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Abstract

This article provides an analysis of the Australian Taxation Office's ("ATO") second report on the taxation of electronic commerce, *Tax and the Internet*, in the context of international developments. It begins with an overview of the basic principles that international consensus has determined will apply to taxation of electronic commerce and how they apply in Australia. A substantial part of the article covers the ATO discussion of the current state of the Internet and the opportunities this affords the ATO, particularly to improve its service delivery. The remainder of the article discusses the impact of electronic commerce on the three crucial areas of jurisdiction to tax, the administration of the tax system and indirect taxation.

Keywords

electronic commerce, taxation, tax and the internet, ATO

THE ATO, TAX AND THE INTERNET: THE EMPEROR'S NEW CLOTHES?

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This article provides an analysis of the Australian Taxation Office's ("ATO") second report on the taxation of electronic commerce, *Tax and the Internet*, in the context of international developments. It begins with an overview of the basic principles that international consensus has determined will apply to taxation of electronic commerce and how they apply in Australia. A substantial part of the article covers the ATO discussion of the current state of the Internet and the opportunities this affords the ATO, particularly to improve its service delivery. The remainder of the article discusses the impact of electronic commerce on the three crucial areas of jurisdiction to tax, the administration of the tax system and indirect taxation.

1 INTRODUCTION

How, when and where do existing taxes apply to the Internet? The Australian Taxation Office ("ATO") raised the level and focus of discussion, at both the domestic and international level, with its comprehensive 1997 report, *Tax and the Internet* ("ATO 1st Report").¹ The ATO Electronic Commerce Project Team has since invested considerable effort and resources in exploring the emerging issues. The Project Team's research is enhanced by the leadership role that the ATO plays in a number of international forums. The ATO has published a summary of its current thinking in *Tax and the Internet: Second Report – December 1999* ("the ATO 2nd Report").²

Reports from a number of governments and international agencies in 1997 and 1998 were useful in dampening expectations that within a very short time governments would lose most of their revenue base to offshore electronic commerce. Informed commentators no longer argue that taxpayers will soon

¹ ATO, *Tax and the Internet* (1997 AGPS).

² (1999 AGPS). Also available on ATO:
<http://www.ato.gov.au/content.asp?doc=/content/businesses/ecommerce_tati2.htm> (at 3 March 2000).

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keep all their funds in untraceable, electronic, tax haven bank accounts. They suggest neither that the United States ("US") will control most electronic commerce nor that disintermediation will become endemic. The reports show that there is a kernel of truth in each of these and many other assertions. However, they give a more balanced view of the Internet trend and provide a focus for discussion of the fundamental issues facing stakeholders in the tax system.

The *ATO 2nd Report* takes up the issues that governments and other stakeholders have identified as important and attempts to take the tax discussion forward. In areas within the ATO's control, its recommendations and action plan are more specific. In areas under consideration by international bodies, the *ATO 2nd Report* is necessarily more vague, but explains the direction that the ATO would like to take.

There is a real sense within the *ATO 2nd Report* that the ATO is constrained by its domestic and international position from putting forward a larger view than it does. There is implicit frustration in the discussions on permanent establishments and identification issues with the narrowness of the OECD position and the limits of the ATO's own arguments. The evolution of electronic commerce presents an opportunity to take a broader view of the international tax canvas. However, international agreement is not easily found. The process of reaching it requires small, incremental steps. But the international community is often so busy watching its feet that it misses the opportunity to influence the wider landscape. There is no harm in reaching a cautious conclusion. To do so at the beginning of a new era without comprehensive debate of all the major issues, including the basic principles of the taxation of electronic commerce, is a lost opportunity.

It is a shame that governments and international organisations have so completely taken control of the debate. The wide-ranging discussions of radical ideas such as the "bit tax", and of the real meaning of the principles underlying international taxation have been discarded to enable us to focus on the serious business of implementing the agreed international agenda. This article analyses the *ATO 2nd Report* in the context of international developments and by reference to the Australian tax environment. The analysis, particularly in Part One, draws attention to some of the wider issues that have received little discussion.

Although the analysis does not follow the strict order of the *ATO 2nd Report*, it is worth setting out the report's structure. Part One of the *ATO 2nd Report* consists of an action plan and chapters on electronic commerce taxation developments, the current market, and where the ATO will exploit the opportunities presented by electronic commerce. Part Two has chapters that are put forward as discussion papers on jurisdictional, administrative and indirect tax issues. Appendix A summarises the comments from the consultation process following the Draft Recommendations in the *ATO 1st*

Report. Appendix B sets out a matrix comparing the *ATO 2nd Report* strategies with the *ATO 1st Report* Draft Recommendations and the Implementation Options set out in the Organisation for Economic Co-operation and Development ("OECD") paper, *Electronic Commerce: A Discussion Paper on Taxation Issues* ("OECD Discussion Paper").³

The article begins with an analysis of the Guiding Principles and puts them in their wider context. The Guiding Principles will shape the way that policy makers implement the recommendations of the *ATO 2nd Report*. The article then analyses the major points in each chapter of the *ATO 2nd Report*. The Action Plan is analysed in the context of each chapter analysis, rather than separately.

2 GUIDING PRINCIPLES

2.1 Introduction

The *ATO 2nd Report* begins by setting out the "Guiding Principles" used in the development of its Action Plan and its "strategies for addressing electronic commerce issues".⁴ There are three guiding principles: neutrality, minimisation of costs of compliance and administration, and privacy issues. These are not the only "principles" used by the ATO. They are simply seen as those most relevant to the issues discussed in the *ATO 2nd Report*.

The *ATO 2nd Report* makes it clear that the ATO subscribes to the broad framework of key taxation "principles" agreed to within the OECD.⁵ These were endorsed at the 1998 OECD Ministerial Conference in Ottawa: "A Borderless World - Realising the Potential of Electronic Commerce" ("Ottawa Taxation Framework Conditions").⁶ That conference not only identified the "broad taxation principles" that should apply to Electronic Commerce. It also set out the taxpayer service opportunities offered by new technologies. These were to improve service standards, minimise business compliance costs, and enhance voluntary compliance primarily through electronic assessment and collection of tax.⁷ The "Guiding Principles" were

³ OECD Committee on Fiscal Affairs ("CFA") (1998 OECD). The paper was presented for discussion at the OECD Government/Business Dialogue on Taxation and Electronic Commerce held in Hull, Quebec, Canada, on 7 October 1998.

⁴ *ATO 2nd Report*, above n 2 at para 1.2.1.

⁵ Ibid at para 1.3.1.

⁶ Committee on Fiscal Affairs, "Electronic Commerce: Taxation Framework Conditions", (1998 OECD), also available at: <http://www.oecd.org/daf/fa/e_com/ottawa.htm> (at 3 March 2000).

⁷ Ibid at para 8.

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clearly implemented with this focus in mind and identify much of the emphasis of the *ATO 2nd Report*.

It is a pity that the OECD and other reports, including the *ATO 2nd Report* have used the word “principle” in a very loose sense. Many legal theorists prefer a clearer definition. For example, Dworkin would argue that a principle defines and protects an individual right, such as the right to privacy.⁸ Improving service standards and minimising compliance costs are collective goals that aim to enhance community welfare. They are policies, not principles. The principle of privacy would “trump” a policy. In other words, an individual’s privacy should not be interfered with simply because the interference would make it easier to minimise compliance costs.

It is not legal pedantry to suggest that the legal distinction should be used. It is rather that the distinction has significant implications for the implementation of the policies and principles. I analyse the OECD “principles” below in detail. Although they are called “principles”, not one provides a taxpayer with a legally or morally enforceable right. Neither does any place an obligation or duty upon OECD members to act in a particular way. The “broad taxation principles” are stated generally as goals to be pursued. At this early stage of the development of the tax framework for electronic commerce the statement of goals is appropriate. However, as the tax framework develops there will be legal and moral principles that have to be considered and a clear distinction needs to be drawn between policies and principles. Otherwise, there is a danger that traditional taxpayers’ rights will simply be regarded as goals and specific rights will lose their protection.

The ATO adheres to its Charter principles and to the legislative, administrative and common law rights of Australian taxpayers. However, the *ATO 2nd Report* would have been improved by more specific reference to these rights where they are relevant, beyond the right to privacy. Specific reference would focus attention on exactly how any new framework will deal with taxpayers’ rights. To avoid confusion, the following analysis uses the term “principle” loosely, as the OECD and the ATO have done.

2.2 OECD principles

Before discussing the “Guiding Principles”, it is worth providing their context by setting out the OECD “broad taxation principles which should apply to Electronic Commerce”.⁹ For each principle, I also identify its interpretation in a cross-section of international reports.¹⁰ The reports are

⁸ For example, in Dworkin R, *Taking Rights Seriously* (1978 Gerald Duckworth & Co) ch 7 and 12.

⁹ OECD, above n 6 at para 9.

¹⁰ The OECD provided further interpretation of some principles in its OECD Discussion Paper, above n 3. The European Union (“EU”) issued its Communication, *E-Commerce and Indirect Taxation*, Com (98) Final, 17 June

chosen either because they are representative of the outcome of discussions among an influential player or group of players in the international arena, or because they are very recent.

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.¹¹

The OECD Discussion Paper¹² emphasises neutrality to support its argument that existing tax rules can apply to electronic commerce. It does not preclude adopting new rules or modifying old rules. It does focus on non-discrimination and the potential for unfair distortion of competition where electronic commerce is treated differently from other forms of commerce. The implication is that, to achieve neutrality, tax authorities should extend existing tax rules to electronic commerce rather than develop a separate system of tax rules. Separate rules are more likely to lead to unintended double taxation, non-taxation, and (it is implied) will always lead to differences in interpretation and application because the rules are different.

Neutrality has emerged as the single most important principle in the taxation of electronic commerce. At the OECD Forum on Electronic Commerce, held in Paris in 1999 ("the Paris Forum") to discuss progress made in developing the Ottawa Taxation Framework Conditions,¹³ one of the working sessions was entitled, "Establishing Ground Rules for the Digital Marketplace". The discussion confirmed that there is international agreement that the Internet is a tax-neutral zone so that there is no discrimination between electronic and

1998 ("EU Communication"). Some of the principles were central to the US Internet Tax Freedom Act, included as Titles XI and XII of the Omnibus Appropriations Act of 1998, approved as HR 4328 by Congress on 20 October 1998 and signed as Public Law 105-277 on 21 October 1998. For the text and an analysis of the law by one of its introducers, Rep Christopher Cox, see <<http://cox.house.gov/nettax/>> (at 3 March 2000). See also, Ross J, "The Internet Tax Freedom Act Finalised" (1999) 1 *Tax Planning International e-Commerce* 19. The United Kingdom ("UK") Government has also adopted the principles in Inland Revenue and HM Customs and Excise, *Electronic Commerce: The UK's Taxation Agenda* <<http://www.inlandrevenue.gov.uk/e-commerce/index.htm>> (at 3 March 2000) ("1999 UK Report").

¹¹ OECD, above n 6 at 5.

¹² OECD Discussion Paper, above n 3 at 4. See also, Hinnekens L, "The Challenges of Applying VAT and Income Tax Territoriality Concepts and Rules to International Electronic Commerce" (1998) 26 *Intertax* 52 at 67.

¹³ 12-13 October 1999. Reported in *Report on the Forum* SG/EC(99)12, 26 November 1999 at <http://www.oecd.org/daf/fa/e_com/ottawa.htm> (at 3 March 2000).

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conventional commerce.¹⁴ However, the discussion emphasised the distinction between taxes and tariffs.¹⁵ There was a general view expressed that the Internet should be a tariff free zone and that the current moratorium on customs duties, under the auspices of the World Trade Organization ("WTO"), should be extended.¹⁶

It makes sense to make the Internet tariff-free to ensure neutrality. Tariffs, unlike taxes, impose a direct burden on the development of international electronic commerce. They are usually designed specifically to prevent the operation of a level playing field. The WTO representative at the Paris Forum confirmed that it is the opinion of the WTO that WTO rules apply to electronic commerce.¹⁷ This would include the agreed WTO definitions of a tariff. The definitions will need review in the context of electronic commerce. It will be difficult to identify hidden tariffs, in the form of subsidies, where all nations are spending significant amounts in an effort to take their own electronic commerce sectors to the forefront of international development.

The EU also emphasises neutrality and non-discrimination between different forms of commerce in its EU Communication.¹⁸ It highlights the need to use international co-operation and, where appropriate, co-ordination to prevent distortion of competition. The stated EU objective is to promote electronic commerce with the minimum tax burden. The EU has jurisdiction over VAT and the individual Member States control their other taxes, which is why the EU Communication primarily has a VAT focus. However, the EU Communication sets out a number of general Guidelines, and the first is that it will focus on existing rather than new taxes.¹⁹ The third EU guideline aims to ensure neutrality, and focuses on unfair competition to EU businesses who are taxed on electronic commerce transactions, where their competitors making supplies from outside the EU are not.²⁰

The US, in its Internet Tax Freedom Act, provides for neutrality between different forms of commerce. It bars discriminatory taxation of electronic

¹⁴ Ibid at 15 and 28.

¹⁵ Ibid at 28.

¹⁶ Ibid at 28 and 33, reflecting the discussion in the Working Group, "Expanding Global Markets: The Road Ahead".

¹⁷ Ibid at 33.

¹⁸ EU, above n 10 at 2.

¹⁹ Ibid at 4. Sceptics might argue that the EU wants no reduction of its jurisdiction to tax through Member States introducing new income taxes on electronic commerce to supplant the VAT. However, a move away from indirect taxes to new income taxes is both unlikely and out of line with general international thinking.

²⁰ For a discussion of the neutrality of taxation between states, see Hinnekens L., "International Taxation of Electronic Commerce: An Emerging Framework" (1999) *Intertax* 440.

commerce in the US until 30 September 2001.²¹ The Act's focus is primarily internal and it attempts to bring the indirect tax and tariff systems of individual states and local governments into line with overall US policy. The Act bars taxes on Internet access, multiple taxation of electronic commerce, and the extension or imposition of new taxes or tax reporting duties on Internet transactions.²² However, it also forms part of the US foreign and trade policy. Congress receives annual reports on the existence and removal of foreign barriers to US electronic commerce.²³ The Act also requires the President to pursue bilateral, regional and multilateral agreements to remove tariffs and discriminatory foreign taxes from electronic commerce.²⁴

The *1999 UK Report* takes a slightly different view of neutrality. It states that "the taxation of e-commerce should seek to be technology neutral so that no particular form of commerce is advantaged or disadvantaged".²⁵ The UK principle is more limited in application than that of the US in that it is neither prescriptive, nor a required element of its national and international policy. It is broader in that it is a basic principle that the authorities should take into account in all matters affecting electronic commerce.

Efficiency

Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.²⁶

The OECD Discussion Paper does not expand on what is meant by efficiency. Rather it identifies how compliance and administration costs can

²¹ §1104. The Advisory Commission on Electronic Commerce (at <<http://www.ecommercecommission.org>> (at 25 March 2000)) was set up by Congress, under the Internet Tax Freedom Act to study the impact of federal, state, local and international taxation and tariffs on transactions using the Internet and Internet Access. The Commission has to make recommendations to Congress by 21 April 2000 on US policy. At its final meeting in Dallas, Texas on 21 March 2000, it voted to recommend repeal of the 3% federal excise tax on telecommunications services, simplification of states' sales and use taxation systems, a prohibition on taxes on Internet access subscription charges, extension of the current Internet Taxation moratorium on multiple and discriminatory taxation, clarification of the nexus standards for collection and remittance of state and local taxes on remote transactions, for tax administration of e-commerce to minimise disclosure of consumers' personal information and to contain sufficient security to protect that information, and exploration of privacy issues associated with the collection and administration of taxes on e-commerce. In another development, the authors of the Internet Tax Freedom Act, Rep Cox and Senator Wyden, have tabled The Internet Non-Discrimination Act, simply designed to make the existing three-year ban on discriminatory taxes permanent. See <<http://cox.house.gov/nettax>> (at 3 March 2000).

²² §1101 and §1104.

²³ §1202.

²⁴ §1203.

²⁵ Above n 10 at 2.9.

²⁶ OECD, above n 6 at 5.

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be minimised by improving taxpayer service and tax administration generally.²⁷ The same approach is taken in both the EU Communication²⁸ and the 1999 UK Report.²⁹

Non-discrimination between different jurisdictions and between different forms of commerce within a jurisdiction is seen as vitally important at both the substantive and administrative levels. Yet, consideration of efficiency is confined to the administration and collection of taxes. There is little discussion of the substantive content of rules and their impact on economic efficiency. It is understandable, as different jurisdictions are still trying to come to terms with the efficient delivery of taxation policy.³⁰ But it is still a pity that electronic commerce has not engendered more international discussion on the issue.

Because minimising taxpayer compliance costs and making compliance easier improves revenue collection, it is a prime focus for tax authorities.³¹ So, too, is any reduction in the cost of administering the tax system. It is in these areas that most can be done in the short-term to improve co-operation between jurisdictions. Although it is a narrow view of efficiency, potentially it could have the most impact on the widest number of taxpayers.

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.³²

Certainty and simplicity are two of the most favoured, yet most elusive, qualities of any tax system. The EU Communication states that there “should be certainty about the rules and compliance should be made as simple as possible to avoid unnecessary burdens on business”.³³ The 1999 UK Report states that, “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”.³⁴

²⁷ Above n 3 at 8.

²⁸ Above n 10 at 7.

²⁹ Above n 10 at 2.9.

³⁰ Consider the current agonised birth pangs of the New Tax System in Australia following the wide-ranging recommendations of the Federal Government’s Review of Business Taxation in its report, *A Tax System Redesigned* (1999 AGPS) (“Ralph Report”), available at <<http://www.rbt.treasury.gov.au>> (at 3 March 2000).

³¹ For a wider discussion and details of the literature, see Bentley D (ed), *Taxpayers’ Rights: An International Perspective* (1998 Revenue Law Journal) ch 1. See also 1999 UK Report, above n 10 at 49.

³² OECD, above n 6 at 6.

³³ Above n 10 at 7.

³⁴ Above n 10 at 2.9.

It is interesting that the EU Communication favours certainty of rules, but simplicity of compliance. Perhaps it recognises the difficulty in making rules simple. The OECD and UK approach is for the rules themselves to be both clear and simple. Even if simplicity is confined to making the rules simple to understand, it is a difficult task. The rules governing the taxation of electronic commerce will follow the nature of the transaction. The rules are often so complex that governments struggle to make them certain, let alone simple. An admirable aim is to draft the rules clearly, using simple language. It will aid certainty. Even then, the rules will only become certain over time, as they are interpreted and applied. During the period of change, as the rules are adapted to cope with electronic commerce transactions, it is inevitable that they will appear complex. They will be new and there will be different interpretations of their meaning.

It is probably a futile exercise to attempt to make the rules substantively simple.³⁵ The EU definition of simplicity as keeping the burden of compliance to a minimum is more realistic. This is one principle that needs more careful definition before it is included, like some mantra, in every statement of principles governing tax systems.

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.³⁶

This definition of effectiveness and fairness is from the tax administrators' perspective. Fairness to the taxpayer is presumably inferred from the statement that only the right amount of tax will be collected at the right time. In most systems based on the rule of law, it would not be open to administrators to collect more than the right amount of tax and to collect it earlier than the prescribed due date. The last sentence mentions proportionality, but then refers to the risks involved. That is more a question of efficiency in the allocation of resources than a statement that the measures used against a taxpayer should be proportionate to the amount of tax or level of avoidance involved. Perhaps "fairness" was added to the principle to give an impression of justice and due process, but with no intention that they should specifically be taken into account.

The *1999 UK Report* does not mention fairness, but in its definition of effectiveness it does state that "the tax rules should not result in either double

³⁵ See Prebble J, "Why Is Tax Law Incomprehensible?" (1994) Br Tax Rev 380, Cooper GS, "Themes and Issues in Tax Simplification" (1993) 10 *Australian Tax Forum* 417 and the analysis in Gale WG and Holtzblatt J, "The Role of Administrative Factors in Tax Reform: Simplicity, Compliance and Enforcement" (22 February 2000 SSRN Journal): <http://papers.ssrn.com/paper.taf?bastract_id=208289> (at 23 March 2000).

³⁶ OECD, above n 6 at 6.

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or unintentional non-taxation".³⁷ Perhaps when fairness is coupled with effectiveness, fairness connotes that there should be no double taxation.

The principle of effectiveness is specifically included to emphasise the importance that revenue authorities place on collecting the full amount of tax due to them. It is particularly sensitive given the potential for avoidance and evasion through electronic commerce. Although many of the concerns about general non-payment of taxes may have been exaggerated, there are still substantial risks to the revenue.

Flexibility

The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.³⁸

The flexibility principle is not specifically taken up in other major reports. However, the tenor of any report on electronic commerce is usually that the rules should be modified or adapted where necessary to ensure that electronic transactions are taxed in the same way as other forms of commerce. This preserves neutrality. Flexibility is therefore accepted as a given. It should be, for it is integral to the efficiency of the system.

As can be seen from this brief overview, the OECD principles are fairly standard in the context of tax reform. I shall refer to them in my analysis of the *ATO 2nd Report*. The *ATO 2nd Report* acknowledges that there will be some difficulty in balancing competing principles.³⁹ However, it implicitly endorses the OECD view that the development of Electronic Commerce to its full capacity while protecting countries' revenue bases depends on maintaining an international consensus on the appropriate balance.⁴⁰

The last two sentences give the impression that individual countries are prepared to reach the best international solution unswayed by self-interest. Coming from an international forum, the OECD documents will take this approach. However, they will inevitably reflect the views of the developed economies. To be fair, the OECD Technical Advisory Groups, formed to take forward the OECD initiatives on taxation and electronic commerce proposed in the Ottawa Taxation Framework Conditions, do involve non-OECD representatives.⁴¹ Nonetheless, the emphasis of the United Nations is different, showing the influence of the less-developed countries.⁴²

³⁷ Above n 10 at 2.9.

³⁸ OECD, above n 6 at 6.

³⁹ *ATO 2nd Report*, above n 2 at para 14.1.

⁴⁰ OECD, "Electronic Commerce: The Challenges to Tax Authorities and Taxpayers", (1997 OECD), a paper presented at an informal round table discussion between business and government in Turku, Finland. Also available at <http://www.oecd.org/daf/fa/e_com/e_com.htm> (at 3 March 2000).

⁴¹ "Progress Report: Taxation and Electronic Commerce", presented by the CFA at the Paris Forum on Electronic Commerce on 12-13 October 1999 ("Progress

The EU Communication directly identifies that it is primarily interested in protecting the interests of the EU Member States. Its support for general principles extends to where those principles are advantageous to the EU Member States. The EU Communication ends with the statement that:⁴³

The [EU] Commission is convinced that taxation consistent with these guidelines will contribute to the success of e-commerce and the EU economy by providing EU businesses with a level playing field for competition.

The US Internet Tax Freedom Act reflects a similar approach at the national level. The EU Member States and the US are usually the most influential players in the international tax environment. The long route to agreement on the detailed content and meaning of the OECD transfer pricing guidelines provides ample evidence that agreement on the wording of broad principles does not represent international agreement on their meaning.⁴⁴

This is the crucial point for any analysis. Although the same general principles appear in almost every national and international report on the taxation of e-commerce, the content of their meaning is not necessarily the same. The ideas behind them are essentially the same. But in their interpretation and application, individual country groupings, individual countries and individual states within countries will all have a particular self-interested perspective.

The general principles are not rendered useless. Rather, the commentator must understand that their content is evolving through the process of international negotiation, agreement and practical cooperation. Before these latter two stages are reached, it is vital to understand the perspective of the country or group under analysis and its interpretation of the meaning of the principles.

Some principles will develop a generally accepted meaning more quickly than will others. Those concerned with tax administration, mutual agreement, and cooperation to prevent tax avoidance and evasion are in the interests of almost all jurisdictions. Tax authorities can give them effect administratively, whatever the content of the substantive rules. For example, the Internet will encourage rapid agreement on what is meant by effective reduction of the

Report”) <http://www.oecd.org/daf/fa/e_com/tags_99.pdf> (at 3 March 2000) at 5.

⁴² The work of the UN bodies involved in taxation of electronic commerce is usefully summarised in The OECD “Revised Report on International Regional Bodies: Activities and Initiatives in Electronic Commerce” SG/EC(99)5 at <http://www.oecd.org/dsti/sti/it/ec/act/Paris_ec/pdf/intbod_e.pdf> (at 3 March 2000).

⁴³ EU, above n 10 at 8.

⁴⁴ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995 OECD).

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risks from increased avoidance and evasion and what are efficient measures to combat such activities. The content of the neutrality principle will take far longer to develop as jurisdictions argue over such issues as what constitutes a tax or duty, and what activities are discriminatory.

2.3 The Guiding Principles

The Guiding Principles flow from the principles enunciated in the Ottawa Taxation Framework Conditions. However, the three principles chosen have been isolated in the context of subsequent work of the OECD and the ATO. The Ottawa Taxation Framework Conditions focused on four areas: improving taxpayer service; tax administration; consumption taxes; and international tax norms.⁴⁵ The OECD formed Technical Advisory Groups ("TAGS") in January 1999 for two years to deal with the following issues within the four areas: technology; professional data assessment; consumption taxes; business profits; and income characterisation.⁴⁶ In its own work and its close involvement in the TAGs, the ATO has identified the principles of neutrality, minimisation of the costs of compliance and administration, and privacy as most relevant.

The work being done by the ATO and the TAGs is exploratory and preparatory. Efficiency in its broader context, certainty and simplicity, effectiveness and fairness, and flexibility are all principles that find fulfilment in the choice, implementation and application of new rules and processes. To a degree, the ATO is justified in isolating those principles that it feels are most relevant to this preliminary stage of its thinking on electronic commerce. In addition, there are the principles of the ATO's Taxpayers' Charter that apply to activity of the ATO or any system or procedure that it introduces.

The ATO may identify key principles it sees as crucial to its current work on electronic commerce. However, the ATO should not ignore basic taxpayers' rights in the development and implementation of new rules and procedures. The Charter is concerned with the basic fairness of administrative procedures.⁴⁷ It also reiterates key taxpayers' rights found in legislation or the common law. For example, it tells taxpayers of their right to appeal against certain decisions of the ATO and their right to claim legal professional privilege over certain documents.⁴⁸ In developing its electronic commerce

⁴⁵ Above n 6 at para 11.

⁴⁶ Reports of the work of the TAGS are in Progress Report, above n 41. Mr Peter Simpson of the ATO is Deputy Chair of the CFA.

⁴⁷ ATO, *The Taxpayers' Charter* (1997 ATO). Discussed in Bentley D, "Formulating a Taxpayers' Charter of Rights: Setting the Ground Rules" (1996) 25 *Australian Tax Review* 97, and Bentley D, "The Taxpayers' Charter: More than a Mission Statement" (1996) 4 *Taxation in Australia - Red Edition* 259.

⁴⁸ ATO, *ibid* at 6.

policies, the ATO and taxpayer representatives with whom the ATO consults should also consider the wider rights of taxpayers.

The first of the Guiding Principles in the *ATO 2nd Report* is that of neutrality. "The ATO considers the guiding principle for determining the legal and administrative framework for taxation of Internet activities must be tax neutrality."⁴⁹ The importance of neutrality is seen in its inclusion in all major reports.⁵⁰ Although, as discussed, whether the reports mean the same thing by neutrality is another question.

The 1998 Report of the Joint Committee of Public Accounts and Audit is interesting on this issue.⁵¹ It found that application of the concept of neutrality might require adjustment to the substantive law. It also found that the application of neutrality principles would require the ATO to ensure "the use of best practice processes and requirements for developing and amending legislation and regulations".⁵² The implication is of a presumption that neutrality should apply to all legislation and subordinate legislation. It suggests that the legislature may have a wider view of the meaning of neutrality than has the executive.

In the *ATO 2nd Report* neutrality means not only that the same tax rules should apply to both electronic and non-electronic transactions, but also the same compliance requirements.⁵³ If the compliance requirements for both types of transaction should be the same, there are some interesting permutations.

The ATO is encouraging taxpayers to maintain records, lodge returns and forms, and pay taxes electronically. According to the instructions for completing tax returns, tax refunds are made more quickly where a return is lodged electronically. Large companies are required to lodge payments electronically under the Pay-As-You-Go instalment system.⁵⁴ The *ATO 2nd Report* focuses on taxpayer service and tax administration. Specifically in the former, and strongly in the latter, there is an emphasis on the ATO concentrating on the potential for electronic operation of many of its services and functions.

Increasingly, tax service and administration will favour those who deal with the ATO electronically. For example, the ATO is providing electronic record

⁴⁹ *ATO 2nd Report*, above n 2 at para 1.2.3.

⁵⁰ The *ATO 2nd Report*, *ibid*, describes it as "virtually universal support" and provides a number of examples at footnote 5 to para 1.2.4.

⁵¹ *Report 360: Internet Commerce – To buy or not to buy?* (1998 AGPS) at para 4.25 ff.

⁵² *Ibid* at para 4.37.

⁵³ The *ATO 2nd Report*, above n 2 at 1.2.5.

⁵⁴ See the ATO Tax Reform website at:
<<http://www.taxreform.ato.gov.au/busihome/index.htm>> (3 March 2000).

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keeping software free of charge to businesses to help them to prepare for introduction of the New Tax System.⁵⁵ There are advantages to both taxpayers and the ATO in moving to electronic interaction. However, it breaches the principle of neutrality to advantage those who choose to do so. It may be a government policy decision, introduced for economic reasons as well as for tax administration and efficiency, that business taxpayers should be forced to move towards operating electronically. It should not be based on an apparent framework of tax neutrality.

The second of the Guiding Principles in the *ATO 2nd Report* is that proposals for regulation of electronic commerce should take account of the cost of compliance and that the ATO will minimise the costs of compliance and administration.⁵⁶ Support for this principle is important, given the widespread concern that the costs of compliance for electronic commerce could be prohibitive.

Revenue authorities are naturally defensive when claims are made about the high costs of compliance. However, the adverse publicity does place pressure on governments and revenue authorities to consider compliance costs in formulating and implementing tax policies. This is doubly important where the potentially high costs of administering and monitoring the taxation of electronic commerce provide a significant incentive for governments to shift those costs to taxpayers and third parties. Adopting the principle that compliance and administration costs should be minimised provides a framework for negotiation between the different stakeholders to determine a fair allocation of responsibilities and associated costs.

This is increasingly the position in Australia, where extensive consultation has taken place to try and ameliorate some of the costs of compliance placed on taxpayers with the implementation of the New Tax System.⁵⁷ Consultation and communication also makes it easier for the revenue authorities to gain acceptance for electronic compliance and delivery of services. Taxpayers can see the ATO, for example, as keeping in touch with the latest developments, but also as assisting taxpayers to take advantage of electronic communication.⁵⁸

The third Guiding Principle is to balance ATO tax administration requirements, particularly taxpayer identification, with that of privacy.⁵⁹ Privacy is essential both for delivery of electronic services to taxpayers and administration of the tax system. It is in these two areas that applications of electronic commerce are developing most quickly.

⁵⁵ Ibid.

⁵⁶ *ATO 2nd Report*, above n 2 at para 1.2.8.

⁵⁷ For example, the Ralph Review, above n 30; the New Tax System Advisory Board; and Industry Partnerships, ATO, above n 54.

⁵⁸ ATO, *ibid.*

⁵⁹ *ATO 2nd Report*, above n 2 at 1.2.9.

It is appropriate that privacy is considered separately. It is not so much a principle that will determine an effective tax system as a fundamental right of taxpayers in a democratic society, which governments have a duty to protect. As the OECD TAGs have found, privacy is not affected so much by the application of existing rules to electronic commerce, but in the application of new products, processes and systems.⁶⁰

As governments adopt new electronic measures to assist in the administration, collection and enforcement processes, they need to pay close attention to the impact on taxpayers' privacy. New measures may present no threat to privacy in their current form. However, as they are upgraded, or as the electronic environment in which they operate develops, there could be damaging potential threats to privacy. The converse is equally the case. Assume a government does not adopt new measures, but continues to use an older platform. Sophisticated platforms developed outside the government environment could find it relatively simple to breach out-dated government security measures.

Governments are put in a difficult position. They are ultimately responsible for regulating privacy in a democratic society. It is their duty to protect the privacy of their citizens. They want to do so with minimum regulation and without stifling the development of electronic commerce. To make responsible decisions governments need to be constantly abreast of latest developments in electronic architecture. Where they do regulate, it must impose a bearable burden on users and be feasible to implement. However, governments cannot leave regulation too long, or it will be impossible to implement anyway; the electronic horse will have bolted. Governments also have to see the importance, when they decide their spending priorities, of investment in developing their own electronic infrastructure for the protection of the citizens they represent and whose information they have on record.

Prescience and very deep pockets are a lot to demand of any government. However, governments can and should ensure that the privacy rules protect individual citizens. A vital part of that protection must extend to taxpayer information. The personal and financial information about any taxpayer that a government holds is usually among that taxpayer's most valuable assets. It is therefore reassuring that privacy is the ATO's third Guiding Principle.

3 THE REPORT IN CONTEXT

3.1 Introduction

Although not obvious from its structure, the *ATO 2nd Report* is closely tied back to the OECD Discussion Paper and the *ATO 1st Report*. Appendix B of

⁶⁰ OECD, above n 41.

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the *ATO 2nd Report* compares the implementation options of the three reports.⁶¹ This section considers the first two substantive chapters of the *ATO 2nd Report*, dealing with electronic commerce taxation developments and the overall electronic commerce market.

3.2 Chapter 2: Electronic commerce taxation developments

Chapter 2 of the *ATO 2nd Report* traces three types of development in electronic commerce that influence taxation policy.⁶² The first type is specific to the development of domestic taxation policy. After the release of the *ATO 1st Report*, the Joint Committee of Public Accounts and Audit ("JCPAA") of the Australian Parliament began a wide-ranging inquiry into Internet commerce.⁶³ The process of the inquiry was valuable for the ATO. It brought together a wide range of government and private sector representatives for a roundtable discussion of the issues surrounding electronic commerce.⁶⁴ The ATO has continued discussion and consultation with interested parties since. The first strategy in the Action Plan is to "set up an Australian consultative forum with business sector representatives to facilitate open and inclusive discussions on electronic commerce taxation issues".⁶⁵

There is always a danger that consultation will become stale. Taxpayer representative bodies have argued for some time that consultation is not genuine if no heed is paid to submissions made by taxpayer groups on proposals for draft legislation and rulings.⁶⁶ However, during the formulation of new policy in an untested area, the ATO is in a position to explore ideas in a way that it cannot where existing government objectives constrain it. Taxpayers should therefore fully support this strategy. It should be used as a model for the development of future policy, building on the consultative process used to develop the New Tax System.⁶⁷

Although the UK is behind Australia in its use of electronic commerce in tax administration, it is ahead in its consultation. This tends to be the position in countries where revenue authorities and taxpayers do not have to overcome a culture of antagonism and confrontation. The UK Electronic Commerce Consultation Forum has been in place since June 1999.⁶⁸ It has representatives from the Inland Revenue, Customs, taxpayer representative groups and business. It provides a forum for cooperative development of

⁶¹ Above n 2 at 189.

⁶² Ibid at 33 ff.

⁶³ Ibid at paras 2.2.1-2.2.19, and JCPAA, above n 51.

⁶⁴ *ATO 2nd Report*, ibid at para 2.2.2.

⁶⁵ Ibid at 12.

⁶⁶ Editorials, articles and comments that take this line are common in the pages of the journal of the Taxation Institute of Australia, *Taxation in Australia*.

⁶⁷ Above n 57.

⁶⁸ *1999 UK Report*, above n 10 at paras 2.17-2.20.

electronic commerce policy and has a number of sub-groups working on specific areas of concern.

There is another imperative encouraging the ATO to explore all available views. The ATO has established a leading role within the OECD TAGs. If it is to provide input to maintain its position, it needs the help of the private sector to do so. It also has a moral duty to ensure that the views of Australian business are represented at the TAGs.⁶⁹ In an open and democratic society, it is no longer the role of government to represent the views of taxpayers without input from taxpayers as to what their views are.

This dual role of the ATO does not always sit easily on what is essentially an authority responsible for tax assessment, collection and enforcement. The traditionally antagonistic ATO approach to taxpayers is slow to break down. Meanwhile, Australian taxpayer representative groups have a duty to ensure that they are represented appropriately in international forums. The huge changes that they have to cope with on behalf of their members domestically must not prevent them from engaging in discussion on the international stage. The issues at stake are likely to have even more fundamental long-term impact on Australian taxpayers than does the implementation of the New Tax System.

The JCPAA Report made a number of influential findings and recommendations.⁷⁰ It endorsed the ATO focus on international cooperation. It noted the risk to fundamental tax concepts and encouraged international consideration of whether they could be adapted to an electronic commerce environment. The report also supported ATO measures to monitor the risks to revenue from electronic commerce and the enhancement of methodologies to do this. In this context it discussed the results of a pilot study of low value consignments imported into Australia, commissioned by the ATO and Customs to determine the potential revenue foregone across product types. The report encouraged ongoing surveys and review of low value thresholds.⁷¹ Overall, the JCPAA Report was a strong endorsement of the ATO policy approach to electronic commerce.

General domestic developments in electronic commerce are identified as the second major influence on the ATO. These include the findings of the Electronic Commerce Expert Group established by the Commonwealth Attorney-General to consider how the law should be updated to take account

⁶⁹ It is expected of Member States in the Ottawa Taxation Framework conditions, above n 6 at 9. The ATO culture will have to adapt to the European approach, where the expectation is that business will have a positive contribution to make to tax policy development.

⁷⁰ JCPAA, above n 51 and as discussed in the *ATO 2nd Report*, above n 53.

⁷¹ Similar monitoring is recorded in the *1999 UK Report*, above n 10 at para 7.3.

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of technological changes.⁷² The Electronic Transactions Act 1999 (Cth) regulates the use of electronic communications in transactions. The Ministerial Council for the Information Economy, supported by the National Office for the Information Economy ("NOIE") generally oversees government policy in the area.⁷³ The aim is to consult widely to determine the barriers to the development of an information economy and to eliminate them.⁷⁴ The work of other government agencies forms the overall government policy framework for electronic commerce and, as such, will influence the ATO approach.⁷⁵

The third type of influence on the ATO is international, primarily in the taxation area. The OECD is the primary forum for policy developments, as seen in the influence of OECD output on the *ATO 2nd Report*. The ATO represents Australia on all five OECD TAGs. It is a pity that more Australian representative groups are not participants, beyond the AMP on the Business Profits TAG and the Australian Society of CPAs on the Professional Data Assessment TAG.⁷⁶ Representation is obviously limited. However, strong lobbying by the ATO and taxpayer groups could have seen more Australian experts as members. Part of the problem is awareness. At least until 1998, the Business Council of Australia appeared to be the only private sector group that sought to make its views known to the OECD Committee on Fiscal Affairs. Australia is also a member of the Asia Pacific Economic Cooperation organisation ("APEC")⁷⁷ and the WTO,⁷⁸ both of which have the potential to play a significant role in shaping developments in the regulation and taxation of Australian electronic commerce.

In an interesting development, Australia has begun to sign joint statements on electronic commerce with foreign governments.⁷⁹ They aim to express non-binding agreement on policy approaches to electronic commerce issues, such as: taxes and tariffs; business and consumer confidence; content; government

⁷² *ATO 2nd Report*, above n 2 at paras 2.2.20-2.2.23. A summary of the Report is available on <<http://www.law.gov.au/aghome/advisory/eceg/Welcome.html>> (at 3 March 2000).

⁷³ See the NOIE website at <<http://www.noie.gov.au>> (at 3 March 2000).

⁷⁴ NOIE, *A Strategic Framework for the Information Economy – Identifying Priorities for Action*, *ibid*. NOIE produces regular reports on the state of the information economy in Australia and its potential.

⁷⁵ The *ATO 2nd Report*, above n 2 at para 2.2.36 provides a useful list of government agencies that have released information relevant to electronic commerce.

⁷⁶ The participants in the TAGs are listed on: <http://www.oecd.org/daf/fa/e_com/tag.htm>. See further on business involvement, Owens J, "Taxation of E-Commerce: Partnering Business and Government" 19 April 1999 Tax Notes Int'l 1587.

⁷⁷ See <<http://www.apec.org>> (at 3 March 2000).

⁷⁸ See <http://www.wto.org/wto/ecom/e_25.doc> (at 3 March 2000).

⁷⁹ *ATO 2nd Report*, above n 2 at para 2.3.27 ff.

services and information; intellectual property rights; and infrastructure.⁸⁰ As statements have been signed⁸¹ with the US, Japan, the People's Republic of China and the Republic of Korea, it suggests a regional approach. What effect the statements will have is unclear. It would be to Australia's advantage if these governments followed an agreed line on matters affecting international trade. It would also be useful if the agreements led to enhanced cooperation between revenue authorities, particularly for the exchange of information.

Paragraph 2.3.34 of the *ATO 2nd Report* provides a useful list of revenue authorities from around the world that have published reports on electronic commerce, with details of their websites. Most reports on taxation of electronic commerce are produced by revenue agencies. Private sector representation on international bodies is, because of the nature of their membership and organisation, limited. It is pleasing that international bodies are trying to expand the views that they take into account in developing international policy. It can only enhance the quality of the decisions made, particularly in light of the "principles" that they espouse.

The cooperation between revenue authorities engendered by the interest in electronic commerce is a positive development. Cooperation should produce more efficient tax administration. The gradual elimination of unnecessary barriers to commerce that are often in place through misunderstandings and lack of communication should also follow. Communication between revenue authorities will improve international collection of tax and enforcement of tax rules. It will provide taxpayers with greater certainty and make the international tax playing field more equitable. On the negative side, there is a danger that the flow of information will adversely affect taxpayers' rights to privacy, confidentiality, appeal and similar rights. This is discussed further below.

3.3 Chapter 3: The market today

Chapter 3 of the *ATO 2nd Report* sets out the major market trends in electronic commerce. It also highlights the difficulties in forecasting the growth of electronic commerce, the access of consumers to the Internet and their use of it. A group called www.consult is reported as predicting that online sales in Australia would reach A\$5 billion by the end of 2000.⁸² Compare this to forecasts that the UK will have sales of US\$4.5 billion in 1999, rising to US\$47 billion by 2002.⁸³ The Australian Bureau of Statistics is developing a number of initiatives to produce the range, quality and international

⁸⁰ Ibid at para 2.3.28.

⁸¹ Ibid at para 2.3.29.

⁸² *ATO 2nd Report*, above n 2 at para 3.2.3, reporting Montgomery B, "Net Sales Surge as shoppers go on-line", *The Australian*, 6 October 1999.

⁸³ *1999 UK Report*, above n 10 at para 1.7.

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comparability of data required by the ATO and other government departments. Currently, given the paucity of information about the Internet and its use, the ATO has to rely on a range of other statistical indicators.⁸⁴

The *ATO 2nd Report* does provide a number of interesting statistics.⁸⁵ Some 650,000 people made a total of about 3 million purchases in the 12 months to May 1999. About 76% of purchases were paid for online. Some 43% of purchases were from overseas suppliers. This last statistic is interesting, given the forecast in the *ATO 1st Report* that most purchases, in the short term, would be made from US sources.⁸⁶ It suggests that Australian sites are more prolific than expected. Goods and services most frequently purchased are books and magazines (38%), computer software or equipment (34%), music (14%), clothing or shoes (11%), holidays (9%), tickets to entertainment events (8%), and sporting equipment (4%). Apparently nearly 5.5 million adults (or 40% of Australia's adult population) accessed the Internet in the 12 months to May 1999, one of the highest levels of access in the world. At May 1999, 1.5 million households had access to the Internet from home, while 2.3 million adults used that access.⁸⁷

The ATO reports that some 83% of all businesses and nearly all medium and large businesses used computers. Nearly half were connected to the Internet in May 1999. Businesses most commonly use the Internet for e-mail, information searches and advertising. However, only 13% of businesses at May 1999 used electronic commerce to transact business.

Although exponential growth is predicted, the ATO does not believe that electronic commerce will have an immediate significant impact on taxation revenues.⁸⁸ They do allow that this could change in the relatively near future. Recommendation R.1 of the Action Plan states that the ATO will closely monitor market trends and address any risks to revenue in a timely manner.⁸⁹ This approach implements the flexibility principle adopted in the Ottawa Taxation Framework Conditions. Monitoring will require the development of high quality statistical information. The ATO will use its information gathering powers to assemble the necessary data to provide it with the statistics it needs.

⁸⁴ *ATO 2nd Report*, above n 2 at paras 3.24-3.25.

⁸⁵ The statistics outlined in this and the following paragraph are taken from *ATO 2nd Report*, *ibid* at paras 3.2.6-3.3.5.

⁸⁶ This point is reiterated, *ibid* at para A.1.4.

⁸⁷ Ernst & Young, in a special report, *Virtual Shopping* (2000 Ernst & Young) (also available from <<http://www.ey.com.au>> (at 3 March 2000)) state that nearly half of Australian households have personal computers, 22% are online, but only 5% had made a purchase over the Internet at the time of the report.

⁸⁸ *Ibid* at para 3.3.4.

⁸⁹ *Ibid* at 12.

The Action Plan addresses the ATO's overall monitoring strategy in the context of its administrative discussion papers.⁹⁰ It essentially involves monitoring market and business trends and identifying risks to the revenue from electronic commerce activities.⁹¹ The types of monitoring identified are unlikely to constitute an invasion of taxpayers' privacy. Neither is the use of existing ATO information likely to breach confidentiality. The proposed monitoring and data matching activities do not go beyond what most taxpayers would believe that the ATO already does.⁹²

The Action Plan identifies a number of jurisdictional and administrative risk indicators that it will monitor.⁹³ It sees the degree of digital certificate uptake by consumers as an important indicator of growth, and notes that uptake is expected to be restrained in the short term by widespread concerns about trust and privacy.⁹⁴ The ATO will monitor overall trends in Internet business activity and, through selective use of Internet Protocol ("IP") number lookups, domain names, Secure Socket Layer ("SSL") servers and credit card intermediary data, will trace the location of business websites. The ATO will also monitor identification, for example, the percentage of adequately identified commercial websites.

The ATO is particularly interested in business migration to low tax jurisdictions and, what it sees as an associated revenue risk, the level of business accountability in electronic payment systems.⁹⁵ Existing ATO data from sources such as tax returns, tax audits, Advance Pricing Agreements and industry taxation standards will supplement external information. The ATO is already liaising with the Reserve Bank and payment system providers to monitor potential evasion through the cash economy via unaccounted systems and the disaggregation of financial functions. Australian resident taxpayers cannot object to the ATO tracing their location, the location of their funds, or the underlying nature of transactions they undertake. Provided the

⁹⁰ Ibid at 16 to 21.

⁹¹ Administrative Strategy A.1 – Monitoring of risks, *ibid* at 16.

⁹² The ATO compliance programs and taxpayer responses are outlined in detail in the papers of the International Conferences on Tax Administration, now hosted by ATAX at the University of New South Wales, Sydney, and held in 1993, 1995, 1998 and 2000. E-commerce companies are far more aggressive than the ATO in their pursuit of private consumer information, for marketing and on-selling. See, "The not-so-private world of cyberspace" *The Australian Financial Review*, Wednesday 15 March 2000 at 16.

⁹³ *ATO 2nd Report*, above n 2 at paras A.1.3-A.1.12.

⁹⁴ Ernst & Young, above n 87, supports this view. It found that fear of credit card fraud was a major deterrent to shopping online for about half of the respondents to its Australian survey. Security generally was the prime concern of Australian respondents.

⁹⁵ All OECD countries have similar concerns. See OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998 OECD) and Pinto D, "Taxation Issues in a World of Electronic Commerce" (1999) 4 *Journal of Australian Taxation* 227.

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ATO maintains its duty of confidentiality, ATO tracing should only be a concern for those taxpayers involved in tax evasion.

Levels of record keeping are key risk indicators. The ATO will introduce real time record keeping reviews to monitor the accessibility, integrity and retention of electronic commerce records.⁹⁶ It will also monitor the percentage of ISPs complying with agreed ATO/ISP record keeping standards. ISPs' transaction logs will become an important source of secondary information, particularly where they are acting as agent for a business website.

The concept of real time record keeping reviews raises immediate concerns for taxpayers, but most can be answered if the ATO uses appropriate safeguards. There is little dispute that the ATO can request access to such information.⁹⁷ It has simply not been possible until recently for real time reviews to occur. Where real time reviews of taxpayer records take place, ATO access would be on a read only basis and there would be no danger of alteration or corruption of files. It would also not prevent the taxpayer from using the accounting system simultaneously with an ATO review. The ATO would use the record keeping reviews to collect and review different types of information using a variety of computer-assisted auditing techniques.⁹⁸

Australian law would not generally require the ATO to notify the taxpayer before each time that it accesses the records in this way. However, in line with other jurisdictions, it should have to do so.⁹⁹ Otherwise a taxpayer would not be able to claim any right of review until after the event. Rights of review of an administrative decision are limited,¹⁰⁰ but they are available and taxpayers should not be put in a position where they are effectively precluded from claiming those rights. Taxpayers would not normally claim legal professional privilege for accounting and tax records. If they wished to do so, they would have to be warned of the ATO's impending review, or they would

⁹⁶ See further, Administrative Strategy A.5 and the strategy on "real time record keeping reviews", *ATO 2nd Report*, above n 2 at paras A.5.23-A.5.25.

⁹⁷ Sections 263 and 264 of the Income Tax Assessment Act 1936 (Cth) ("ITAA 1936"). Although these sections do not refer explicitly to electronic records and computer access, arguably the requirements to provide access and all reasonable facilities are broad enough to cover real time access (see also s 25 of the Acts Interpretation Act 1901 (Cth)). The sections could easily be amended, but the *ATO 2nd Report*, above n 2 at para 6.3.13 assumes that the current sections, when combined with s 262A(3), requiring records to be convertible into writing in the English language, are sufficient.

⁹⁸ They could range from statistical sampling, through profiling, to specific record keeping. Each of these could also capture targeted information, eg, for transfer pricing, CFC or goods and services tax purposes.

⁹⁹ See below at 4.2, under the heading "Information".

¹⁰⁰ Bentley, above n 47 and *Morabito V and Barkoczy S*, "Restricting the Judicial Review of Income Tax Assessments" (1999) 21 *Sydney Law Review* 36.

have to keep all relevant documents in files not open to ATO real time access.¹⁰¹

A major issue for the ATO will be its ability to collect the relevant data. When it has the data it must be assured of its accuracy and reliability. It is an issue for government as a whole and there will be significant liaison between departments out of necessity. The same necessity is likely to facilitate new levels of international cooperation between revenue authorities. This has already happened, with the OECD acting as a willing catalyst. Of possible significant benefit to taxpayers is the need for the ATO to consult with business, industry and other interest groups, simply because it requires their cooperation in keeping abreast of the trends it is trying to monitor.¹⁰² This could lead to tax solutions for electronic commerce that both work and also comply with the Guiding Principles.

3.4 Chapter 4: Opportunities

This chapter is concerned with how the ATO can support the overall government initiative to use electronic commerce to improve efficiencies and raise service levels.¹⁰³ The two features of this are first, supporting and providing services to the community and second, breaking down the barriers between the ATO and the community by facilitating communication. Specifically, the ATO aims to use the technologies underlying electronic commerce to: support the implementation of tax reform; improve service to the community; support business on-line; improve the efficiency of the ATO; and contribute to international best practice in tax administration. These aims are reflected in the Action Plan "Service Strategy S.1 – Improving service standards".¹⁰⁴

Critics of revenue authorities are becoming less cynical when those authorities talk about creating efficiencies and improving service standards. Since the compliance research in the 1980s and 1990s showed that improving service standards resulted in increased compliance and collection, establishing a good relationship with taxpayers has become a goal of most

¹⁰¹ *FCT v Citibank* (1989) FCR 403 at 437 is authority for the requirement that the ATO must allow holders of documents a practical and realistic opportunity to claim privilege during an investigation. The "practical and realistic opportunity" might be provided by the ATO identifying in advance the files to which it wants real time access. The taxpayer would simply not place privileged documents in those files.

¹⁰² *ATO 2nd Report*, above n 2 at 20, Administrative Strategies A.2 and A.3.

¹⁰³ *Ibid* at para 4.1.1. Paras 4.1.1-4.1.5 outline the framework for this chapter. This section reflects the Ottawa Taxation Framework Conditions commitment to improving taxpayer service using the new technologies, above n 6 at 6.

¹⁰⁴ *ATO 2nd Report*, *ibid* at 13.

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sophisticated tax administrations.¹⁰⁵ A major purpose of the tax reform that has swept through many countries in the last few years has been to simplify tax systems and provide greater certainty for taxpayers.¹⁰⁶ The services that revenue authorities provide to taxpayers make a significant contribution to that purpose.

In Australia, developments over the past few years have added to the pressure on the ATO to maintain and improve service standards. In 1993 the JCPAA inquiry into the administration of the tax system resulted in a number of fundamental changes to the service culture of the ATO.¹⁰⁷ The ATO was itself already working on becoming a service organisation.¹⁰⁸

Following the JCPAA inquiry, the government established the position of Special Adviser on Taxation in the office of the Commonwealth Ombudsman.¹⁰⁹ The first incumbent worked hard to identify weaknesses in the systems and processes within the ATO.¹¹⁰ The Commissioner made it clear that he would act on the recommendations in the initial reports and provided an environment where ATO accountability has become more open.¹¹¹

The government also required the ATO to develop a charter of taxpayer's rights, which it did in consultation with taxpayer representative groups and the community at large.¹¹² The Charter, together with its supporting Explanatory Booklets, was released in June 1997. It now appears, or is referred to, in most ATO literature. The literature also clearly identifies available dispute resolution procedures, including the possibility of complaint to the Commonwealth Ombudsman.

In an environment where the ATO is seen as accountable to Parliament and to taxpayers for its actions, ATO commitments to improve service standards can be taken seriously. That electronic interaction will also improve the efficiency of the ATO in performing its primary tasks of assessment,

¹⁰⁵ Above n 31. See also, ATO, *The Taxpayers' Charter* (1997 ATO).

¹⁰⁶ See Ralph Report, above n 30.

¹⁰⁷ JCPAA, *Report 326, An Assessment of Tax* (1993 AGPS).

¹⁰⁸ The titles of the papers at the 1993 ATO Research Conference, Canberra, 2 and 3 December 1993 (now the ATAX conferences, above n 92) reflect this. For example, Bird S, "Helping tax agents help taxpayers", Wirth A, "Changing taxpayer compliance: the impact of business auditors as service providers" and Anderson R, "Taxpayers are people".

¹⁰⁹ With wide-ranging powers of investigation: see Ombudsman Act 1976 (Cth), Pt II. The position is similar to the UK Revenue Adjudicator: see Oliver D, "The Revenue Adjudicator: A New Breed of Ombudsperson?" [1993] *Public Law* 407.

¹¹⁰ For example, see Evans D, "Hard Cases" (1995/96) 30 *Taxation in Australia* 236 and "Out in the Open" (1997/98) 31 *Taxation in Australia* 251.

¹¹¹ "Counter Culture" (1995/96) 30 *Taxation in Australia* 230.

¹¹² Above n 47.

collection and enforcement, should be seen by taxpayers as an advantage rather than a concern. The days are gone when any advance in the efficiency of the ATO should be seen in the community as a direct threat to the rights of the individual taxpayer. The ATO operations are now sufficiently transparent and accountable that the culture of confrontation should be left behind. The Commissioner is working towards achieving a more cooperative relationship with taxpayers.¹¹³ However, my own experience suggests that there is still a surprising lack of trust and high level of antagonism between the ATO and taxpayer representative groups. It prevents genuine cooperation of a kind that occurs in New Zealand and the UK.¹¹⁴

The main issue in using electronic commerce technologies to improve service standards is to ensure that there is ongoing dialogue and genuine consultation between the private sector and the ATO. It will provide more options for policy development and identify weaknesses in proposals before they occur. Throughout the development process, all parties need to be keenly aware of potential infringements of taxpayer rights. The ATO's choice of "privacy" as an overarching principle underlying the development of its electronic commerce policy is reassuring. However, it is only one right that may be affected.

The list of initiatives that the ATO is undertaking is very impressive. When compared with the *1999 UK Report*, it underlines the advantages that Australia has. The ATO is large enough to be able to invest in the infrastructure to support electronic technologies. However, the relatively small size of the taxpaying population means that the ATO can be more flexible in its reaction and quicker in its progress than countries with populations three or more times larger. The ATO should take advantage of its lead in providing electronic services to influence the shape of future international tax administration. There are also likely to be significant cost savings for the ATO where it can work with developers and suppliers of new technologies to produce and implement new applications that can then be used in tax administrations around the world.

Many of the ATO initiatives outlined in the report have been well publicised elsewhere. Nonetheless, the technological support for the implementation of

¹¹³ For example, Carmody M, "Future directions in tax administration or Community confidence: the essential building block" in Evans C and Greenbaum A (eds) *Tax Administration: Facing the Challenges of the Future* (1998 Prospect) ch 16; "Taxpayers' Charter: ATO Perspective", paper presented at the ATAX Conference, Current Issues in Tax Administration, 11 and 12 April 1996; and "ATO Directions and Operations – Issues Affecting the Practitioner", speech to the Taxation Institute of Australia Canberra Convention, 21 March 1996.

¹¹⁴ I outline the conflict escalation in the Australian tax system in Bentley D, "Problem Resolution: Does the ATO Approach Really Work?" (1996) 6 *Revenue Law Journal* 17.

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the New Tax System is impressive. Particularly when it is compared to the *1999 UK Report*, where similar initiatives are still being considered, or perhaps tested. The ATO supports a wide range of interaction with taxpayers, particularly business taxpayers. In addition to the information available on the ATO and Tax Reform websites, businesses can register electronically for the New Tax System, will use digital public key technology in dealing with the ATO, can file returns on-line, and can make tax payments and receive refunds electronically.¹¹⁵

The UK Inland Revenue and HM Customs and Excise are following a similar approach. They expect between 4-5% of taxpayers to lodge returns electronically for 1998/1999, where the ATO is not satisfied with 75% electronic lodgment.¹¹⁶ The UK Report shows how quickly businesses adapt to an electronic environment. Nearly 60% of payments of VAT were made electronically in 1998/99.¹¹⁷ Both the UK and the ATO experiences suggest that a majority of taxpayers, and businesses in particular, will very quickly use electronic services that are available. It shows that tax authorities are justified in emphasising electronic provision of services.

General community acceptance of electronic commerce and its advantages has provided the ATO with a unique opportunity in implementing the New Tax System. With over 80% of businesses connected to the Internet¹¹⁸ and required to register for the New Tax System, much of the information given to taxpayers is provided electronically. The ATO can provide extensive information on the new system to a much broader audience at a fraction of the cost. Use of paper information is extensive, but the ATO could not possibly have matched the sheer volume of information available to all taxpayers on its websites using conventional methods. The ATO can provide services, such as taxpayers being able to practise filling out Business Activity Statements for the New Tax System on the Tax Reform website, that were simply not available on such a scale to taxpayers in other jurisdictions having to go through a similar implementation process.¹¹⁹

The ATO has another major advantage in implementing the New Tax System today, rather than even three years ago. Where in the past it has provided taxpayers with sample paper records and documentation to help maintain proper accounts and records, now it can provide electronic records. Evidence

¹¹⁵ *ATO 2nd Report*, above n 2. The ATO services and proposed services are outlined in Chapter 4.

¹¹⁶ Compare *1999 UK Report*, above n 10 at para 4.16 and *ATO 2nd Report*, *ibid* at para 4.3.2. Strictly, the statistics may not be comparable, but they give an indication of how far the ATO has progressed in its electronic lodgment program, in general terms, as compared with similar systems of tax administration.

¹¹⁷ *1999 UK Report*, *ibid* at para 4.48.

¹¹⁸ *ATO 2nd Report*, above n 2 at para 3.2.18.

¹¹⁹ *Ibid* at para 4.2.7.

from tax audits suggests that many businesses do not keep proper records, and “the ATO has produced an electronic record keeping software to help smaller cash-based businesses comply with the GST”.¹²⁰ Providing a free copy of the software package to all businesses of this kind has benefits for both the ATO and taxpayers. Taxpayers can keep proper records to run their businesses efficiently and the ATO has designed the packages to capture exactly what information it needs to audit the businesses quickly and efficiently. It will be interesting to see whether businesses will use the package.

Where the UK is concentrating still on putting in place efficient call centres for taxpayer queries and is looking to introduce electronic interaction with taxpayers in the future, the ATO is focussing now on electronic interaction.¹²¹ The ATO already uses automatic interactive telephone systems to deal with many common taxpayer enquiries. The advantages are faster, more consistent and accurate answers. The ATO is now working on e-mail responses from ATO staff. E-mail offers the opportunity for ATO officers to respond “with a point-and-click approach to answering e-mails using a database of frequently asked questions and their technically cleared answers”.¹²² The advantages are the same as for automatic telephone answering systems.

The ATO will probably experience some adverse reaction from a mainly automated taxpayer service program, but wider use of its services. The advantage of the UK call centre approach is that callers have the reassurance of talking to a human being who can listen to their specific concern or problem. The ATO currently provides advice over the telephone and now has a statutory obligation to provide binding oral advice, which is treated as a private ruling.¹²³ Where this information cannot be automated, higher level responses to taxpayer queries will have to continue. A national database of private rulings should make this advice consistent and accurate nationwide.

The ATO can now provide copious amounts of electronic information to all taxpayers. Tax agents and taxpayers can find out from the ATO websites what the ATO’s interpretation of the law is on a particular issue. By using ATOLaw,¹²⁴ the tax agent and taxpayer will use the same research tools as ATO officers and should reach a broadly similar interpretation of the law. It should surely be an advantage to make the interpretation and the application

¹²⁰ *ATO 2nd Report*, above n 2 at para 4.2.8. Available through the Tax Reform website, above n 54.

¹²¹ *1999 UK Report*, above n 10 at paras 4.56 to 4.63. Compare *ATO 2nd Report*, above n 2 at paras 4.34-4.37 and para 4.39, which outline the measures discussed in this paragraph.

¹²² *ATO 2nd Report*, *ibid* at para 4.3.7.

¹²³ Proposed Pt 5-5 Taxation Administration Act 1953 (Cth) (“TAA 1953”) and Subdiv 360 Income Tax Assessment Act 1997 (Cth) (“ITAA 1997”).

¹²⁴ *ATO 2nd Report*, above n 2 at para 4.4.8.

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of the tax law more consistent, accurate and certain? I see two potential problems.

First, taxpayer general access to the law is always a good thing. However, there is a danger that taxpayers inexperienced in the interpretation and application of complex laws will rely on their own interpretation of the law based on an incomplete picture gained from information on the ATO website. This is not an argument for maintaining a closed shop for tax advice, restricted to lawyers and tax agents. Rather, it is a realistic concern based on the complexity of Australian tax law. Take the question of something as simple as the deductibility of the expenditure on a pair of stockings by an airline flight attendant. This simple question exercised the Federal Court.¹²⁵ It is not a lone case and it suggests that the everyday operation of the tax law is not easily discerned. Most taxpayers use a tax agent for that very reason. If taxpayers rely on electronic information instead of professional advice, there could be an increase in tax compliance errors. The ATO should monitor it.

Second, there are dangers for taxpayers in the very high level of service that the ATO provides. In Australia, under the separation of powers, the legislature passes laws, which the executive applies, and the courts interpret as they adjudicate disputes. The executive is sometimes given considerable discretion in the exercise of its powers, for example, the Commissioner's powers under section 263 ITAA 1936. However, under Australian law, the Commissioner cannot make laws. The executive may state its interpretation of the law and the way it will apply the law until the courts or the legislature advises the executive that it is wrong. There is a fine line between this and the executive applying its interpretation of the law as the law. The ATO is in danger of stepping over that line, albeit unintentionally.

The ATO website contains the tax technical database that ATO officers use as their primary research tool. All public rulings and other information about the tax system placed on the ATO website is carefully vetted to ensure that it provides what the ATO believes is the correct interpretation of the law. The ATO must take this approach to fulfil its duty of care to the state and to taxpayers, who may rely on that advice, even if it is wrong.¹²⁶ Tax agents who now have access to the ATO website should use the high quality information that it provides. They would be forgiven for not paying for commercial commentaries on the tax law, when there is such a comprehensive summary of the law available free from the ATO. Furthermore, if they use the ATO interpretation of the law, they are less likely to have disputes on a subsequent audit.

The upshot is that the information the ATO provides on its website becomes the law. The volume of successful tax litigation over the past 50 years suggests that it should not. The ATO interpretation of many of the difficult

¹²⁵ *Mansfield v FCT* (1996) 31 ATR 367, 96 ATC 4001.

¹²⁶ Parts IVAA and IVAAA TAA 1953.

sections of the tax law has been wrong. The provision of so much information by the ATO in electronic form poses a serious threat to the proper interpretation of the law. The ATO view will, to all intents and purposes, become the law. Only taxpayers paying for expensive professional advice will bother to challenge the ATO.

This may be something that the government favours as the quid pro quo for the high level of service to taxpayers. After a period of great change, it will help to provide some certainty and confine disputes to complex questions of law of interest to a minority of taxpayers. More likely it is something that is happening without being noticed and is too difficult an issue to address. Provided taxpayers do not complain, it will continue without much comment.

I believe it is a problem. Democracy stands on the separation of powers. As Sir Gerard Brennan, the former Chief Justice, has said of the increasing power of the executive in Australia:¹²⁷

There are dangers in maintaining a structure which lends itself to the concentration of political power in the Executive Government. There is a risk of efficiency turning to tyranny.... The traditional checks and balances are inadequate to protect minorities and the interests of individuals.

The chapter concludes with a brief description of the ATO contribution to international best practice in tax administration. It involves collaboration through the OECD, and forums of international tax administrators. The focus is on sharing best practice approaches to tax management. It is surprising that tax administrations have taken so long to cooperate at a level that commercial organisations found useful decades ago. It will be beneficial both for the ATO and taxpayers.

One initiative receives particular mention.¹²⁸ The Forum for Strategic Management has been established under the auspices of the OECD's CFA, for senior tax administrators of member states. The ATO is establishing a website for the Forum "where revenue authorities can exchange views on strategically important tax management issues".¹²⁹ Apparently, "the capability to provide ready access to best practice and facilitate virtual interaction ... Are critical enablers for dealing with a dynamic globalising environment".¹³⁰

Provided potential participants see it as important enough to fit into their busy schedules, it could be a very useful tool. The experience of the OECD

¹²⁷ In his 1998 Inaugural Gerard Brennan Lecture at Bond University, 21 February 1998 at 15.

¹²⁸ *ATO 2nd Report*, above n 2 at para 4.6.3-4.6.5.

¹²⁹ *Ibid* at para 4.6.4.

¹³⁰ *Ibid*.

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and other groups' efforts to generate worthwhile Internet discussion suggests that a general discussion group may not be the most effective approach. It may be more worthwhile to identify specific groups (as has happened with the TAGs) to take forward important tax management issues between meetings. The groups could circulate specific summaries of their discussion on the general forum between meetings for comment and report to the meetings.

4 PART II: DISCUSSION PAPERS

The second part of the *ATO 2nd Report* provides discussion papers on the remaining issues raised in Ottawa Tax Framework Conditions. The papers cover jurisdictional issues, administrative issues and indirect tax issues. Where the first part of the *ATO 2nd Report* focuses on areas where the ATO can determine its response, the issues raised in the second part depend on an international approach.¹³¹ The papers are put forward as discussion documents. However, in the Action Plan, the ATO sets out what it will do to take forward the discussion.

4.1 Chapter 5: Jurisdictional issues

4.1.1 Jurisdictional strategy

The Action Plan identifies the approach the ATO will take to pursue its jurisdictional strategy. It is largely a continuation of what the ATO is already doing. The discussion papers focus on three specific issues. The ATO acknowledges in the introduction to this chapter that it is also working on the concept of residence, whether it should adapt the Controlled Foreign Corporations ("CFC") rules for electronic commerce, and the transfer pricing rules. There is no separate discussion on these points.¹³²

First, the ATO will monitor the effect of electronic commerce on its jurisdiction to tax.¹³³ This will require significantly improved data, as the scope of the monitoring includes actual levels of cross border digital service and product provision via the Internet. How the ATO will obtain the information it needs is of great interest to taxpayers. It is unlikely that the

¹³¹ Ibid at 5 and 74.

¹³² Place of residence and transfer pricing are discussed in the *1999 UK Report*, above n 10 at ch 8. The Ottawa Taxation Framework Conditions, above n 6 at 7 recognised their importance. However the *ATO 2nd Report* discussion papers reflect the work of the TAGs, which are not yet considering place of residence and transfer pricing issues as separate issues.

¹³³ *ATO 2nd Report*, above n 2 at 14: Jurisdictional Strategy J.1.

Australian Bureau of Statistics will be able to provide such specific information. It will require new initiatives to gather data, which have the potential to be intrusive. The ATO needed data gathered from several years of audits before it could properly determine the effects of transfer pricing.

To this end, the ATO states that it will begin an inquiry into the tax effects of intranets on the basis that they can be used for a range of purposes by large corporations, including production, manufacturing and distribution.¹³⁴ Unless the ATO can find large corporations that will volunteer what often will be extremely price sensitive and highly confidential information, it is likely that the data collection will form part of the overall audit process. Otherwise, the information will be too vague and unspecific. It makes sense for the ATO. Given the resources it puts into the audit of a large corporation, the audit should take a holistic view and provide the ATO with a detailed and comprehensive understanding of the corporation, its business, and its industry sector.¹³⁵ Anything less is probably an abrogation of its responsibility to manage taxpayer compliance, which requires an appropriate risk management program.¹³⁶

Taxpayers and their agents will have to manage their affairs and information to cope with the broader scope of tax audits. The second jurisdictional strategy is for co-operation and consultation.¹³⁷ It refers, briefly, to consultation, where appropriate, with relevant business industry bodies and private and public sector agencies. The consultation is probably on the substance of the rules, rather than on how the ATO intends to gather information to see how the rules are working. However, taxpayers will need to take a strong position if they are to influence the ATO's compliance measurement and information gathering.

Until now, the ATO appears to have driven the agenda in these areas, adjusting its methods at the edges when taxpayers react. For example, the ATO has developed its approach to issues such as legal professional privilege, dispute settlements and private rulings.¹³⁸ The ATO modifies its approach when taxpayer groups react strongly. But it is little more than tinkering at the edges. For all their submissions and representation at meetings, taxpayer groups unfortunately have little input into the broad

¹³⁴ Ibid.

¹³⁵ Wide-ranging inquiries or "fishing expeditions" were sanctioned in *Industrial Equity Ltd v DFCT* (1990) 170 CLR 649 at 662.

¹³⁶ Section 8 of the ITAA 1936 and s 3A of the TAA 1953 set out the general powers of administration. For a comprehensive discussion of those powers and the risk management program, see Woellner R, Barckoczy S and Murphy S, *2000 Australian Taxation Law* (10th ed 1999 CCH) Pt B.

¹³⁷ *ATO 2nd Report*, above n 2 at 14.

¹³⁸ See the comprehensive summary and literature in Woellner et al, above n 136.

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thrusts of policy.¹³⁹ This is discussed further under administration issues. However, if the ATO wants to improve efficiency and compliance, it needs to take a genuinely co-operative approach in developing the process it will use to gather information to measure and monitor compliance and the operation of existing rules.

The ATO intends to continue working at an international level to achieve consensus on tax policy and jurisdictional rules, mainly through the OECD and in co-operation with other revenue collection agencies.¹⁴⁰ It can do little else. If Double Taxation Agreements ("DTAs") or their interpretation are amended to cope with electronic commerce, it needs international agreement. Otherwise, double or non-taxation, and distortions from different tax treatment that DTAs are designed to overcome, would re-emerge. The focus will be on taxation of business profits, including the permanent establishment concept, income characterisation, residence, and allocation of income and transfer pricing.¹⁴¹

4.1.2 Source of income

The ATO does not attempt to resolve the issues raised in this discussion paper. It reiterates problems that have been raised before and does little more than give its view on the difficulties in applying the current domestic law.¹⁴² Second-guessing what the courts will do and identifying problems that have been under discussion for some time is hardly constructive. The ATO should have put forward possible solutions, even if it did not wish to express a preference.

The discussion paper begins by noting that Australia's traditional source rules are based on common law concepts developed early in the century.¹⁴³ It mentions the concern that these rules are not appropriate to deal with electronic commerce and outlines the main features of these rules. It then considers a number of issues.

¹³⁹ The frustration is evident in almost any editorial in *Taxation in Australia*. For example, Cooper G, "Issues & agendas" (1999/2000) 34 *Taxation in Australia* 339 and see Dirks M, "Why the ATO needs formal advisory boards" (1999/2000) 34 *Taxation in Australia* 139. Simple recognition as a major tax lobby group in question time in Federal Parliament was seen as a major victory for the Taxation Institute of Australia. See their *Annual Report 1999* 1.

¹⁴⁰ *ATO 2nd Report*, above n 2 at 14: Jurisdictional Strategies J.3 and J.4.

¹⁴¹ *Ibid.*

¹⁴² See, eg, Bentley D, "The Internet: Taxing electronic transactions" (1996) 5 *Taxation in Australia - Red Edition* 122; Owens J, "The Tax Man Cometh to Cyberspace?" 2 June 1997 Tax Notes Int'l 1833; Pinto, above n 95.

¹⁴³ *ATO 2nd Report*, above n 2 at para 5.2.2. This section analyses paras 5.2.1-5.2.54 of the *ATO 2nd Report*. The ATO summarises its views in paras 5.2.51-5.2.54.

The discussion paper considers the source of income from the sale of goods over the Internet. It emphasises the importance of economic activity in determining source and highlights the distinction between trading with a country and trading within a country. How are these rules to apply to electronic commerce? The paper outlines the difficulties using the example of a website where goods are advertised or displayed, through which orders are placed and processed, and where payment, are made. It makes the point that disaggregation of functions makes determining source even more difficult and suggests that it would lead to apportionment of income.

Australian courts have focused on where the selling activities of an enterprise are in determining the source of trading profits. The ATO believes that where these functions take place through a website, “the relevant activity of the enterprise is the operation of the software which constitutes the website”.¹⁴⁴ The software operating the website is on a server and it is there that the income is likely to have its source.

This section should refer to the more developed OECD discussion on permanent establishments, which is relevant here (see below). The paper gives a broad overview. If the ATO wants change,¹⁴⁵ then it could at least have identified some of the difficulties more specifically. For example, the ATO suggests that disaggregation would lead to apportionment. How is apportionment determined? How much activity must occur on a website to constitute selling activities? How does disaggregation affect this decision? Issues like these highlight the deficiencies in the current law, yet they are not discussed.

Where the paper discusses apportionment, it does so in the context of statutory apportionment under ss 38-41 of the ITAA 1936. Section 41 deems goods to have been sold in Australia where something done by the person (or their agent) when in Australia is instrumental in bringing about the sale.¹⁴⁶ This means that contracts may be concluded, delivery made, or payment made outside Australia, but the person may still be subject to Australian tax on the selling profit on a sale.¹⁴⁷ The paper notes that although a person may not be physically present in Australia, the website activities may be sufficient to source the sale in Australia. It also mentions that the Commissioner’s discretion to determine source under s 42 is probably broad enough to cover digital products, although arguably they are not “goods”, nor are transactions involving digital products “sales”.

¹⁴⁴ Ibid at para 5.2.20.

¹⁴⁵ Ibid at para 5.2.53.

¹⁴⁶ *ATO 2nd Report*, above n 2 at para 5.2.38 and discussed generally from para 5.2.37-5.2.41.

¹⁴⁷ Ibid. See also, Bentley, above n 142 at 128; and the comprehensive discussion in Lehmann G and Coleman C, *Taxation Law in Australia* (5th ed 1998 ATP) 18.620.

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However, the paper does not say how apportionment will occur or identify any difficulties in carrying out the apportionment. The only other place where apportionment is mentioned is where a purchase and sale of shares may lead to apportionment of the income from the trade.¹⁴⁸ Again, there is no mention of the process. While acknowledging that apportionment may be a problem, the paper seems more intent on showing how the Commissioner will interpret the law to paper over any cracks until new rules are developed.

The paper highlights some of the problems of determining source based on the place of a contract of sale.¹⁴⁹ Electronic commerce can make it difficult to determine the place where the contract or its terms are negotiated, or where acceptance of an offer is communicated. Where a purchase is made from a website, the ATO prefers the view that the source of the contract is the location of the website. It also takes the view that an e-mail contract has its source where the customer receives an e-mail message notifying the vendor's acceptance of an offer to purchase.

However, the ATO also emphasises that for tax law, other factors are relevant.¹⁵⁰ The Commissioner clearly intends to pursue contracts that have a connection with Australia, but which are concluded electronically outside Australia leading to the payment of less Australian tax. The paper specifically mentions Part IVA and the CFC legislation.¹⁵¹ There are examples of where the Commissioner would consider other factors. If a customer accepts a contract negotiated in Australia and connected to an Australian business while on holiday in the Cook Islands, the source of the contract would still be Australia. The same applies if an Australian seller and buyer use an offshore website to conclude a contract.

The discussion paper also considers services provided over the Internet.¹⁵² It identifies the three factors that courts consider relevant in determining the source of income from services: the place where the contract is negotiated; the place where the services are performed; and the place where the remuneration is payable.¹⁵³ For each, electronic commerce may cause concerns for the ATO. The place of contract is discussed above. The place of performance of services may be confused by disaggregation of the services, or their performance by automated means using "intelligent agent" software. The ATO points out that the place of performance may be less important than the result of the performance of the services, in which case other factors, such as the place of contract or payment, may become important. These factors are open to manipulation. The ATO suggests a possible solution may be to

¹⁴⁸ ATO 2nd Report, *ibid* at paras 5.2.44-5.2.45.

¹⁴⁹ See further, Bentley, above n 142 at 124 and the 1999 UK Report, above n 10 at 71.

¹⁵⁰ ATO 2nd Report, above n 2 at paras 5.2.32-5.2.36.

¹⁵¹ *Ibid* at para 5.2.34.

¹⁵² *Ibid* at paras 5.2.46-5.2.50.

¹⁵³ *Ibid* at para 5.2.46, citing *FCT v French* (1957) 98 CLR 398.

source the income in the place of residence of the person paying for the services. However, it acknowledges that the courts would not adopt this approach unless the income is derived from property used in Australia or from acts done in Australia.¹⁵⁴

The ATO is concerned about the difficulties in applying the current rules. The ATO sees it as problematic for electronic commerce that, to have an Australian source, income must derive from a function physically performed in Australia or from an asset physically located in Australia.¹⁵⁵ The rules do not take account of the mobility of income. Contrast this with the EU approach to the taxation of VAT, which is moving towards the current Australian income tax position. The *1999 UK Report* suggests that existing VAT rules should be changed so that taxation in the country of consumption becomes the basic rule for services in general, not just electronic supplies.¹⁵⁶ Australia is likely to take a similar position to the UK on GST consumption, which indicates that the solutions will not be the same for direct and indirect taxes.

The ATO is also concerned about the administrative costs of ensuring compliance, and the potential manipulation of the rules for tax planning purposes. The paper seems to favour statutory source rules where there is no DTA. However, it emphasises again the importance of seeking international approaches.¹⁵⁷ Does this mean that we are moving towards enforced standardisation of tax treatment, definition and rates? Harmonisation is unrealistic, given the EU experience. But standardisation based on the OECD approach is possible.¹⁵⁸ There could be trenchant criticism that poorer countries do not share the common principles adopted to suit the OECD's administrative and compliance concerns. However, if those countries want OECD members' aid and investment, they may have no choice.¹⁵⁹

The Action Plan includes a statement that, "the ATO will examine the practicality of treating electronic commerce income derived by Australian controlled foreign entities located in preferential tax regimes as 'tainted' for CFC purposes".¹⁶⁰ Given the mobility of electronic commerce, it is

¹⁵⁴ Citing *FCT v United Aircraft Corporation* (1943) 68 CLR 525; 7 ATD 318 per Latham CJ at 322.

¹⁵⁵ The summation of the ATO position, analysed here, is in *ATO 2nd Report*, above n 2 at paras 5.2.51-5.2.54.

¹⁵⁶ Above n 10 at para 6.33.

¹⁵⁷ See further, Jurisdictional Strategy J.5 in the Action Plan, above n 2 at 16.

¹⁵⁸ Discussed in Terra BJM and Wattel PJ, *European Tax Law* (2nd ed 1997 Fed Deventer) and Vann R, "International standardisation of tax laws: a better model for TLIP" *CLS Tax Disk* 0471/1996.

¹⁵⁹ See further, Chang HL, "The Impact of E-Commerce on Allocation of Tax Revenue Between Developed and Developing Countries" 21 June 1999 Tax Notes Int'l 2569.

¹⁶⁰ Jurisdictional Strategy J.6 – Controlled Foreign Companies ("CFC") rules, above n 2.

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understandable that the ATO wants to address the problem. However, the ATO proposal discriminates against electronic commerce, violating the principle of neutrality. It also places an onerous compliance burden on affected taxpayers that fail the active income test because of their electronic commerce activities. If a business is to engage in electronic commerce, the ATO will only support it where the activity takes place in one of the seven broad-exemption listed countries.¹⁶¹

If it really wanted to take discussion forward, the ATO should have used the paper to make more specific proposals and to show how statutory source rules could overcome the problems of the current common law rules. Otherwise, it is valid to argue that the common law is by nature flexible and capable of change to meet the demands of modern commerce. Just as the cases¹⁶² of *Entores* and *Brinkibon* adapted the common law principles of offer and acceptance to deal with electronic communication, future cases will do the same to deal with issues affecting the source of income, raised by electronic commerce. A further problem with statutory rules in areas where their application is a question of fact is that they need interpretation by the courts in any event. The rules cannot cover every eventuality and the common law's strength is that it fills gaps in the rules, creates exceptions, and deals with questions of equity. It may well be that statutory rules are the best solution. However, the ATO has yet to make its case.

4.1.3 Taxation of business profits under DTAs

This discussion paper focuses on whether existing DTA provisions for allocating taxing rights for business profits are appropriate for electronic commerce. It focuses particularly on the use of the permanent establishment ("PE") as a threshold for allocating taxing rights between jurisdictions.¹⁶³ Under Australia's DTAs, where an enterprise has a PE in a country, that country can tax profits attributable to the PE. The enterprise's country of residence must provide relief from double taxation for those profits either by exemption or tax credit. Where there is no PE, the enterprise's country of residence has sole taxing rights over its business profits.

¹⁶¹ The 1999 UK Report, above n 10 at para 5.30 also questions the adequacy of the UK CFC legislation. Given the complexity of the Australian CFC rules, the ATO should consider solutions from other countries.

¹⁶² *Entores Ltd v Miles Far East Corp* [1955] 2 QB 327 and *Brinkibon Ltd v Stahag Stahl & Stahlwarenhandels GmbH* [1982] 1 All ER 293. For a discussion of these cases and their application to electronic commerce see Bentley, above n 142.

¹⁶³ ATO 2nd Report, above n 2 at paras 5.3.1-5.3.72. See also, 1999 UK Report, above n 10 at 72 and CFA Progress Report on the Business Profits TAG, above n 41 at 7. The general principles are discussed in Hinnekens L, "Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the 21st Century" (1998) 26 *Intertax* 192.

Where electronic commerce forms part of an enterprise's ordinary activities, there is usually no difficulty in deciding whether those activities fit the definition of a PE. However, where an enterprise's activities are mostly electronic, with little or no physical presence in a jurisdiction, it may be unclear whether the PE definition applies. Australia's DTAs follow the OECD *Model Tax Convention* ("OECD Model") Article 5 definition of a PE.¹⁶⁴ Australian courts have held that the OECD Commentary on the OECD Model can be used to interpret Australian DTAs.¹⁶⁵ Accordingly, the ATO is vitally interested in the development of the OECD Commentary to deal with electronic commerce.

The discussion paper includes an examination of the preliminary views of the OECD Working Party 1 on Tax Convention and Related Questions ("Working Party") on the application of the existing definition of PE in the context of electronic commerce.¹⁶⁶ It is useful to have the ATO view of the Working Party proposals. The paper examines each of the three elements that the OECD Commentary explains are necessary for a PE:¹⁶⁷ the existence of a place of business; which must be fixed in terms of a distinct place and a certain degree of permanence; and where business is carried on.¹⁶⁸ The paper then discusses the different views on their application to electronic commerce, with a particular focus on the Working Party proposals.

Where a place of business traditionally requires a physical presence, electronic commerce does not. Can a website itself be a PE?¹⁶⁹ The Working Party believes not, as the website does not involve any tangible property and therefore a physical presence to constitute a place of business.¹⁷⁰ If an enterprise is carrying on business through a website, the Working Party believes that there is no PE unless the server on which the website is hosted is also owned, rented, or otherwise at the disposal of that enterprise.¹⁷¹ The ATO appears to take a different view. It suggests that, using a functional

¹⁶⁴ OECD, *Model Tax Convention on Income and on Capital* (1998 OECD).

¹⁶⁵ *Thiel v FCT* (1990) 171 CLR 338.

¹⁶⁶ OECD, *Draft Revisions to Article 5 (Permanent Establishment)* <http://www.oecd.org/daf/fa/e_com/paris99.htm> (at 3 March 2000) ("Working Party proposals"). These were revised on 3 March 2000 ("revised Working Party proposals") and comments are requested on the revised draft by 15 June 2000. See <http://www.oecd.org/daf/fa/first_en.htm> (at 3 March 2000).

¹⁶⁷ OECD Model, above n 136, para 2 at 70.

¹⁶⁸ *ATO 2nd Report*, above n 2 at para 5.3.10. The analysis in this part is of paras 5.3.11-5.3.29.

¹⁶⁹ For the purposes of the discussion paper (and therefore this analysis) a "server" refers to actual hardware and a "website" refers to operating software, data and goodwill. *Ibid* at 97, footnote 106.

¹⁷⁰ Working Party and Revised Working Party proposals, above n 166, both at para 2.

¹⁷¹ *Ibid* at paras 2 and 3. The revised Working Party proposals do not accept that "at the disposal of an enterprise" would include web hosting contracts for rental of the disk space taken up by a website, above n 166 at 4.

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approach, a place of business could exist on a website where the business functions are carried out, whether or not there is a physical presence.

The ATO cites Article 5 of the OECD Model, which defines a PE to include use of a facility, including equipment, for carrying on the business of the enterprise. It also quotes Paragraph 4 of the OECD Commentary, which states that it is immaterial whether the facilities are owned, rented, or otherwise at the disposal of the enterprise. The ATO concludes that:¹⁷²

An enterprise that maintains a server located within a jurisdiction, and carries on business through that server (eg by hosting websites of other enterprises or by conducting commercial activities through a website on that server), would be regarded as having a PE in that jurisdiction, irrespective of whether the server is owned, leased or otherwise made available to that enterprise.

In the next paragraph, the ATO endorses the Working Party view that a server is a piece of equipment, which may be a fixed place of business, and therefore a PE.¹⁷³ But it also seems to endorse the view that an enterprise's website would not be a PE unless the server on which it is hosted was owned, rented or otherwise at the disposal of that enterprise. This appears to contradict the previous paragraph. The ATO notes that a server would fall under the provision in many Australian DTAs that the use of substantial equipment constitutes a PE.

Under the second condition for a PE, a business must be fixed in terms of a link to a distinct place and there must be a certain degree of permanence. The Working Party states that it is not the possibility that a server may be moved that determines whether it is fixed, but whether it is moved. To be fixed, it would need to be located in one place for sufficient time, although the proposals do not say how long that is.¹⁷⁴ According to the ATO, a server would be fixed if it were left stationary in a computer room, or even moved within a building. It is less clear whether it could be a PE if it were moved, say, from one city to another, or even from one building to another. Websites

¹⁷² ATO 2nd Report, above n 2 at para 5.3.14.

¹⁷³ Ibid. Compare Dunahoo CA, "Electronic Commerce Tax Study Group Comment on Working Party No 1" (2000) 2 (1) *Tax Planning International e-commerce* 10, which proposes that computer equipment should not constitute a PE, business of an enterprise should not be considered to be "carried on through" such equipment and the "preparatory or auxiliary" exceptions should apply, in any event. See also, Portner R, "Comments on the OECD Working Party No 1's Proposal Concerning Application of the Existing 'Permanent Establishment' Definition with Respect to ISPs" (2000) 2 (1) *Tax Planning International e-commerce* 14.

¹⁷⁴ Working Party proposals, above n 166 at para 5 and revised Working Party proposals, above n 166 at para 4.

moved from server to server, each time detached from the previous server, would not be fixed. However, the ATO believes that:

A server array, where transactions move from website to website depending on particular activities or traffic congestion would generally constitute a place of business for each of the servers involved, although whether this leads to them constituting a PE will depend on whether the functions performed on that server amount to carrying on a business or are otherwise excluded from constituting a PE.¹⁷⁵

Contrast again, the Working Party proposal for a PE, where the server hosting the website must be owned, rented, or otherwise at the disposal of that enterprise.¹⁷⁶ The revised Working Party proposals reiterate its view that a website by itself could not constitute a PE, because there would then be no facilities in the relevant jurisdiction at the disposal of the enterprise operating the website.¹⁷⁷

The ATO also takes a functional approach to the degree of permanence required for a PE. It believes that the traditional six-month requirement is not applicable to a particular site (presumably, whether a server or a website). Instead, the six months should apply to the enterprise's economic presence in a jurisdiction.

To meet the third condition for a PE an enterprise must carry on business on or through its fixed place of business. The OECD Commentary on Article 5 of the OECD Model already accepts that automated equipment, such as gaming or vending machines, can be a PE. Both the ATO and the Working Party proposals¹⁷⁸ accept that automation is sufficiently sophisticated for a PE to exist without human presence. The revised Working Party proposals note that some countries would not accept this position. They would draw a distinction between a gaming or vending machine that must stay in a fixed place to conduct transactions, and a server, whose location is irrelevant to the customer of an e-commerce operation.¹⁷⁹

The revised Working Party proposals put forward both the ATO view that automated equipment can constitute a PE without human intervention, and an alternative view that it cannot.¹⁸⁰ There are three variations of the alternative view. The first is that the intervention must take place in the country where the equipment is located. The second is that intervention must take place by employees or dependent agents of the enterprise. The third is that humans

¹⁷⁵ *ATO 2nd Report*, above n 2 at para 5.3.20.

¹⁷⁶ Working Party proposals, above n 166 at paras 2 and 3.

¹⁷⁷ Revised Working Party proposals, above n 166 at 5 and 6.

¹⁷⁸ Working Party proposals, above n 166 at para 4.

¹⁷⁹ Revised Working Party proposals, above n 166 at para 5.

¹⁸⁰ *Ibid* at paras 7-11 for the views described in this paragraph.

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must operate the equipment for there to be a PE. With so much division evident, it is unlikely that the ATO view will prevail without some compromise.

Under Article 5 of the OECD Model, an enterprise may have a PE in a jurisdiction where it has a dependent agent who habitually concludes contracts on its behalf. The Working Party believes that an Internet Service provider ("ISP") will not generally be a PE of an enterprise for which it hosts a website.¹⁸¹ The ISP is carrying on its own business as an independent agent, and would not have the authority to conclude contracts on behalf of the enterprise. The Working Party believes that the Article 3 OECD Model definition of a "person" does not extend to a website, which would also preclude it from being a dependent agent.¹⁸² The ATO does not disagree with these conclusions.

Under Article 5(4) of the OECD Model, preparatory or auxiliary activities will not constitute a PE. Under Australia's DTAs, these activities may still constitute a PE if, in the context of the business activities of the enterprise taken as a whole, the activities are more than preparatory or auxiliary. The ATO believes that this overcomes the problem of disaggregation that is possible in an electronic commerce environment. Assume automated functions are put on servers in different locations simply to take advantage of the exclusions under the PE definition. The ATO will look at the business activities as a whole in applying the definition of a PE under Australia's DTAs.

The ATO notes that the Working Party limits the exclusion for preparatory and auxiliary activities "where the functions performed through the computer equipment include activities that form in themselves an essential and significant part of the commercial activity of the enterprise as a whole".¹⁸³ However, it is awaiting clarification of what is meant by "an essential and significant part of the commercial activity". It would be convenient for Australia if the OECD agreed to look at the overall business activities of the enterprise before applying the PE exclusion, as that is already the position under Australia's DTAs.

The revised Working Party proposals are more explicit and appear to move towards the Australian position.¹⁸⁴ They give examples of activities that all countries, including Australia, agreed would be preparatory or auxiliary:¹⁸⁵

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

¹⁸¹ Working Party proposals, above n 166 at para 6.

¹⁸² Ibid. Still in the revised Working Party proposals, above n 166 at para 15.

¹⁸³ Working Party proposals, above n 166 at para 7.

¹⁸⁴ Revised Working Party proposals, above n 166 at paras 12-14.

¹⁸⁵ Ibid at para 12.

- Advertising of goods or services;
- Relaying information through a mirror server for security and efficiency purposes;
- Gathering market data for the enterprise;
- Supplying information.

To go beyond the preparatory or auxiliary, these functions would have to form an essential and significant part of the commercial activity of the enterprise as a whole. Otherwise, they would have to occur in conjunction with other core functions of the enterprise, for example, a server constituting a fixed place of business.¹⁸⁶ This suggests a functional approach. However, there was no agreement on the meaning of “core functions”. For some countries, where sales functions are performed through computer equipment, whatever the mode of delivery of the product, the equipment would be a fixed place of business and there could be a PE. For others, the selling is the core function of the business, and the communication tools used to sell, whether by telephone, mail order or a website, do not make a PE. Only where the server carries out the whole transaction (automatically) would these countries consider that there could be a PE.¹⁸⁷

The ATO expresses concern about the general application of the PE definition and the continued appropriateness of the PE concept.¹⁸⁸ It first examines the PE definition in light of its earlier discussion. It concludes that physical location is increasingly irrelevant for electronic commerce and enterprises can easily structure their business to avoid having a PE. The point is made that much of the complexity and consequent tax planning could be avoided if OECD members accept that a website is not itself a PE. The ATO prefers a functional approach.

The problems with current interpretation of the PE definition are explored in four areas. First, a database of digital products located on a server poses problems of classification. It could be the equivalent of a warehouse and not a PE, but such exclusion would depend on an analysis of the functions connected to the database. Alternatively, it could be an asset where payment for use of information is a royalty, when the PE definition would not be relevant.

Second, there is the sale of goods into Australia where there is a DTA. Normally, delivery of goods from an Australian warehouse or store would be auxiliary to the business. But for an Internet business, where all or most other

¹⁸⁶ Ibid at para 13.

¹⁸⁷ Ibid at para 14.

¹⁸⁸ *ATO 2nd Report*, above n 2 at paras 5.3.30-5.3.72. For further general discussion, see Lejeune I, Vanham B, Verlinden I and Verbeken I, “Does Cyber-Commerce Necessitate a Revision of International Tax Concepts” (Pt II) [1998] *European Taxation* 50.

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business activities are automated, the ATO considers it may go beyond the auxiliary to establish a PE.

Third, profits from share trading where there is a DTA would be taxable in Australia only if the share trader had a PE in Australia. A non-resident could trade Australian shares over the Internet using an independent Australian broker and pay no Australian tax.

Fourth, Articles 14 and 15 of the OECD Model govern Independent and Dependent Personal Services respectively. They both use a fixed base or physical presence test, similar to the PE test, to give a jurisdiction taxing rights over profits from the services provided. The ATO notes that there is far greater capability for the delivery of all services over the Internet, obviating the need for the physical presence that gives rise to a fixed base.

These examples raise nothing new. However, they do show the depth of the ATO's concern for potential revenue loss from the provision of Internet services. The ATO makes it clear that it will monitor the taxation of income from services and participate in international efforts to adapt rules that it believes are no longer appropriate. This will be one of the more difficult arguments to carry forward within the OECD, unless the revenue is escaping taxation altogether. Where one member state is taxing profits on electronic commerce under normal taxing rules, it will likely oppose another member state changing the rules to take away a share of its tax revenues. However, if the profits are disappearing to a non-member state, particularly a tax haven, there is more chance of agreement to change the rules.¹⁸⁹

The ATO questions whether the PE concept is still appropriate. It points out that the original concept was premised on a physical presence that is no longer necessary to carry on business in another jurisdiction. Even if the Working Party proposals are adopted there will be discrimination between enterprises carrying on the same business simply because one chooses to have its own server in a jurisdiction, while the other does not. There will also be discrimination between businesses that have to establish a physical presence to carry on business and those that carry on a similar level of business, but over the Internet. Businesses will find disaggregation of functions and other forms of tax planning to prevent the application of the physical presence tests increasingly attractive. The ATO is justified in highlighting the problems that arise where businesses can manipulate definitions to achieve a completely different result. Neutrality requires a consistent tax treatment, where mobility cannot distort the taxing arrangement, and where the taxing arrangement itself is clear.

¹⁸⁹ For example, in its efforts to eliminate harmful tax competition the OECD meets strong resistance from its members to eliminate perceived harmful practices. There is much less resistance to taking action against third parties. See OECD, above n 95. For a comprehensive summary of the debate, see Easson A, "The Tax Competition Controversy" 25 January 1999 Tax Notes Int'l 371.

Even where a PE applies to electronic commerce, it is unclear how income is attributed to those activities.¹⁹⁰ Again, the problem relates to the attempt to adapt rules based on physical presence to electronic activities. The rules now need to allocate income within multi-jurisdictional spoke and hub arrangements, particularly those that use electronic product and service centres.¹⁹¹ Can the OECD develop rules that can do this efficiently where the allocation is not within a large multinational corporation, but within the operations of a small enterprise? Transfer pricing has shown how costly it is for large companies to get agreement between revenue authorities.¹⁹² If smaller businesses are involved, there is strong pressure to move to standard definitions and formulae. There is also a strong incentive for the OECD to implement its recommendations to counter harmful tax competition, although they constitute negative discrimination against tax havens and low tax jurisdictions.¹⁹³

The ATO argues that the PE is a threshold measure of an enterprise's participation in the economic life of another jurisdiction. Where physical presence used to be an appropriate measure of such participation, it is no longer. The result could be an "unacceptable shift in the traditional balance between source and resident country taxing rights" and there should be a new test.¹⁹⁴ The paper mentions the contrasting view that existing rules should simply adapt to reflect the natural evolution of changing business methods, including the shift from source to residence country taxation.

The ATO does not hold to the latter view, although it does not say so expressly. Rather, it states that it will continue to explore ways to adapt existing rules, for example, by adopting a new threshold test or a test to deal specifically with electronic commerce. It will also support OECD work on the application of attribution of income concepts to electronic commerce. In the short term, it will wait for the recommendations from the TAG examining these issues. The Working Party has refrained from commenting on changes to the existing PE rules (as opposed to the OECD Model Commentary) until the Business Profits TAG reports back.¹⁹⁵ The TAG is examining:¹⁹⁶

¹⁹⁰ The revised Working Party proposals, above n 166 at 3, acknowledge the importance of income attribution and note that it should be given priority by the CFA. The Business Profits TAG has included the issue in its work program.

¹⁹¹ This is discussed more fully in Hinnekens, above n 12 and n 163.

¹⁹² Simply look at the procedures for Advance Pricing Agreements. For a comprehensive international review, see Sandler D and Fuks E (eds), *International Guide to Advance Rulings* (1999 IBFD Publications BV).

¹⁹³ OECD, above n 95. Criticisms of this approach are summarised in Easson, above n 189.

¹⁹⁴ *ATO 2nd Report*, above n 2 at para 5.3.61.

¹⁹⁵ Revised Working Party proposals, above n 166 at 3.

¹⁹⁶ *ATO 2nd Report*, above n 2 at para 5.3.66, where the ATO reports that this was decided at the first meeting of the TAG in September 1999.

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- the use of the place of effective management to determine corporate residence;
- whether the existing PE concept “provides an appropriate threshold for allocating tax revenues between source and residence countries”¹⁹⁷ and deals effectively with the use of tax havens;
- whether there need to be special PE rules for electronic commerce and “whether such rules would be a viable alternative to existing international tax norms”;¹⁹⁸
- the rules for allocating income between associated enterprises.

The ATO signals that it will not accept a diminution in its taxing rights. It acknowledges the danger of unilateral action, particularly as unrelieved double taxation would likely result. However, it is looking for a timely and internationally acceptable solution that preserves “the neutrality of tax treatment between electronic and traditional businesses, and the fair sharing of tax revenues between jurisdictions”.¹⁹⁹ If there is no international solution before ATO monitoring detects a significant diminution of its revenue, which can be attributed to the PE rules, the ATO may well take unilateral action. It would likely be introduced as a stopgap measure pending international agreement.

4.1.4 Income characterisation

Like other revenue authorities, the ATO is concerned about the characterisation of payments for digital products.²⁰⁰ Digital products include “text, static and moving images, sounds or any combination of these three”.²⁰¹ Physical products usually involve the purchase of physical originals or copies. The types of purchase of digital products are more diverse, including, for example, access to the product on the vendor’s website, various types of download, modification and use, printing, and licensing for copying. As international electronic commerce grows, income characterisation will become an issue of major importance for revenue authorities.

The OECD has set up a TAG group specifically to consider the characterisation of different types of electronic commerce payments.²⁰² It has provided its preliminary conclusions.²⁰³ The views set out in the *ATO 2nd*

¹⁹⁷ Revised Working Party proposals, above n 166 at 2.

¹⁹⁸ Ibid.

¹⁹⁹ *ATO 2nd Report*, above n 2 at para 5.3.68. See further, Hinnekens, above n 20.

²⁰⁰ This part of the analysis refers to the *ATO 2nd Report*, ibid at paras 5.4.1-5.4.58. See also *1999 UK Report*, above n 10 at 72 and CFA Progress Report on the Income Characterisation TAG, above n 41 at 7.

²⁰¹ *ATO 2nd Report*, ibid at para 5.4.3.

²⁰² Ibid at para 5.4.8, and Progress Report, above n 41.

²⁰³ Available on the OECD website at:

<<http://www.oecd.org/daf/fa/treaties/tcecommpay.htm>> (at 27 March 2000).

Report reflect the majority opinion in the TAG. They also tie in with the revision of the Commentary on Article 12 of the OECD Model.²⁰⁴

The ATO reiterates the principle that the character of a payment depends on the nature of the transaction that gives rise to the payment. This might include the supply of goods, the provision of services, the use of or right to use an intangible, transfer of know-how, or the disposal of an asset.²⁰⁵ The discussion paper explores these options and highlights what it sees as the main issues.

The ATO's first concern is with characterisation of a royalty, which is defined to include a "use of, or the right to use, any copyright".²⁰⁶ The ATO outlines developments in Australian copyright law to support its wide application of the term. It points out that Australian copyright law follows the Berne Convention for the Protection of Literary and Artistic Works ("Berne Convention").²⁰⁷ Article 2 of the Berne Convention defines the term "literary and artistic work" very broadly to include computer programs.²⁰⁸ Article 9 of the Berne Convention defines the reproduction right of authors to include "the exclusive right of authorising the reproduction of these works, in any manner or form". The ATO takes up this broad approach to interpretation and suggests that, "such all-inclusive language would cover every situation where reproduction occurred, including where the copying was temporary or incidental or where material is downloaded off the Internet".²⁰⁹

Article 8 of the WIPO Copyright Treaty establishes a new right of communication to the public "by wire or wireless means", which covers public access from a time and place of their choice. The purpose is to cover authors' rights on public networks, such as the Internet. The ATO points out that parties to the Treaty may also provide for the protection of incidental or temporary copies. Australia has reacted to international developments with its Copyright Amendment (Digital Agenda) Bill 1999,²¹⁰ which will extend broad copyright protection to all forms of technological communication.

The effect is that most digital products available electronically are literary, artistic or scientific works protected by copyright laws (unless the copyright

²⁰⁴ OECD, "Revision of the Commentary on Art 12 Concerning Software Payments" <http://www.oecd.org/daf/fa/treaties/art12_e.pdf> (at 27 March 2000).

²⁰⁵ *ATO 2nd Report*, above n 2 at para 5.4.9.

²⁰⁶ Section 6(1) of the ITAA 1936. A similar definition is found in Australian DTAs and Art 12 of the OECD Model.

²⁰⁷ The Berne Convention can be found at: <http://www.wipo.org/eng/iplix/wo_ber0_.htm> (at 3 March 2000).

²⁰⁸ As agreed under Art 4 of the World Intellectual Property Organisation Copyright Treaty ("the WIPO Copyright Treaty") concluded in Geneva on 20 December 1996.

²⁰⁹ *ATO 2nd Report*, above n 2 at para 5.4.20.

²¹⁰ Available on <<http://www.dcita.gov.au>> (at 3 March 2000).

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has expired or another exception applies). How are payments for on-line use of those products characterised? The ATO supports the view that no copy is made when a temporary image is made on a computer screen. Viewing a copyrighted work would not constitute use of copyright for tax purposes and any payment would not be characterised as a royalty.

Downloading a product from the Internet means the customer has copied the digital information. The ATO puts forward two arguments for their taxation treatment. Although technically a copy is made when a customer downloads information, the economic nature of the transaction is that of delivery of a product. Another view is that payment is for the right to make a copy of the original product. The customer uses the electronic signal to make the copy on a physical medium, such as a computer disk. The first view would characterise payment for the transaction as payment for a supply of goods and the second as a royalty. The ATO does not state its view. However, it does state that it regards any payment for the right to modify, adapt, or incorporate digital information in another digital product as a royalty.

The ATO sees on-line services, where a customer pays to operate software on a provider's website, as a supply of services that would not give rise to a royalty. As soon as the service manipulates the information and provides it for download by the customer, it is likely to become a mixed contract, when the payment must be apportioned between the different elements. If the minor parts of the contract are ancillary and largely unimportant compared with the principal purpose, the principal purpose will characterise the payment.²¹¹

There are compliance and administration difficulties with characterisation and apportionment, even where definitional issues are resolved. The ATO wonders whether the principles underlying its approach to computer software payments could be adapted to digital products.²¹² The basis for its approach is that computer software transactions can involve the transfer of a number of rights. Payments are classified as royalties where they are made "for the right to do any of the acts comprised in the copyright (eg, modification, adaptation or reproduction)".²¹³ Where payments are "for rights in the tangible article, or for rights to use the program", ²¹⁴ they are not royalties.

Using the "principal purpose" approach, TR 93/12 finds that payments would be minimal for the royalty element of a licensing arrangement where an end-user can use the program and make only sufficient copies to operate the

²¹¹ *ATO 2nd Report*, above n 2 at paras 5.4.43-5.4.44, applying para 11 of the OECD Commentary on Art 12 of the OECD Model.

²¹² These are set out in Taxation Ruling TR 93/12 ("TR 93/12"), which can be found at <<http://law.ato.gov.au>> (at 3 March 2000).

²¹³ *ATO 2nd Report*, above n 2 at para 4.4.49.

²¹⁴ *Ibid.*

program under the licence.²¹⁵ As with computer software, the ATO argues that there should be a distinction drawn between rights to use copyrighted information and rights to use a copyright. The first is concerned with a right to use the product and the payment should be characterised as a business profit. The second is concerned with the right to use the copyright in the product and should be characterised as a royalty.

The ATO acknowledges the difficulty in applying existing tax principles to digital products, but points out how hard it is to get international agreement on change. The ATO rightly sees international consensus on these issues as particularly important. Characterisation of income will affect the vast majority of taxpayers engaging in electronic commerce. It goes to the substance of the trade. For many international trades, where the vendor does not have a PE, the existence of a royalty withholding tax under most DTAs alters the incidence of tax and introduces associated compliance and administration difficulties. As with changes to the tax treatment of a PE, changes to the application of the definition of royalty could alter the tax balance between countries.

4.2 Chapter 6: Administration issues

In contrast to the discussion papers on jurisdictional issues, the papers on administration consider possible approaches to resolve the issues raised by electronic commerce. The papers concentrate on taxpayer identity and jurisdictional location, obtaining reliable and verifiable information to calculate taxes, and tax collection.²¹⁶

4.2.1 Identification

Taxpayer identification is fundamental to the tax system. This discussion paper focuses on identification in an electronic environment.²¹⁷ In introducing this section, the ATO focuses on the benefit that taxpayers will gain from proper identification, so that they only pay the right amount of tax. A greater imperative for the ATO is surely that it can identify taxpayers so

²¹⁵ The paper notes that this follows the proposed revision to the OECD Commentary on Art 12 of the OECD Model, available on the OECD website at <<http://www.oecd.org>> (at 3 March 2000).

²¹⁶ *ATO 2nd Report*, above n 2 at paras 6.1.1-6.4.26. See also, Ottawa Taxation Framework conditions, above n 6 at 6 and CFA Progress Report on the Technology and Professional Data Assessment TAGs, above n 41 at 5. OECD SG/EC(99)5, above n 42, provides an excellent summary of international work in these and related areas.

²¹⁷ *ATO 2nd Report*, *ibid* at paras 6.2.1-6.2.30. See also, the *1999 UK Report*, above n 10 at paras 5.13-5.15.

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that tax can be collected? And indeed, it is the risks to revenue and not the benefit to taxpayers that the ATO emphasises in the rest of the paper.²¹⁸

The paper highlights the problem the ATO has in tracing ownership of a website and notes that consumers face a similar problem in deciding whether to place their trust and confidence in an electronic business. Businesses are increasingly complying with consumer organisation codes of conduct and identifying themselves on their websites.²¹⁹ However, ATO audit activity has shown that on approximately 15% of domain named websites, the entities conducting the business did not identify themselves. On ISP operated websites, the percentage was significantly higher.

The ATO proposes use of the Australian Business Number as an identifier for all Australian business websites. It would make the identification the same for both electronic and non-electronic businesses in accordance with the neutrality principle. Alternatively, or in addition, the ATO suggests the use of digital certificates backed by a trusted third party. These should build on solutions and systems developed by the private sector and widely accepted by the market. The ATO already issues digital certificates to prove identity when dealing with the ATO, for example, when lodging tax returns on the Internet. The paper favours comparable identification processes across jurisdictions and suggests that revenue authorities be involved in their promotion. It comments that this approach would minimise compliance costs and reduce "the likelihood of tax/cost driven website migration".²²⁰

The ATO is already collecting information on businesses that trade on the Internet. Questions are included in tax return forms and these will increase to collect additional information in future years.²²¹ Where it wants to trace the owner of a website, the ATO proposes to use IP numbers, although it recognises that they are currently unreliable.²²² The ATO will cooperate with other revenue authorities to develop a more reliable IP numbering system.

Website identification will be essential as electronic commerce matures. Comparable identification regimes should reduce costs. However, tax havens are likely to guard the right to secrecy of those operating from them, unless there is a reason to suspect illegality. Identification alone will not prevent tax

²¹⁸ Refer to the discussion on "Effectiveness and Fairness" in Section 2 above.

²¹⁹ See the Australian Consumer and Competition Commission "Consumer protection principles in electronic commerce" at: <http://www.accc.gov.au/ecommerce/access1.htm> (at 3 March 2000).

²²⁰ *ATO 2nd Report*, above n 2 at para 6.2.26.

²²¹ *Ibid* at 21: Administrative Strategy A.4.

²²² Each computer has an Internet Protocol ("IP") number that allows messages (information packets) to be routed to it. The current IPv4 standard has limited IP numbers available. A computer is often dynamically allocated a temporary number by its ISP, perhaps for a session. Proxy servers and other mechanisms can further mask an IP number. However, IP numbers can generally be traced, at least to a jurisdiction. See *ATO 2nd Report*, *ibid* at 23 and 149.

driven migration of websites. Websites that operate from a foreign jurisdiction and do not wish to be traced will simply establish an entity in that jurisdiction to satisfy international identification requirements. International requirements are highly unlikely to require a website to be traced back through separate legal entities to its ultimate beneficial owner. Identification requirements will discourage, but certainly not eliminate, tax evasion.

4.2.2 Information

The ATO is concerned that the combination of electronic records, unaccounted payment systems and Internet access to tax haven banking could be a serious threat to revenue.²²³ The ATO will liaise with third party participants in the tax reporting process to respond to these problems.²²⁴ For example, with the Payment Systems Board and the Reserve Bank, it will ensure that issuers of electronic money report amounts on issue. The ATO will liaise with the Australian Banking Association on the level of risk from the inappropriate use of inter-bank settlement accounts. It will consult with the relevant parties to ensure that equivalent legislative and regulatory arrangements apply to electronic money as they do to physical cash.

It is important to develop appropriate standards. The ATO should ensure that the standards meet the needs of the tax system. They should also not be tax driven, diverting them from their proper purpose.

The integrity of electronic records can be difficult to verify. The ATO supports the inclusion of mechanisms in accounting systems that prevent after-the-event manipulation.²²⁵ It also encourages businesses to take steps to prevent unauthorised access to their records, and thereby maintain their completeness and reliability.

The problem with encryption is where the ATO is denied access, whether intentionally or not. Current penalties may be an inadequate deterrent. The ATO implies support for a combination of a presumption that the records do

²²³ The discussion paper on information is found in the *ATO 2nd Report*, above n 2 at paras 6.3.1-6.3.49. See also the *1999 UK Report*, above n 10 at paras 5.16-5.23.

²²⁴ Administrative Strategy A.6, "electronic money", *ATO 2nd Report*, *ibid* at paras A.6.1-A.6.9.

²²⁵ See further, "record integrity mechanisms", *ibid* at paras A.5.13-A.5.19. The ATO "will seek cooperation from local suppliers to incorporate record integrity checks into their products". See also, PricewaterhouseCoopers, "The Technologies of Electronic Commerce: The Integrity of Electronic Transactions and Digital Records for Tax Administration and Compliance" 7 September 1998 Tax Notes Int'l 731.

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not exist if the ATO is not given access²²⁶ and promotion of appropriate key management systems and practices. The latter are currently expensive to implement and the ATO favours government support for key management products tailored for small business systems.

A presumption that records do not exist, even where a business denies access to the ATO through inadvertent loss of its encryption key, is a heavy penalty. The onus of proof is already firmly on the taxpayer.²²⁷ However, medium and large businesses have found the onus a heavy one under the CFC rules, where an Australian resident controller is required to provide information about a CFC that it is deemed to control.²²⁸ Often, the deemed control does not extend in reality to being able to obtain records of the kind demanded by the ATO.

Many small businesses forced into using complex encryption techniques for self-protection when trading on the Internet are likely to struggle with the technology. As a safety net for those that make inadvertent errors leading to the loss of access to records, the ATO should set out clear guidelines on how it will exercise its discretion where inadvertent errors are made. The guidelines should provide a fair way for a business to reconstruct its records where they have been lost inadvertently. They should also provide for remission of penalties. This could form part of the proposed new ATO electronic record keeping ruling.²²⁹

In conjunction with fair treatment of businesses that make mistakes in coming to grips with new technology, it is important that the government sponsors the development of key management systems that are accessible to small businesses. Small businesses will trade on the Internet. They are also likely to take advantage of encryption. Just as the ATO has promoted and even provided record keeping software for the GST,²³⁰ it is equally to its benefit to take a similar approach to key management software. The government might provide incentives, say in the form of increased deductions or cash vouchers, to encourage businesses to use the software.

What happens where a business stores its encryption key overseas and does not give the ATO access? An accepted cost of doing business in any country

²²⁶ Following recommendation 56 of the Canadian joint Government/Business report on "Electronic Commerce and Canada's Tax Administration" (April 1998) <<http://www.rc.gc.ca/ecommm/>> (at 3 March 2000).

²²⁷ Sections 14ZZK and 14ZZO of the TAA 1953.

²²⁸ The ATO may increase this burden, with the introduction of specific contemporaneous record-keeping requirements for transactions associated with jurisdictions with low or preferential tax rates. See *ATO 2nd Report*, above n 2 at paras A.5.10-A.5.12.

²²⁹ Ibid at 25.

²³⁰ See the ATO Tax Reform website at <<http://taxreform.ato.gov.au>> (at 3 March 2000).

is that the rules of that country apply to the way business is done. Private transactions, such as contracts, can be made subject to the jurisdiction of a different country. The tax laws, on the other hand, may be planned for, but they cannot be evaded. If there is blatant refusal to comply with the tax law, the ATO has a responsibility to other Australian taxpayers to pursue every possible means to require compliance, while upholding due process and protecting taxpayers' rights.²³¹

Section 25 of the Acts Interpretation Act 1901 (Cth) deems documents, records and writing to include any form of electronic record. The record keeping and access provisions of the tax law therefore extend to electronic records, which are generally admissible as evidence in court.²³² The position was reinforced by the Electronic Transactions Act 1999 (Cth) and Electronic Transactions Regulations 2000 (Cth), which apply to make most electronic documentation in dealings with the Commonwealth legally equivalent to paper documentation.

Where the ATO is illegally denied access to information it intends to make use of Exchange of Information provisions in DTAs and multilateral treaties.²³³ It should also make full use of its powers to reconstruct records based on its own understanding of a taxpayer's position.²³⁴

There is a strong theme of international cooperation throughout the *ATO 2nd Report*. It is most likely to become a reality, in the context of practical tax administration, with the exchange of information between revenue authorities. If they are to monitor the increasing numbers of taxpayers engaged in international business transactions, revenue authorities must cooperate. However, in doing so, they must preserve due process.

Revenue authorities have been limited in their use of agreements to exchange information. They have faced a number of barriers. Political barriers include a concern that regular information exchange will discourage foreign investment. Legally, there are definitional issues, for example, information exchange may be limited to taxes and there may not be a common definition of what a tax is. The level of legal protection for information in one country may be lower than in the other. There are many technical barriers. For

²³¹ For an extensive discussion, see Bentley, above n 31 and n 47.

²³² Evidence Act 1995 (Cth).

²³³ For example, Australia may well now sign the OECD/Council of Europe Multilateral Convention on Mutual Assistance in Tax Administration ("Convention on Mutual Assistance"), available at: <<http://www.transdata.ro/drept/coe/127e.htm>> (at 3 March 2000).

²³⁴ Sections 166 and 167 of the ITAA 1936.

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example, the translation of the information from one language or one tax system to another may prove too difficult.²³⁵

OECD members are ironing out these problems. They are developing standard procedures to determine exactly what information is being exchanged and on what basis it is being compiled.²³⁶ For example, the US has promoted exchanges with its treaty partners “through the development and adoption of a uniform set of standards and specifications relating to record layouts, interchange codes and the physical properties of the media”.²³⁷ Nordic countries automatically exchange information that includes details of passive income, wages, pensions and social security payments. Other European countries are following suit.²³⁸ The EU is working on linkage points within each Member State, with the linguistic capability to talk directly on specific cases. There are plans to increase multi-state audits, joint training schemes for tax administrators, and the systematic exchange of information.²³⁹ This is made easier by the requirement for EU Member States to maintain electronic databases for information exchange on VAT matters.²⁴⁰ It allows immediate confirmation of the validity of VAT identification numbers. Information must be retained on the database for five years.

DTA articles based on the information exchange Article 26 of the OECD Model may be too narrow for this type of exchange. Article 26 does not cover all types of taxes, as the non-discrimination Article 24 does.²⁴¹ Amendment to the OECD Model would require international agreement.

A critical issue in information exchanges is to ensure the protection of taxpayers. The Convention on Mutual Assistance applies the higher level of protection given by two countries when they exchange information. For example, Article 22 provides that the stricter secrecy laws in either of two states exchanging information will apply to any information that is provided.

²³⁵ For a comprehensive discussion, see Bentley D, above n 31 at chapters 3 and 16 and Tanzi V, *Taxation in an Integrating World* (1995 The Brookings Institution) ch 6.

²³⁶ In Administrative Strategy A.5, *ATO 2nd Report*, above n 2 at para A.5.7, the ATO notes that it will pursue the development of secure links with other revenue authorities.

²³⁷ Novack S, “The US Experience” in OECD, *Taxation and investment flows* (1994 OECD) 171 at 174.

²³⁸ Offermanns R, “Netherlands: Exchange of Information” (1999) 39 *European Taxation* 166. For a detailed discussion of the position in the EU, see Terra and Wattel, above n 158 and Knobbout RR and Reith HE, “Memorandum on the Legal Basis for the Exchange of Information on Indirect Taxation – 21 April 1998” (1998) 26 *Intertax* 244.

²³⁹ Discussions with officials from DG21 (October 1998).

²⁴⁰ Council Regulation 218/92/EEC.

²⁴¹ Discussed in Miller C, “Alternatives to the OECD Model” in OECD, *Taxation and International Capital Flows* (1990 OECD).

This standard should apply to all information exchanges. There should be enforceable procedures put in place to protect taxpayers.

For example, taxpayers should be informed before information about them is exchanged, so that they can have a prior right of review.²⁴² There should be clear guidelines as to when exceptions to the right to exchange information would apply. There should be avenues for redress and compensation, where the information exchanged is misused and causes damage to a taxpayer. Where the damage is caused by the revenue authority in the country where the taxpayer is not resident, there may need to be procedures so that the taxpayer's own government represents the taxpayer. A major shortcoming of the *ATO 2nd Report*, is that it does not address issues of taxpayer protection in this context, despite its emphasis on privacy as a "Guiding Principle".

Compare the position under the 1977 EU Directive on Mutual Assistance.²⁴³ Authorities can use the information obtained for administration of taxes, including prosecution, to counter tax fraud, and to determine appeals. However, the information must be kept secret. Authorities must exploit all domestic means for obtaining the information before requesting it from another jurisdiction. A revenue authority need not provide the information: if it is against its domestic law or administrative procedure; unless there are similar levels of confidentiality in the requesting state; if the information contains trade secrets; if the information could not be obtained under the domestic law of the requesting party; or if the information would damage public order. Some of these restrictions would have to adapt to automatic electronic exchange of information, but they are the kinds of protection that the ATO should be putting forward for discussion, whenever it talks of increased information exchange.

Currently, third parties provide much of the information available to the ATO and withhold a significant proportion of tax, for example, through the new Pay-As-You-Go system. This is a major counter to evasion. The disintermediation encouraged by electronic commerce challenges the effective use of third parties in the tax administration process. So does the development of unaccounted and offshore electronic payment systems. There

²⁴² As is the case in Germany and the Netherlands. See Daiber C, "Protection of Taxpayers' Rights in Germany" in Bentley (ed), above n 31 at 180 and Offermanns, above n 238.

²⁴³ Directive 77/799 EEC, OJ No 336 27/12/77, amended in 1979 and 1992 and see Council Regulation 218/92/EEC. Although, a recent report from the Commission to the Council and European Parliament Com (2000) 28 Final (<<http://europa.eu.int/en/comm/dg21/comrep/index.html>> (at 3 March 2000)) is scathing about the resources applied by EU Member States in exchanging tax information. European information exchange is discussed in Offermanns, *ibid*. See also, Docclo C, "Belgium: Exchange of Information" (1999) 39 *European Taxation* 310.

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is a risk that the cash economy will become much larger in its electronic form.

Electronic systems provide information, but the ATO has “to establish mechanisms to ensure reliable access to this information in an efficient and cost effective manner”.²⁴⁴ It will therefore pursue the introduction of requirements for some accountability in any payment system. The ATO recognises that this will require international cooperation.²⁴⁵

The ATO admits that accountability in payment systems will remove a level of anonymity. It distinguishes between business anonymity and consumer anonymity. It maintains that businesses cannot be anonymous for tax systems to work. However, the requirement for consumer information is usually limited to determining the consumer’s jurisdiction for indirect tax purposes. As with non-electronic tax collection, the ATO does need more information to operate withholding and self-assessment systems, but these are usually not concerned with pure consumption.

The ATO is right to limit its requirement for consumer information. It is important to distinguish between normal consumer activity, in which participation seems to imply acceptance of loss of privacy,²⁴⁶ and consumers who specifically wish to maintain their privacy. The position of these consumers should be protected. The ATO has to be far less aggressive than the private sector, simply because the ATO can enforce its position.

4.2.3 Collection

The ATO has had to examine new mechanisms to collect tax efficiently and effectively from electronic transactions. The paper on collection raises the spectre of disintermediation and the possible removal of third parties integral to the current collection system.²⁴⁷ The ATO uses it to justify the use of new collection methods, particularly for cross border transactions.

²⁴⁴ ATO 2nd Report, above n 2 at para 6.3.43.

²⁴⁵ Discussed further in Bentley D, “A Model for Electronic Tax Collection” in (1999) 1 *Tax Planning International E-Commerce* 15 and Bentley D and Quirk P, “A proposal for Electronic Transactions Tax Collection (ETTC) in the context of tax-driven reform of banking laws” (1999) 10 *Journal of Banking and Finance Law and Practice* 125.

²⁴⁶ The *Australian Financial Review*, above n 92. However, see OECD, *Progress Report on the OECD Action Plan for Electronic Commerce* (SG/EC(99)4 1999 OECD) at 7, which describes the OECD approach to protection of privacy and personal data. The Report was prepared for the Paris Forum and is available on <http://www.oecd.org/dsti/sti/it/ec/act/Paris_ec/pdf/progprep_e.pdf> (at 3 March 2000).

²⁴⁷ This part analyses the ATO 2nd Report, above n 2 at paras 6.4.1-6.4.26.

A customer's jurisdiction often governs the rules for the application, collection and remittance of both indirect and direct taxes. The ATO suggests that it could trace a customer's jurisdiction using IP numbers and credit card details in the short term. In the longer term, it could use information on digital certificates embodied on smart cards.

In looking at tax collection, the ATO favours business as the primary collection point, but allowing for the sharing, flow through or transfer of tax revenue or customer information between governments. It sees this as beneficial as it keeps the advantages of the traditional tax collection system, without introducing completely new mechanisms. Until there is international agreement on how this would work, the ATO foresees that governments may require businesses to "register in all jurisdictions in which they have customers and account for and pay tax on transactions made to those jurisdictions".²⁴⁸ This already applies, for example, in the EU where telecommunications providers doing business in the EU must register and account for VAT, although they do not have a base within the EU. Multiple registration places a significant burden on businesses, which is why the EU allows one registration for the whole EU, rather than requiring registration in each Member State.²⁴⁹

The ATO recognises that electronic payment system providers could withhold taxes. However, it suggests that: all significant electronic payment system providers would have to agree; there would need to be sufficient data to levy the tax; there should be reliable means to avoid double or non-taxation; and there should be harmonisation of product classification and tax rates. The paper says that the system could be self-assessed provided there was an acceptable level of compliance verification, it protected consumers' privacy and it did not create significant additional compliance and administration costs.

Implementing any of these proposals would require international cooperation. The ATO supports the development of an article in the OECD Model to provide for one state to assist another to collect direct taxes. However, because of the extent of bilateral treaties and the need to renegotiate them all, it prefers a multilateral approach, which would also cover indirect taxes.

The ATO should be more aggressive in obtaining multilateral agreement on an appropriate tax collection mechanism.²⁵⁰ It could then cut down on the

²⁴⁸ Ibid at para 6.4.14.

²⁴⁹ The Sixth Directive. See *1999 UK Report*, above n 10 at para 6.35.

²⁵⁰ The *ATO 2nd Report* mentions that there are proposals, but does not explore them to determine their usefulness based on its own criteria. My own experience is that both the ATO and the OECD have been very reticent in providing specific comment on the proposals in circulation (eg, above n 245). Proposals such as that of Dittmar F and Selling HJ, "How to control Internet transactions?"

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record-keeping and other information requirements that it intends to place on businesses to keep track of their transactions. It could also ensure that appropriate measures are built into the collection mechanisms to protect privacy. An automated system of collection is much simpler to manage. That is why withholding taxes are so popular and successful. They need to be extended to the international level. There is little point talking about international cooperation if the ATO is simply going to pursue existing unilateral and bilateral measures.

4.3 Chapter 7: Indirect tax issues

As the Goods and Services Tax ("GST") operates from 1 July 2000, this chapter is short and contains little detail. It focuses on the international discussion, mainly through the OECD. The first part of the chapter considers the challenges to the Wholesale Sales Tax System ("WST"). Many issues also apply to the GST.

The ATO will monitor the insubstantial value provisions that allow the WST/GST-free import of low value consignments. Otherwise, the ATO will focus on the challenge to the GST posed generally by supplies from offshore to Australian consumers. The paper offers no solutions. It simply reiterates the issues the OECD has identified as important in Ottawa Taxation Framework Conditions.²⁵¹

It notes that the GST legislation taxes consumption in Australia, ie in the place of consumption. The legislation does not treat digitised products as goods. The *ATO 2nd Report* also notes that Australia uses the reverse charge mechanism where supplies of services or intangibles are imported and the importer is not entitled to full input tax credits on the supply.²⁵² The effect is to tax imports that will not be subject to GST further down the supply chain. The reverse charge does not apply to imports by those not registered for GST. Doubtless, the ATO will try to monitor imports of services and intangibles by individuals to gauge the revenue loss. The ATO wisely limited the use of the reverse charge mechanism in the legislation. Even for ordinary business transactions, it is cumbersome to administer and resource intensive to monitor and verify.

– A contribution from the point of view of German Tax Inspectors" (1998) 26 *Intertax* 88 are simply footnoted without discussion.

²⁵¹ Above n 6 at 7 and see CFA Progress Report on the Consumption Tax TAG, above n 41 at 6.

²⁵² *ATO 2nd Report*, above n 2 at para 7.3.11.

Presumably a discussion of the issues that face Australia in applying GST to electronic commerce would have delayed the issue of the *ATO 2nd Report*. I will not attempt an analysis here.²⁵³

The *1999 UK Report* identifies two main strands of work on consumption taxes by the OECD: “a clear definition for place of consumption, and effective tax collection mechanisms that do not impose undue burdens on business”.²⁵⁴ It notes that there is emerging agreement that the place of consumption for private consumers should be defined as their usual place of residence, but for digitised products simple and effective ways need to be found to self-assess and collect VAT.²⁵⁵ The UK supports a long-term solution that uses an automated tax charging and collection mechanism.²⁵⁶ When the ATO does analyse GST and electronic commerce, it is likely to face similar issues to the UK, summarised as follows:²⁵⁷

- 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;
- 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.

5 CONCLUSION

The *ATO 2nd Report* is like the curate’s egg: good in parts. It is notable more for what it has left out and the issues it has raised but not pursued than for what it contains. I have tried to add to the discussion with relevant points

²⁵³ Discussion on other systems is informative. See Harley G, “VAT and the Digital Economy: How can VAT Evolve to Meet the Challenge of E-Commerce?” (1999) 1 *Tax Planning International e-commerce* 11; Kogels HA, “VAT @ E-Commerce” (1999) 8 *EC Tax Review* 117; Terra BJM, “The determination of the person liable for payment of VAT: a proposal for a directive amending the 6th Directive” (1999) 8 *EC Tax Review* 42; and Lejeune et al, above n 188, (Pt I) at 1.

²⁵⁴ Above n 10 at para 6.6.

²⁵⁵ Ibid at paras 6.23-6.25.

²⁵⁶ Ibid at para 6.27. See further Bentley, above n 245.

²⁵⁷ *1999 UK Report*, ibid at para 6.35.

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from recent literature. I have also tried to highlight issues that the ATO needs to consider as it implements its Action Plan.

If the ATO wants its guiding principles to be taken seriously, it needs to use them in its analysis of each proposal. It is not sufficient to pay lip service to the principles in the introduction to every paper without exploring their implications in the substance and detail. There are significant issues raised in the *ATO 2nd Report* for taxpayers' rights, both administrative and legislative. They need broad discussion. This is vitally important for taxpayers in the areas of identification, information and collection.

The ATO is widely recognised as an international leader in providing taxpayer services over the Internet. It should exploit its position in the international arena, not simply to guide developments at the international level, but also to help finance its operations by selling its products and expertise to other countries. The defence industry provides an example. The ATO should also consider using its products and expertise within the Australian aid program.

The *ATO 2nd Report* supports the work of the OECD and does not pre-empt the conclusions of the TAGs. However, in the discussion of the taxation of business profits under DTAs, in particular, there is frustration over the failure of the OECD to take a broader view of the tax rules. The ATO should take a lead in generating a wider debate. It would not detract from its involvement in the international working groups to act as a catalyst for such a discussion. The danger in a consensual approach is that the outcome generally follows a failure to agree, pleases no one and achieves little.

The fundamental problem with a comprehensive report of this nature is that it is too broad to explore the detail. Any analysis of the whole report is also therefore restricted to making general comments. The ATO is to be commended for its decision to issue future reports focusing on single issues rather than "comprehensive" periodic overviews.