK on assets used by the branch or agency are also included within the charge.

- 8.12 A non-resident is trading in the UK if the contracts that give rise to the profits are made in the UK or, where the profits arise from activities such as providing services or manufacturing, if the activities that give rise to those profits take place here. Where a business consists simply of selling goods, either directly or through an agent, the place of contract will be of paramount importance.
- 8.13 Whether Internet sales to the UK by non-residents constitute trading in the UK depends on the place of contract, which in turn will depend on the stages involved in its completion. Where acceptance is communicated instantaneously, the place of contract is generally in the territory to which the acceptance is communicated: that is to say, in the straightforward case of a simple offer to buy by the purchaser and acceptance by the seller, the territory of the buyer. A draft European Directive<sup>44</sup>, is seeking among other things to provide certainty on the execution of electronic contracts.
- 8.14 The decision on whether any charge on a non-resident company trading here is to income tax or to corporation tax depends on whether there is sufficient presence here to constitute a “branch or agency” of the company.
- 8.15 The rules in other countries for taxing non-residents carrying on business there are not always the same as the rules in the UK for non-residents carrying on business here. UK residents trading overseas should seek help from the relevant overseas revenue authority or from their professional adviser if they have queries on overseas tax law.

#### Double taxation treaties – permanent establishments

- 8.16 It is possible that a non-resident trading in the UK may be taxable both here and in the country of residence. It is similarly possible that a UK resident trading abroad may be taxable here and abroad.
- 8.17 Under the terms of most of the UK’s double taxation treaties, the source territory, that is to say the territory in which the non-resident is trading, may only exercise its taxing right in respect of profits that arise through a “permanent establishment” in that territory.
- 8.18 What constitutes a permanent establishment will depend on the precise terms of the relevant treaty, but the principal requirement is a fixed place through which business is carried on. Fixed places of business are excluded from constituting permanent establishments where, for example, the activities carried out there are of a preparatory or auxiliary character to the non-resident’s business. Also a permanent establishment of the non-resident is deemed to exist if contracts are regularly made through a local agent who is not an independent agent.
- 8.19 The permanent establishment article was first introduced into the UK’s tax treaties at a time when trading between territories was more likely than now to take place through a local and permanent presence.
- 8.20 There are some doubts as to what constitutes a permanent establishment in the context of e-commerce. In particular, it is unclear as to whether, and if so in what circumstances, a web site on a server is a fixed place through which business is carried on, and hence a permanent establishment. It seems clear, however, that some

<sup>44</sup> Commission Proposal for a Directive on Certain Legal Aspects of Electronic Commerce; available at [www.dti.gov.uk/cii/ecomdirective/index.htm](http://www.dti.gov.uk/cii/ecomdirective/index.htm)

activities (such as advertising) on a web site will not of themselves constitute a permanent establishment since they will fall into the category of preparatory or auxiliary activities.

- 8.21 The possibility has also been raised that a web site could be a deemed permanent establishment on the grounds that it acts as an agent concluding contracts.
- 8.22 A practical outcome to these issues is needed that will both keep down compliance costs for business and be easily enforceable by tax authorities.
- 8.23 As e-commerce grows, the permanent establishment concept may become less appropriate and it is unclear whether a local and fixed place of business is the right threshold for taxation in the long term. But the concept is of long-standing and is very widely supported. To date, no clearly better alternative has emerged and there is at present no compelling reason to depart from it.

Attributing profits to permanent establishments

- 8.24 Deciding whether or not there is a permanent establishment is not an end in itself. If it is decided that a permanent establishment exists, that leads to the separate but related issue under the relevant double taxation treaty, of what profits are properly to be attributed to that permanent establishment over which the country in which it exists will have primary taxing rights.
- 8.25 So, for example, if it were to be decided that there are circumstances in which a web site on a server can be a fixed place through which business is carried on – and therefore a permanent establishment – there will remain the difficult task of determining how much of the profit of the enterprise of which the permanent establishment is a part, is properly attributable to the web site.

### **Characterisation of income**

- 8.26 Images of certain products can be transmitted electronically rather than in physical form, including various forms of written text (such as newspapers, magazines or reference material), photographs, videos, computer software and music. The market for digitised music and videos is likely to grow significantly in the near future with developments in software and the availability of higher bandwidths. Customers may have to pay a fee before being allowed to view the images or sample the product; and will in any event usually have to pay a fee before being allowed to download a copy of the product. They may also be allowed to modify downloaded products or to incorporate them in products which they develop themselves, either for their own use or to sell to others.
- 8.27 An important issue is whether payments made for those purposes are royalties or payments for the provision of goods or services not involving the use of copyright.
- 8.28 If individuals or businesses pay royalties to a non-resident, they may be required, under the tax laws of their countries, to deduct withholding tax from the payment and to pay it over to their tax authorities. This is a mechanism for obtaining the tax that the non-resident is liable to pay on the income.
- 8.29 The UK, like many other countries, requires tax to be withheld from royalty payments in some circumstances, that is from payments for the use of, or for the right to use, a copyright. The current rules which distinguish between such payments and those for goods or services, from which tax does not usually need to be withheld, were developed in relation to physical products.

- 8.30 Whether a payment is for the use of, or for the right to use, a copyright will depend on the copyright law of the country concerned. This is not tax law. There are also a number of international copyright treaties to which most countries subscribe. These cover material available on-line or on demand, and reproduction rights. But it is unclear whether they extend to certain transient electronic reproductions.
- 8.31 If a payment made by someone in the UK to a non-resident for viewing or downloading digitised information is a royalty because it is paid for the use of, or for the right to use, a copyright, then:
- the recipient might have a tax liability in the UK which might not be the case if the payment was for physical goods or services; and
  - the payer of the income might be under a legal obligation to deduct income tax from the payment and to pay the tax to the Inland Revenue.
- 8.32 The taxation of such payments between the UK and someone in another country may be covered by a double taxation treaty between the UK and the other country concerned. In the case of royalties, a treaty may cancel the taxing rights of the country from which the royalties are paid, or it may reduce the rate of tax that this country may charge.
- 8.33 Most of the UK's tax treaties cover the taxation of royalties in the way just described. If under a particular agreement royalties may be taxed in the country from which they are paid, then this will confirm the right of that country to tax cross-border payments for digitised information if its domestic law so allows.

#### *Legal issues*

- 8.34 It is not always clear, for direct taxes, whether payments to view and download digitised information are, in whole or in part, payments for the use of, or for the right to use, a copyright on the one hand, or are payments for the purchase of goods or services.
- 8.35 The process of viewing on a computer screen copyrighted material such as written text or a photograph involves the making of a reproduction of that item, so that a payment for that may be, in whole or in part, a royalty.
- 8.36 And if the product is downloaded, any payment for the right to do that could be a payment for the right to make a copy of the product. If a product is protected by copyright, the payment would be for the use of that copyright and hence a royalty.

#### *Policy issues*

- 8.37 If it is established that a payment for digitised data is, in whole or in part, a royalty, then it will be necessary to determine whether that is an outcome that is desirable on policy grounds. The issues include:
- ensuring that the tax rules are clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction;
  - achieving neutrality as between payments for transactions carried out by electronic means and those conducted by other methods;

- preserving traditional taxing rights in the UK; and
- minimising compliance costs for taxpayers and administration costs for tax authorities as far as possible.

8.38 There are also practical issues. With increasing use of the Internet, there are likely to be large numbers of payments directly from customers to authors. Tax authorities will not know about these payments, and many of the people making them may not be aware of the domestic and international legal requirements.

## THE WAY AHEAD

### International co-operation

8.39 The need for an international consensus on issues and how they should be taken forward has been stressed earlier in the paper. And it particularly applies in the case of the issues for direct taxes which have been outlined above. The Government is working actively with its international partners to achieve this consensus.

8.40 The focus for the work is the OECD, not least because the UK bases its tax treaties on the OECD's Model Tax Convention and has effectively incorporated the OECD's Transfer Pricing Guidelines into domestic law. The OECD's work programme includes:

- ensuring that the 1995 Transfer Pricing Guidelines can be supplemented or changed as necessary to reflect developments in e-commerce;
- considering how the rules in double taxation treaties for the attribution of profits to permanent establishments should be applied to e-commerce, and reviewing, in particular, whether the same considerations that underlie application of the arm's length principle to transfer pricing between associated enterprises can be adopted in addressing the process of attribution;
- considering whether a web site on a server is ever a permanent establishment and, if so, in what circumstances. OECD is aiming to provide clear guidance by March 2000 and has recently issued draft revisions to the Article 5 Commentary on the OECD Tax Convention<sup>45</sup>;
- considering how appropriate the permanent establishment concept will be in the long term as a requirement for taxing the profits of a non-resident; and
- considering the application of the definition of royalties in the OECD Model Tax Convention in the context of e-commerce, commenting on the distinction that can be drawn between various types of payments and whether they are for sales or lease of property, the provision of a service or a royalty. OECD is aiming to provide guidance by the end of 2000.

The Government is working with other OECD member countries to ensure these timetables are met.

## UK measures and consultation with business

- 8.41 The Government has taken a number of steps to consult business and to help provide business with certainty in these areas.
- 8.42 Two sub-groups of the Electronic Commerce Consultation Forum (see 2.18) are looking at these issues. The participants include a number of representative bodies as well as UK business representatives that participate in the Business Profits and Income Characterisation TAGs at OECD (see 3.12). The groups are being kept up to date with the progress of the OECD work and are being consulted as it continues.
- 8.43 The Business Profits sub-group of the Forum is considering:
- the application of the permanent establishment concept to web sites and servers;
  - the longer term future of the permanent establishment concept; and
  - whether any clarifications or changes might be desirable to the definition of residence.
- 8.44 The Income Characterisation sub group of the Forum is considering the issues outlined earlier in the chapter on characterisation. In particular, it is looking at examples of payments in circumstances where it is necessary to make the distinctions between sale or lease of property, provision of a service or a royalty.
- 8.45 In this year's Finance Act, the Government introduced a domestic process under which business will be able to reach advance agreement with the Inland Revenue about transfer pricing issues and about issues relating to the attribution of profits to permanent establishments<sup>46</sup>. It is targeted at assisting taxpayers in those situations where there are particular doubts or difficulties in applying the arm's length principle.

## CONCLUSION

- 8.46 Progress is being made to give business the certainty it needs about the way in which international transactions will be taxed. The Government is working with international partners on the issues which e-commerce raises in this area to ensure that clarification is provided in a number of areas by the end of 2000.
- 8.47 At the same time, the Government is aware of business concerns that it should not act too hastily to change long standing and widely accepted concepts, since changes brought in too rapidly might work inappropriately as technology develops. The Government agrees with this analysis and will continue to monitor closely how developments in technology will affect the international tax rules and UK tax revenues, so as to be ready to adapt any of the rules in the future should this become necessary.

<sup>46</sup> Statement of Practice 3/1999 (31 August 1999); available at [www.inlandrevenue.gov.uk/leaflets.c13.htm](http://www.inlandrevenue.gov.uk/leaflets.c13.htm)



# Glossary of Terms

BACS	Banks Automated Clearing System
Bandwidth	The capacity of a data transmission medium. The higher the bandwidth, the faster that data can be exchanged.
CFSP	Customs Freight Simplified Procedure
CGT	Capital Gains Tax
CHIEF	Customs Handling of Import and Export Freight
<b>Double Taxation Treaties</b>	Bilateral agreements entered into between two countries in order to relieve the double taxation that occurs when income or gains are in principle taxable in both of them.
E-cash	Electronic cash, possibly stored on a smart card
E-mail	Message sent electronically between individuals or organisations, including via the Internet.
EC	European Community
ECOFIN	Meeting of European Economic and Finance Ministers, takes place approximately monthly.
ECU	European Currency Unit
EDI	Electronic Data Interchange
EDIFACT	EDI messaging format. (United Nations) Electronic Data Interchange for Administration, Commerce and Transport
EU	European Union
FICO	Financial Intermediaries and Claims Office
G7	The G7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States of America.
G8	The G8 countries are Canada, France, Germany, Italy, Japan, the Russian Federation, the United Kingdom, and the United States of America.
GPC	Government Procurement Card
GSI	Government Secure Internet
Internet	The network that allows the free exchange of data between computer-based devices.
Intrastat	Intra-Community trade statistics
Meta tag	Coding to support Internet searches.
Micropayments	Very small payments, for example tenths of pennies for single pages of text.

NICO	National Insurance Contributions Office
OECD	Organisation for Economic Co-operation and Development. Membership comprises 29 countries: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States of America.
OJEC	Official Journal of the European Communities
PAYE	Pay As You Earn
PC	Personal computer
PCS	Purchasing Cycle System (Inland Revenue procurement system)
PIU	Performance and Innovation Unit, part of the UK Government Cabinet Office. The Prime Minister announced the creation of the PIU in July 1998, to focus on issues that cross departmental boundaries and to seek out innovation to improve delivery of government objectives.
PKI	Public Key Infrastructure. A mechanism for ensuring the integrity, authenticity and confidentiality of electronic communications.
SAD	Single Administrative Document
SAM	Single Administrative Message
SERPS	State Earnings Related Pension Scheme
Server	A central computer that makes services available on a network.
Smart card	Plastic card that can store data for identification or e-cash purposes.
SME	Small and Medium Sized Enterprises
TAG	OECD Technical Advisory Group
URL	Universal Resource Location - the address of a web site
VAT	Value Added Tax
Virtual	E-commerce, for example, is based on the virtual presence of suppliers and customers on the Internet, which needs not correspond with any physical presence.
World Wide Web	Part of the Internet where much public information is located.
Web site	A virtual location on the Internet that has been developed by an individual, business or organisation to give information, advertise or sell.
WTO	World Trade Organisation

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