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# Foreign (Non-US) Taxes On Internet Transactions

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**Abstract**

*In most discussions of Internet taxation in the United States focus is on sales and use taxation of e-commerce. While such taxes are an important component of the taxing regime on e-commerce, it would be myopic to consider only US taxes as the only tax on Internet transactions. This paper discusses the most important foreign tax on e-commerce is the Value Added Tax (VAT), since a large number of foreign countries impose the VAT.*

## 1. The Value Added Tax

A Value Added TAX (VAT) is inherently different from the US sales and use tax. However, the two tax systems do pose some similar problems regarding enforcement of Internet transactions. In order to understand these problems it is necessary to understand the Value Added Tax system.

The VAT is collected along the entire chain of production and distribution for both goods and services. In simple terms, a seller charges its customers the VAT on their purchases. The following example assumes that all parties are in the same VAT jurisdiction. A seller of raw material charges its customers the VAT on their purchases of the raw material. The amount of the VAT is a percentage of the selling price. Then as the purchaser uses the raw material in the manufacture of its product, it enhances the value of the material. The manufacturer will charge its customers the VAT on the value of their purchases. If a wholesaler purchased the goods, then on the sale of the goods to a retailer, the wholesaler will collect the VAT from the retailer. Finally, the retailer will collect the VAT when the goods are sold to the consumer. At each point in the production/distribution cycle the seller must determine its VAT liability.

The calculation of the VAT liability will vary depending on the method used by the taxing jurisdiction, but in general terms, the amount of VAT collected is reduced by the amount of the VAT paid on the components used in the manufacturing process. Only the excess VAT is transmitted to the tax authority. The seller may not be able to reduce the VAT collected by the entire amount of VAT paid, if any of the items purchased are not resold but used by the purchaser directly. As can be seen by this simple example is that the VAT is paid entirely by the final consumer of a product or service. There are a variety of characteristics of a Value Added Tax that can affect sellers under that type of tax system. These characteristics will be discussed in the following section.

## 2. Characteristics of a VAT Affecting All Sellers

### *2.1 Design of the VAT*

Those taxpayers subject to the VAT should be aware that not all VAT are the same. There are five factors that affect the cost of the VAT vendors subject to the tax. The five factors are: treatment of exports; collection method; type; inventory recognition; and payment frequency.[1] The factor, treatment of exports has two variations.

First, exports can be taxed the same as other sales. The alternative is to zero-rate export sales, which ex-

[1] See Robert P. Crum and Bruce H. Lubich, "The Effect of Value-Added Tax Collection Alternatives on Revenue Yield," *The Journal of the American Taxation Association*, vol. 10, no. 2, Spring 1999, pp. 24 – 43; and Robert P. Crum, "Financing Value-Added Tax Cash Flow," *The Journal of the American Taxation Association*, vol. 13, no. 1, Spring 1991, pp. 1 – 35.

cludes the sales from taxation, and the vendor can claim a refund or credit for the VAT paid. The second factor, collection method, also has two variations. Under the cash method, sales and purchases are recognized when cash changes hands. The sales and purchases are recognized when an invoice is issued when the invoice method is used. The invoice method is essentially the same as the accrual method for financial accounting. The difference between the two methods is that under the cash method, the vendor becomes liable to remit the VAT on sales when the cash is collected. Since the invoice method requires the vendor to remit the VAT the month that invoice is prepared, the vendor must finance the VAT due from the buyer until it is collected. This factor does not affect those business that make only cash sales. In this case, the VAT would be due in the period that the sale is made.

The third factor, type, has three variations, the consumption type, the income type, and the gross-product type. This factor addresses the issue of whether and how businesses can recover the VAT paid on capital assets purchased by businesses. The consumption type allows a deduction or credit for the VAT on capital assets at the time of the expenditure. The income type permits a deduction or credit for the VAT as the goods are consumed, while the gross-product type allows no deduction for the VAT on capital goods. The gross-product type VAT treats the business purchasing capital assets as the consumer subject to the tax. If either the consumption type or income type VAT treats the business purchasing capital assets as intermediary and permits them to recover the VAT paid. The difference is the time period of the recovery, under the income type the business must recover the VAT gradually over the life of the asset, and therefore the business must finance the VAT over the recovery period.

The fourth factor, inventory recognition, deals with the issue of when a purchaser can deduct or claim a credit for the VAT paid on items purchased for resale or used as a component of items manufacture for resale. The period recognition method allows a credit or deduction for the tax in the period of purchase or consumption. The product recognition method allows a credit or deduction for the tax in the period that the inventory is sold. Under the product recognition method the purchaser of inventory items or component of items to be used in the production of inventory items must finance the VAT during production, if applicable, and storage period before the actual sale. The longer the period, the more costly is the financing. The fifth factor, payment frequency, refers to the frequency of the required payments of the VAT collected. The payment periods are typically semi-monthly, monthly, or quarterly. The shorter the payment period, the more likely the vendors will have to finance the VAT if the invoice method is used.

### *2.2 Other Characteristics*

A major difference between the VAT and the U.S. sales tax is the VAT routinely is applied to service transactions with domestic customers. Under the VAT a few services are commonly exempt, such as financial services. Others services, such as telephone services, receive different treatment in assessment and collection. Generally, VAT jurisdictions tax services the same as goods.[2]

Most VAT jurisdictions use the “place of supply” rule to determine whether goods and services are subject to the VAT. Under this rule, if the seller’s place of supply is in a VAT jurisdiction, the seller must assess and collect the VAT. If the seller’s source of supply is not within a VAT jurisdiction, the seller has no obligation to assess and collect the VAT. If the latter situation applies, a buyer in a VAT jurisdiction may still have to self-assess the tax and pay it to its home country.[3] If goods are to be delivered, the place of supply is the location where the transportation begins.[4] Thus, if the goods are transported from a location within a VAT jurisdiction, the seller must pay the VAT. If the goods are transported from outside the VAT jurisdiction, such as from the U.S., the seller has no VAT, but the buyer must pay the VAT. The buyer’s home government will have custom records of the importation of the goods from a non-VAT seller, thus there will be a record of the transaction for the buyer’s government to enforce the tax against the importer in a VAT jurisdiction.

Application of the VAT “place of supply” rule to Internet transactions complicates VAT taxation for sellers that are virtual businesses. True virtual businesses maintain no retail or warehouse space and only offer the products

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[2] David Hardesty, *Electronic Commerce Taxation and Planning*, §11.09 (1999).
[3] See European Council Sixth VAT Directive 77/388 of May 17, 1977, Article 9(a).
[4] David Hardesty, *Electronic Commerce Taxation and Planning*, §11.09(1)(a) (1999).

of third-party suppliers on their web site. The goods necessary to fill a customer's order are dropped shipped from the suppliers and never pass through the Internet seller's hands. Under the place of supply rule, the Internet seller will be obligated to assess and collect the VAT. In this case, the supplier should charge the virtual seller the VAT on the charge for the merchandise dropped shipped. The Internet virtual business must charge its customer the VAT on the amount the seller charges. Under this rule, a virtual business can be subject to the VAT in multiple jurisdictions if the business' suppliers ship from multiple VAT jurisdictions. For U.S. Internet sellers, the application of the source of supply rule obligates the seller to comply with foreign VAT requirements, such as registration, collection, and remittances, if they want to ship products from foreign suppliers. The other choice is for U.S. Internet sellers not to use foreign suppliers in order to avoid VAT filing requirements. On the other hand, if U.S. Internet sellers drop ship goods from a foreign supplier in a VAT jurisdiction to U.S. customers, the U.S. Internet sellers would not collect the VAT from such customers and may be able to collect the VAT paid to the foreign supplier's government if exports are zero-rated.

## 3. VAT Taxes On Internet Sales of Services

VAT taxes are imposed on services at the place the service provider is located.[5] Therefore, a service provider located in a VAT jurisdiction must register with that government and collect the VAT on the gross price of its services provided from that location. A service provider's location(s) can include a place of incorporation, an office, showroom, factory, or even a residence if the service provider is an individual.

Many foreign countries consider the mere presence of physical property as insufficient to constitute an establishment for the purpose of collection of the VAT on service. This is unlike the U.S.' nexus requirement for the collection of sales and use taxes on the sale of goods. The collection of the VAT on services requires some human presence. In Latin America countries, other than Mexico, the physical presence of equipment or other property, without employees, may create an establishment and trigger the VAT service tax requirements.

In Europe and Mexico, the mere presence of a service provider's (ISP) home page on a server in a VAT jurisdiction does not obligate the ISP to collect and remit the VAT to that jurisdiction.[6] The Internet tax provisions in Europe and Mexico approximate the U.S. rule under the Internet Tax Freedom Act moratorium. None of the other Latin American countries have rules pertaining to the place of establishment for e-commerce transactions, thus, the ownership or lease of a web server in these jurisdictions may result in that country requiring the ISP to collect and remit the VAT.

The "place of supply" rule has several exceptions relating to service transactions, which have significant impact on VAT collections in e-commerce. In the European Union, the place of supply for certain services[7] is the customer's location.[8] With the exception of telecommunications, transactions involving the listed services do not result in any VAT requirements for service providers outside the European Union. In transactions in which services are provided by foreign vendors the business customers must self-asses and remit the VAT to their home country. This is similar to the treatment of U.S. businesses located in a state with a sales and use tax and purchases taxable goods outside of the state and brings the goods into the state and that state's tax was not collected by the vendor. However, unlike the states in the U.S., the European VAT jurisdictions waive self-assessment for individuals engaged in services transaction with outside providers. This may be s touch of reality in taxation in that these countries expect no revenue from transactions in which the tax is difficult to enforce.

The European Union (EU) treatment of telecommunication services differs from other services. Business customers must self-asses and remit the VAT, thus relieving the foreign service provider of satisfying the VAT requirements. For sales to consumers, the telecommunication service provider must comply with all VAT require-

[5] David Hardesty, *Electronic Commerce Taxation and Planning*, §11.09(1)(b) (1999).
[6] Jean-Luc Pierre Frederic Subre, "The Application of the French VAT in the Framework of E-Business Transactions," *Tax Planning International – E-Commerce*, October 1998, pages 40-42.
[7] These services are: accounting, advertising, architecture, banking, consulting, data processing, engineering, financial services, insurance, legal services, providing information, the transfer of intellectual property, and telecommunications.
[8] European Council Sixth VAT Directive 77/388 of May 17, 1977, Article 9(2)(e).

ments and collect the VAT from consumers. In the United Kingdom, Internet access is considered to be a telecommunication service, thus, ISPs are required to assess and collect the VAT.

The European Union requires non-EU ISPs to register for the VAT and collect it in each EU jurisdiction where they provide Internet access services to consumers.[9] As a result, both the EU and the United Kingdom requires U.S. ISPs to make sure that their accounting system allows them to account for VAT at different rates on their services.[10] An alternative to possibly modifying their accounting system to account for the VAT and to multiple VAT registrations, non-EU ISPs can restructure their transactions so that all EU contracts are between the consumers and a subsidiary incorporated in the EU. As an EU legal entity, the subsidiary would only be obligated to charge the VAT at the rate applicable in its jurisdiction when providing Internet access services to EU consumers. Once incorporated within the EU, the subsidiary would avoid the need for multiple EU VAT registrations and payments at multiple VAT rates.

## 4. VAT On Digital Transmitted Products

Both in the U.S. and abroad the classification of digitally transmitted products such as computer software, CDs, books, periodicals and videos are subject to debate. Whether such items are classified as goods or services can affect their taxability under the U.S. sales and use tax in those states that do not tax services.[11] In those states that do tax services. In states that do tax services, the classification is irrelevant, but only in regards to the digital products sold to consumers within the state or other states that the vendor has a physical presence under the *Quill* doctrine.[12]

In VAT jurisdiction, if digital products are classified as a service, individual consumers in Europe would not paid the VAT on purchases of the service from foreign service providers since the VAT jurisdictions waive self-assessment for individuals engaged in services transaction with outside providers. Business consumers of services provided by foreign vendors must self-asses and remit the VAT, if the provider is not required to collect the tax. This is true for all services other than telecommunications. However, if digital goods are classified as goods, all purchasers of foreign goods must self-asses and remit the VAT. Since the digital transmitted goods would not undergo the import and customer process, the VAT jurisdictions would not have a documental trail of these purchases, thus the enforcement of the tax on imported digital products would be difficult. Compliance becomes a major problem for both the jurisdiction and merchants within that jurisdiction. For if consumers if the VAT jurisdiction are not likely to self-asses and remit the tax on digital products, then vendors outside of the VAT jurisdiction with no VAT collection obligation has a marketing advantage over their foreign competition obligated to collect the VAT from the purchaser. In addition, the obligation to collect the VAT by sellers of digital products in VAT jurisdictions creates an additional problem.

For Internet sellers operating in VAT jurisdictions, the selling and the transmittance of digital products do not require the vendor to know the actual location of the customer. Therefore, the vendor may not know whether there is a requirement to collect the VAT without making inquiries of the purchasers, and the response may not be truthful. For U.S. e-commerce firm, this requirement does not affect them if they have no establishment within the VAT jurisdiction. In most VAT jurisdictions owning equipment or web presence on a server is not sufficient presence in most VAT jurisdictions. Thus, if a U.S. e-commerce vendor has all its employees based exclusively in the U.S. will not be liable to collect and remit the VAT.

Unlike the United States, VAT jurisdictions have not approached the complexity of Internet transactions with a moratorium. On the contrary, all VAT jurisdictions are attempting to create greater compliance among domestic and international firms with the jurisdiction's VAT requirements.

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[9] European Council Sixth VAT Directive 77/388 of May 17, 1977, Article 9(3)(b).
[10] John Morgan et al., "Don't Be Afraid of the Internet," *International Tax Review*, vol. 8, pages 19-22 (1997).
[11] See the discussion of state sales and use taxation in James T. Collins and Robert M. Kozub, *State and Local Taxation Answer Book*, 2nd edition, Panel Publishers, New York, New York, 1999.
[12] *Quill v. North Dakota*, 112 S.Ct. 1904 (1992).

**5. Additional Results of Creating a Permanent Establishment**

United States Internet firms with a permanent establishment in a VAT jurisdiction become liable to follow the VAT requirements of that jurisdiction. Creating permanent establishment also create an income tax liability on the income earned in those countries in which permanent establishment. International sales transactions with customers in a country in which the vendor lacks a physical establishment are taxed solely by the vendor's home country. In situations where a vendor engages in a transaction with a buyer through a permanent place of business in the buyer's government also has the right to tax the seller's income. Under international tax treaties, when a vendor has a place of permanent establishment, the country in which a transaction occurs and the vendor's home country must share the income for income tax purposes. Therefore, multinational companies must consider their locations very carefully to avoid creating permanent establishments in countries where the tax treatment would be disadvantageous because of high tax rates and/or cumbersome compliance requirements. U.S. multinationals should also organize their affairs to take maximum advantage of U.S. foreign tax credits that apply to income taxes paid abroad.

The permanent establishment issue for income taxation of Internet transactions is the same as for VAT compliance: whether the presence of web sites on a file server constitutes the existence of a taxable presence. In Europe and Mexico, the mere presence of a service provider's (ISP) home page on a server in a VAT jurisdiction does not obligate the ISP to collect and remit the VAT to that jurisdiction.[13] What is required is the presence of employees. In the rest of Latin America, the ownership of equipment or maintaining of inventory locally is a sufficient permanent establishment to create an income tax liability in that country, similar to the nexus requirement for sales and use taxes.[14]

However, being subject to income taxation raises a different issue not relevant to VAT compliance. In the United States and many other taxing jurisdictions royalty payments are treated differently than the income from the sales of goods or services. Foreign jurisdictions require the withholding of income taxes on certain international transactions. The characterization of income as royalty income or sales revenue determines whether or not withholding tax will apply to a particular payment. The digital products sold and transmitted over the Internet have been classified as sales of goods, transfer of intellectual property rights, performance of services, and licenses. Various tax jurisdictions have taken different approaches to classification of the same type of transaction. Under a U.S. and Mexico tax treaty, withholding of taxes is not required on payments made to a U.S. seller on sales of goods or services to a Mexican consumer on Internet transactions. This treaty treats such transactions as falling within the business profits provisions, which give the U.S. the right to tax the U.S. seller on the entire income provided that the seller does have a permanent establishment in Mexico. Other Latin American countries as well as other countries, Internet transactions may be subject to income tax withholding depending on the type of income. Most countries do not require withholding on the sale of goods, while royalty payments are subject to withholding. At the present classification is on a jurisdiction-by-jurisdiction basis and will remain so until transactions on the web becomes more consistent and multilateral treaties address the classification issues. Multinational companies need to plan their transactions to avoid or minimize creating an income tax liability in countries where the tax treatment would be disadvantageous because of high tax rates and/or cumbersome compliance requirements. Analysis of a country's classification of each transaction should be part of a companies' tax planning. U.S. multinationals should also organize their affairs to take maximum advantage of U.S. foreign tax credits that apply to income taxes paid abroad.

**6. International Political Concerns**

Some members of the international community are pushing for greater enforcement of their tax laws in international transactions. The European Union wants U.S. firms selling software, music, and any other electronically transmitted products to ensure that their taxes are paid on these items. European customers of U.S. firms can download digital products without paying their country's VAT, while European sellers of the same products are subject to the VAT requirements. The European Commission, the policy drafting unit of the European Union, is considering rules to have third parties such as banks and credit-card companies collect the VAT. Additional proposed rules

[13] Jean-Luc Pierre Frederic Subre, "The Application of the French VAT in the Framework of E-Business Transactions," *Tax Planning International – E-Commerce*, October 1998, pages 40-42.
[14] Rita Marie Cain, "Mail Order Taxation in the Post-Quill Era," *Journal of State Taxation*, vol. 9, pp. 48 – 60, 1995.

would require U.S. firms register for VAT collection in EU countries, which is already required of telecommunication companies. While the EU may not be able to force U.S. sellers to register for the VAT, there are ramifications for not doing what is required. First, if the U.S. firm is required to have audited financial statements, the auditor may insist that any uncollected and remitted VAT be included as a liability. As the liability growths, it can have a negative impact on the credit worthiness of the firm. Second, foreign governments may decide to use the issue of VAT collection as a negotiating item in dealing with other matters of importance to U.S. firms, such as international cooperation in copyright enforcement.

While the World Trade Organization (WTO) does not have jurisdiction over income or sales taxes in specific transactions through its multinational trade agreements. Yet, the WTO is in a position to aid in establishing an environment of international cooperation on tax policy that could assist the growth of e-commerce. In 1998, the WTO ordered a moratorium on custom duties on e-commerce transactions.[15] At the 1999 Seattle Conference of WTO Ministers, the Unites States urged the delegates to extend or permanently adopt the moratorium. The European Union supported the extension of the moratorium, but was opposed to a permanent ban. The anti-trade demonstrations in Seattle forced the 1999 WTO meeting to end without an agreement on the custom duties. Since that meeting, the WTO has not show any interest in addressing this issue. Instead, the EU announced plans to tighten control over the Internet economy, which runs counter to the hands-off approach advocated by Washington. There is a feeling that foreign governments have been dancing to the Washington economic music long enough and that it was time and that its time to create their own situation on the Internet trade.

Another international organization that may affect taxation of Internet transactions is the Organisation for Economic Co-operation and Development (OECD). This organization is a 29 nation consortia, in which the U.S. is the only non-VAT country. The OECD is cited as the relevant policy making body on Internet tax issues. The OECD's foundation for its current work on Internet taxation is contained in its October, 1998, "Taxation Framework Conditions."[16] That announcement contains numerous principles advocated by the U.S., including neutrality between taxation of traditional sources and e-commerce, efficiency and simplicity, effectiveness and fairness, certainty and flexibility.[17] Yet, the U.S. and the OECD differs on one major point, since the OECD believes that these principles can be applied through existing tax rules which is consistent with the EU push for enforcement of existing systems. The U.S. on the other hand believes that Internet transactions de-emphasize source-based taxation, increasing the importance of residence-based taxation.

The OECD has created five Technology Advisory Groups to analyze various Internet tax issues.[18] Despite the different philosophies of the participants, a few of the assumptions upon which these groups operate are similar to the U.S. debate on sales and use taxes: (1) businesses can be expected to self-assess VAT taxes that are not collected by the vendors; (2) consumer transactions create the most significant enforcement challenge; (3) web sites do not establish sufficient presence in a jurisdiction to trigger tax requirements, and servers seldom would; and (4) the financial services industry may be able to play a role in tax collection.

## 7. Conclusion

How to tax Internet transaction is an important issue for firms and countries, and the solution is still in doubt. Compounding the search for the answer is international politics and the belief that e-commerce is mainly the domain of U.S. situated firms. International e-commerce of goods is easier to tax within existing tax structures, while international Internet transaction of goods and services are most difficult to enforce. Electronic transactions with businesses are less likely to avoid taxation, while transactions with consumers are most likely to be unreported and untaxed. In times of budget deficits, it is less likely to be an international agreement of the taxation of Internet transactions.

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[15] See WTO: U.S. Sees Likely 18-24 Month Extension of E-commerce Tariff Ban, AFX European Focus, Dec. 3, 1999.
[16] See OCED Ottawa Conference on Electronic Commerce Final News Release (Oct. 13, 1998), available at http://www.ocedwash.org
[17] Department of the Treasury Office of Tax Policy, Selected Tax Policy Implications of Global Electronic Commerce (Nov. 1996), available at http://www.treas.gov/taxpolicy/Internet.html
[18] These groups cover Technology, Professional Data Assessment, Consumption Tax, and Business Profits and Income Characterization.