Electronic Commerce: Are the Current Tax Rules Adequate, or Even Relevant?

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I. Introduction

There is little doubt that the "Internet" is one of the most exciting technological developments of recent decades. However, tax laws that are based on traditional concepts like source and jurisdictional thresholds for taxation of business profits, may not be well equipped for the flexibility offered by the Internet.

At a minimum, until the issues are resolved on a consistent basis, taxpayers are able to take advantage of uncertainties arising from the proper framework for analyzing the issues. On the other hand, taxpayers also face some risk of double taxation and uncertainties in planning. Are these opportunities and risks present because the current rules are inadequate? Are new rules required?

The Internet is currently used not only for research and delivery of goods and services available at no cost to the user, but also for the delivery of goods and services on ordinary commercial terms.

-- Software can be delivered by "downloading" software files

-- Publications can also be delivered in this manner

-- Tangible goods can be ordered by catalog

-- Services of various types can be delivered (e.g., passive information services like stock quotes, as well as interactive services like banking and stock brokerage)

-- Internet services (accessing the Internet itself, as well as commercial "on-line" services)

-- Engineering and architectural services

-- Professional services such as legal and accounting

Examples of Problems: (Assume Foreign Owner)

1. ATM machine?
2. Vending machine?
3. Download CDs
   a. machine?
   b. internet?
4. Gambling?
   a. foreign owner
   b. US owner
5. Order of Goods?
   a. final sale?
   b. location of server?
   c. acceptance in US required?

II. Background to the Internet

A. Application of proper tax concepts must be based on a sound understanding of what the Internet is and how it works.

B. What is the Internet?

A network of computer networks, made possible by software developed decades ago for breaking down and reassembling data into digital packages, facilitated by academic institutions and government as well as commercial efforts to create software enabling more efficient data retrieval and interaction. It acts as a bi- or multi-directional "pipeline," not dissimilar to telephone and cable systems.

C. How does it work?

Computers on the network are connected by hardware (e.g., network servers, concentrators, "backbone" and other lines (including telephone and cable), possible satellite communication equipment, including transponders, etc.). A customer in one country may communicate with server located in another country, and a mirror server in third country may be the server actually used to "book" a transaction (user may not know which server has been used).

D. Commercial use of the Internet

1. Sales

2. Services

3. License

III. Tax Avoidance Opportunities and Tax Duplication - Are They Acceptable?

Despite significant commercial impact in the US, it appears that, under current law, the seller or provider may be able to avoid tax in the jurisdiction of the consumer on its sales of tangible products and software made over the Internet. In order

to understand that, some background in US tax law concepts is required.

A. Sales of Tangible Property into the United States

1. Sales under the Internal Revenue Code.

The Code focuses on whether the seller of tangible personal property is engaged in a U.S. trade or business. Internal Revenue Code §§871(b) and 882(a) impose a tax on income that is effectively connected with the conduct of a trade or business within the U.S.

a. If the seller is not engaged in a U.S. trade or business, its sales into the U.S. via the Internet will not attract U.S. tax, regardless, of where title passes. Therefore, an initial question under the Code is whether a world wide website, where the seller's home page is situated on a computer server located in the United States, will cause the seller to be considered engaged in a trade or business within the U.S.

b. Generally, whether a foreign seller is "engaged in a trade or business" in the U.S., is a question of fact, depending on the continuity and regularity of its economic activities. The courts have held that where goods are regularly purchased and sold in the U.S., the seller is considered to be engaged in a trade or business in the U.S.

c. If a foreign seller has an employee in the U.S., it is clear that the employee's activities are attributed to the employer in determining whether the employer is engaged in a trade or business in the U.S. While the treaty area includes bright lines tests for independent contractors, the activities of the independent contractor are also often attributed to the foreign principal under the Code if there is a regular relationship between the foreign seller and an independent contractor operating in the U.S. In De Amodio v. Commissioner, 34 T.C. 894 (1960), aff'd 299 F.2d 623 (3d Cir. 1962), for example, the court held that a nonresident alien who owned properties in the U.S. was engaged in a trade or business in the U.S. through the continuous and regular activities of his agents who were all independent contractors.

d. Another issue is whether the use of a U.S. server to store a sales catalogue (and, possibly, accept orders) constitutes solicitation activities, and if so, whether solicitation alone is ever sufficient to cause a foreign seller to be considered engaged in a trade or business in the U.S. In Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297 (1941), nonacq., 1941-2 C.B. 22, aff'd, 127 F.2d 260 (5th Cir. 1942), a foreign corporation

which executed contracts abroad relating to broadcasts designed to be heard by listeners in the U.S. was held not subject to U.S. income tax on the income from those contracts. The circuit court's opinion in the case rested solely on the ground that the taxpayer's source of income was outside the U.S., but the lower court also found that the foreign corporation was not engaged in a U.S. trade or business in the U.S.

e. Solicitation into the U.S. - In Rev. Rul. 56-165, 1956-1 C.B. 849 the Service ruled that regular and active solicitation in the United States was sufficient to consider a taxpayer engaged in a U.S. trade or business. In this situation, however, the company sold logging equipment which was brought into the United States for demonstration purposes and to generate orders, so this physical presence in the United States could be regarded as more involved than mere solicitation over the Internet.

f. Effectively Connected Income - Under current law, even if one concludes that use of a U.S. server with the power to accept orders from a catalogue constitutes a U.S. trade or business, it is still possible to avoid U.S. tax on the sales income if the income in question is not effectively connected with the U.S. trade or business. Section 864(c)

defines effectively connected income, and it even includes income derived from a sale or exchange of inventory that takes place outside of the U.S. if it is attributable to an office or other fixed place of business within the U.S. I.R.C. §864(c)(4)(B)(iii).

(1) Income will only be attributable to the U.S. office or other fixed place of business if such office or fixed place of business is a material factor in the production of such income, and such office or fixed place of business regularly carries on activities of the type from which such income is derived. I.R.C. §864(c)(5)(C). For this purpose, a store or sales outlet of an independent agent (i.e., a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity), is not considered an office or other fixed place of business of a foreign seller irrespective of whether such agent has authority to negotiate and conclude contracts in the name of the foreign seller, and regularly exercises that authority, or maintains a stock of goods from which he

regularly fills orders on behalf of his principal.

(2) The office or other fixed place of business of an agent who is not an independent agent is disregarded unless such agent (a) has the authority to negotiate and conclude contracts in the name of the nonresident alien and regularly exercises that authority, or (b) has a stock of merchandise belonging to the nonresident alien from which orders are regularly filled on behalf of such alien. See Treas. Reg. §1.864-7(d).

(3) Under the above standards, it should be possible to make a strong argument that a foreign source sale over the Internet does not give rise to effectively connected income.

(4) Other means of avoiding effectively connected income may be to engage in the digital equivalent of consignment sales or, ultimately and simply, to locate all the sales software on servers located outside the U.S. If these alternatives prove to be effective for foreign sellers, the U.S. will not be able to tax income from these sales under the current income tax. Similarly, the

use by a foreign seller of a mirror server located outside the U.S. may make such international sales difficult, or impossible, for the U.S. to reach for tax purposes. Indeed, the fact that the buyer may not know where the seller's server is actually located may also prevent the tax authorities from effectively auditing international Internet sales activities.

2. Source of Income

   a. Passive income

   b. ~~Foreign~~ income

3. Application of Treaties

   a. Permanent Establishment - The threshold issue arising under a typical bilateral treaty of the U.S. is whether the server used by the seller constitutes a "permanent establishment" of the seller in the host country. A number of the U.S. treaties in force provide that a permanent establishment is a "fixed place of business" including specifically an office or branch.

      (1) A typical U.S. treaty excludes from permanent establishment status the use of facilities or maintaining a stock of goods or merchandise <u>solely</u> for the purpose of storage, display, or delivery of the goods or merchandise;

maintaining a stock of goods solely for the purpose of processing by another enterprise; or maintaining a fixed place of business solely to carry on any other activity of a "preparatory or auxiliary" character.

(2) U.S. treaties also generally provide that an enterprise shall not be deemed to have a permanent establishment as a result of carrying on a business through a broker, general commission agent, or other independent agent who is acting in the ordinary course of their business.

(3) On the other hand, a dependent agent who has and who habitually exercises the authority to conclude contracts in the name of an enterprise, will normally create a permanent establishment for the enterprise on whose behalf the agent is acting.

(4) Whether a seller has a U.S. permanent establishment as a result of sales activities generated through a "home page" situated on a server located in the United States depends on the answers to many questions, such as whether the location of a computer file, constituting a home page on a server located in the U.S., and which might be used only in

a portion of a seller's Internet sales, constitutes a "particular site" and, therefore, a place of business with sufficient permanence to constitute a fixed place of business under a treaty. Can the website be considered solely (an exempt) display of goods?

(5) Does it matter whether a "home page" is the tax equivalent of a mail order catalog or, rather, is more like an entire sales outlet located in the United States?

(6) Should the standard for a website be greater than, equal to or less than that for a physical catalog mailed into the U.S.? Is preserving sales approval, including credit and reference checks, to be exercised solely outside the U.S., adequate to avoid a permanent establishment under the treaty?

(7) If the seller's home page on a computer server located in the U.S. permits not only the viewing of merchandise but also placing and accepting orders, a strong case can be made for treatment of the site as a fixed place of business, like a catalog store. While a server may be shared with many other users, that may not matter to the tax

analysis if space on the server is properly analogized to leasing space in a mall containing many other sales outlets. On the other hand, if no individual is making decisions or taking action in the U.S., the mere fact that sales-related software is located in the United States may well not be considered a "particular site" or other fixed base under a treaty, regardless of attempts to paint the facts with labels such as a "virtual" storefront. Furthermore, it may be argued that the use of an independent agent's server is more closely analogized to a print, broadcast, or interactive advertisement.

(8) The Commentaries in paragraph 10 to Article 5(4) of the 1992 OECD Model Convention state that a permanent establishment may exist if the business of the enterprise is carried on "mainly through automatic equipment," with the activities of personnel restricted to setting up, operating, controlling, and maintaining such equipment. It appears, however, that these Commentaries are focusing on gaming and vending machines where a user's entire transaction is conducted by interaction with the machine. In contrast,

the activities conducted or functions performed at the site of a computer server on the Internet will normally be much more limited. In the case of software sales, however, the server may be fully capable of accepting orders and "delivering" a copy of the software for downloading by a user; even in such cases, and assuming furthermore that such a transaction should be treated as a sale, it is far from clear that the seller would have a permanent establishment in the country in which the server is located, because the server might be considered an (exempt) instrument for delivery. In any case, the OECD Commentary does not appear focused on Internet transactions.

b. Income Attributable to Permanent Establishment -

(1) Once it is determined that a permanent establishment exists under existing US treaties, the treaty partners must address the question of what income is "attributable to" the permanent establishment. It would appear that if a mirror server located outside the United States is actually used to effect the transactions, then any foreign source income from those sales should not be

attributable to the U.S. permanent establishment.

B. Services

1. Internal Revenue Code Rules. Under the Code, services are generally sourced and taxed at the place of performance (i.e., source). IRC Code §§861,862,864(b).

a. Rendering services at any time during a taxable year generally results in the performer being subject to U.S. tax on a net basis.

b. Withholding rules in this area are confused, however, with employees subject generally to wage withholding and independent contractors subject to withholding under section 1441.

c. There are limited exemptions available under the Code (Code §864(b)). Are these exemptions based on an "ancillary" theory? Or is it just de minimis relief (e.g., the commercial traveller's exception)? Was it administratively too difficult to allocate the profits?

d. Business vs. nonbusiness income. Once the source and jurisdiction to tax has been determined, the next step is deciding the appropriate amount of income.

(1) Under Code §482, compensation for services is based on cost unless the services are

considered "integral," in which case an arms'-length amount is to be charged.

(2) The global trading APAs (round the clock and round the world trading)(and IRS Notice 94-40) illustrate the possible potential for avoiding traditional rules on services where it is difficult to determine who did what and when. IRS allowed profit split without regard to customary rules.

(3) Effect of Hospital Corp. of America, case concerning the "proper" allocation of future hospital administration profit. Query: Could this have been avoided through the Internet?

2. Treaties

a. Treaties to which the U.S. is a party generally follow the U.S. treatment of services, with focus on the jurisdiction to tax.

b. Treaties appear to operate under the assumption that services constitute a permanent establishment ("PE").

c. Commonly, activities of a preparatory or auxiliary nature are excluded from PE status:

(1) E.g., purchasing, storage of goods, etc.

(2) There are also some broader exceptions to the treaty rules, including:

(3) Durational limitation rules (construction sites)

d. Most treaties distinguish independent from dependent personal services.

(1) Many treaties also specifically address artists and athletes.

(2) These provisions also raise issues about the use of agents.

(3) Does a subcontractor in the U.S. constitute a PE? Cf. Rev Rul 75-7, Vetco, Ashland Oil (branch cases under Section 954).

3. Other International Treatment for Services.

a. There are alternative world views on the appropriate taxation of services. Countries such as Brazil feel that the appropriate jurisdiction to impose a tax is the one in which the service-recipient resides.

b. Other nations feel that VAT taxes are appropriately levied where the recipient of the services resides.

c. These differences in approach suggest the possibility of double taxation (or zero worldwide taxation), depending upon where such services are rendered.

4. Electronic-age digital services

a. Conventional services rendered in part in different countries. E.g., architectural services. If a

foreign company is employed to design a building abroad that will be built in the U.S., how do you allocate the architectural firm's services when it needs to travel to the site to view it, to modify its plans and to inspect the actual construction. The majority of the "brain power" occurs overseas. Do you allocate on time spent, level of activity?

b. Conventional services rendered in places the recipient would not normally know. E.g., data processing.

c. Electronic services.

(1) Web page design

(2) Advertising by Web search engine

(3) Internet service provider

(4) We might anticipate that someday virtually any service will be available electronically

d. Global trading - How is profit to be attributed? APA used by IRS in this context to at least attribute some profit

C. Lessons/Suggestions from the Treasury White Paper?

The White Paper emphasizes:

a. Digital/analog neutrality (this is neutrality in taxation between transactions occurring electronically and those that occur the "traditional way") The position here is that taxation should not affect one's decision to

transact business electronically or not. - Compare this to recent investment tax credit case in Tax Court.

b. No need to impose new taxes on Internet transactions.

c. With services, is there an equally difficult or impossible tracing of recipient or renderer?

d. Treasury appears to believe that new rules may not be necessary because we can employ residence based taxation as opposed to source based taxation, and eliminate the title-passage rule, which is subject to manipulation in electronic sales.

(1) Isn't this in and of itself a change?

D. Controlled Foreign Corporation Rule (US Owner)

1. Foreign Base Company Sales Income

2. Foreign Base Company Services Income

3. Foreign Personal Holding Company Income

E. Double Taxation -

1. One can imagine that each country will have its own answers to these developing issues.

2. Whatever decision the U.S. reaches on these questions under its treaties must be coordinated with the similar decisions reached by its treaty partners in order to avoid double taxation. Governments may ultimately decide to agree to a lower threshold of taxation for Internet sales, or attempt to reach these sales by extending rules such as US Subpart F or transfer pricing to prevent taxpayers from avoiding taxation merely by locating their servers in, and conducting all other sales activities from, low tax jurisdictions.

3. At the present time, it seems clear that the current rules are not sufficiently advanced to deal with all of these issues, and therefore there is substantial room for tax planning.

F. Recent Developments

1. International Fiscal Association Conference - New Dehli, India, October 22, 1997

   a. U.S. Treasury official stated that tax authorities around the world need to rethink their concept of PE as a result of electronic commerce.

      (1) OECD is reviewing its guidelines on defining a PE and plans to have draft guidelines on electronic commerce available in 1998

      (2) Key issue: whether a server is a fixed place of business. Defining a server as a fixed

place of business could result in multiple taxation.

(3) OECD considering a residence based approach

2. Second Forum on Legal and Tax Aspects of Business on the Internet - Amsterdam, Holland, October 28, 1997

a. Representative of U.K. Inland Revenue stated that a server located in the U.K. that did "advertising only" would most likely not be treated as a PE. However, if the server also did order-taking and order fulfillment, it is likely to be treated as a PE.

(1) It was noted that it is easy to do business in a country without locating the server in that country.

b. However, practitioners argue that PE should mean physical presence and substantial nexus, and that a mere server is not sufficient to give rise to a PE. It is certainly unclear at this time how this issue will be resolved.

3. OECD announced plans to draft a series of uniform taxation guidelines for electronic commerce by October 1998.

IV. Application of Taxation Concepts - Summary

A. Characterization of software products

1. Proposed IRS Regulations

a. Debate over "prepackaged" or "shrinkwrapped" software (compare OECD position with that taken by representatives of IBM)

b. Sales vs. services vs. licenses of intangible property

B. Is a seller/user engaged in trade or business in the U.S.?

1. Does it matter whether the server is owned by independent agents?

2. Is the server analogous to a display of goods or a stock of goods out of which delivery is made?

C. Is an Internet-linked server a Permanent Establishment?

D. Should we tax on the bases of source or residence?

E. Some of the thinking relevant to the Internet sales questions:

1. Questions of Due Process and Commerce Clause nexus have involved state taxation of mail order sales, including some references to software sales or support.

2. VAT authorities (other jurisdictions)

F. Application of Concepts to:

1. ATM

2. Vending machine

3. Download of CD's

a. machine

b. internet

4. Gambling

5. Order of Goods

   a. Final sale

   b. Acceptance in US requirement

   c. Location of server

G. For more detailed background, see Levine, et al., "Internet Sales Pose International Tax Challenges", 84 Journal of Taxation 325 (1996).

V. Tax Avoidance Opportunities-Summary-Are They Acceptable?

A. Inbound Sales (Foreign Ownership) - Many opportunities

1. Avoid being engaged in trade or business in U.S. ("ETB")

2. If ETB, avoid "effectively connected income"

3. Avoid intercompany pricing issues by eliminating related U.S. distributors

4. Avoid PE

5. Avoid income "attributable to" PE.

B. Inbound Services (Foreign Ownership)

1. Avoid actual physical performance in U.S.

2. Convert character of income, if desirable

3. Rely on PE exceptions

4. Use of general rule under Code §482

C. Outbound Sales and/or Services (U.S. Ownership)

1. Avoid Subpart F income even with complete U.S. ownership and U.S. customer base.

2. Avoid ETB

VI. Double Taxation Risk-Is It Acceptable?

VII. Taxation of Electronic Services: A Suggested Approach

A. Consider the following: For tax purposes, the category of personal services is really contracting; instead a new category of economic activity arising from the exploitation of the expanding classification of intellectual property is emerging.

B. Are Electronic Services Personal Services?

1. Electronic services can be classified into two types:

a. Type I Services - services which involve some specific aspect of the service being provided by human beings (e.g., professional services of an architect, accountant or engineer delivered through the Internet).

b. Type II Services - involves use of electronically accessed databases, which are largely mechanized, and do not require significant human input (e.g., provision of information searches such as legal databases, and on-line banking).

C. Do We Need New Rules?

1. Generally, international service income is sourced by reference to the place of performance

a. because of the difficulty of identifying the place of performance for electronic services, our concept

restricts the place of performance rule to Type I services.

b. Type II services would be taxed under the international tax rules applicable either to the exploitation of intangible property, including its creation, licensing, lease or sale, or to the disposition of tangible or intangible personal property, depending on the Type II service involved.

c. Open issues

(1) If Type II services involve the delivery of potential trade secrets instead of personal services, should the royalty rules apply to determine the source and character of income?

(2) In cases where no human services are performed, is it appropriate for Type II services to attract little or no worldwide taxation?

(3) What if the Type II service provider subcontracts functions that are, in fact, performed by human beings? Should the Type II service provider tax result be different than where the subcontractor performs all of its functions digitally?

D. Distinguishing Services from Intangible Property Under Current Law

1. Entities as well as individuals can render "personal services" through their dependent agents.

a. A foreign corporation could be deemed to be engaged in a U.S. trade or business through Type I services performed by an independent agent.

(1) Most treaties provide no PE will be attributed to an independent agent unless the agent has the authority to conclude contracts in the name of the principal.

(2) Tax law has historically looked to legally predictable rights to distinguish property from services for tax purposes (e.g., compare Ingram v. Bowers, 57 F.2d 65 (2nd Cir. 1931) (compensation for services) with Rafael Sabatini, 32 B.T.A. 705 (1935) (royalty income)).

(3) Further, within the category of intangible property - issue of whether an item is sold (title passage rule) vs. licensed (sourced where intangibles are used or where the rights to such use are granted).

E. Separating Services from Sales of Products

1. Most authority is under Code §351.

a. A transfer of services is tax-free as long as merely ancillary or subsidiary to the property transfer

b. If not ancillary or subsidiary, allocation between property and services required

(1) determination of whether services are ancillary or subsidiary is a question of fact

(a) demonstrating and explaining use of product (considered ancillary)

(b) teaching employees new, necessary skills considered educational and not ancillary

2. contrast software regs requiring a separate allocation to transfers of copyright rights, transfers of copyrighted articles, services, and know-how unless the item at issue is "de minimus"- see Prop. Reg. 1.861-8(b)(2); and the typical treaty rule-no PE if activities of a "preparatory or auxiliary" nature.

F. Allocation of Personal Service Profit

1. Type I service income sourced at place of performance; will require an appropriate allocation where the services are performed in more than one jurisdiction

a. in real world - allocation of both income and expense often based on time spent - see Treas. Regs. §1.861.4(b) and §1-861-8

2. Code §482 requires compensation for personal services performed between related parties be based on an "arms-length charge"

   a. the "arms-length charge equals the costs and deductions incurred in performing the services unless the services are considered "integral"; in that case, the arms-length charge is the amount that would have been charged for similar services performed for an unrelated party in a similar situation

   b. there are four tests under which services will be deemed integral to the business activity of either party rendering the services or receiving the services

      (1) First test - either party is engaged in the trade or business of rendering similar services to unrelated parties. Treas. Reg. §1.482-2(b)(7)(i).

      (2) Second test - rendering such services is a principal activity of the renderer of the services

         (a) considered principal activity where costs associated with rendering the services exceed 25% of the total costs or deductions of the renderer for the taxable year. Treas. Reg. §1.482-2(b)(7)(ii)

(3) Third test - the renderer is "peculiarly capable" of rendering the services and such services are a principal element in the operations of the recipient. The regulations do not provide an adequate definition of "peculiarly capable." Treas. Reg. 1.482-2(b)(7)(iii).

(4) Fourth Test - the recipient has received the benefit of a "substantial amount" of services from one or more related parties during the taxable year.

(a) "substantial amount" requirement met when the recipient's costs for the taxable year attributable to such services from related parties exceed 25% of its total costs or deductions for the taxable year. Treas. Reg. 1.482-2(b)(7)(iv).

3. In the global trading area, which involves a mix of Type I and Type II services (as well as income from sales) the Service in several APA's has agreed to using a profit split method reflecting the contribution of each trading location to the overall profit of the "book positions" (Notice 94-40, 1994-1 C.B. 351). Three factors were used in each APA with different weights assigned to reflect the particular facts and circumstances of each situation.

(1) risk factor

(2) value factor

(3) activity factor

G. Foreign Viewpoint

1. While most foreign jurisdictions tax income from services under similar rules to those of the U.S., there is at least one minority view.

   a. e.g., Brazil sources income from services based on where the recipient resides. Similarly, VAT and foreign consumptions taxes are based on where the consumer resides.

2. These differences in approach provide for the possibility of double taxation (or zero taxation).

3. Also note the possibility of different tax characterization rules between different taxing jurisdictions, e.g., (sale in one jurisdiction, service in another) resulting in at least a deferral of tax in both jurisdictions.

H. What Factors Should Govern Source?

1. The White Paper suggests that the place of residence rule is often easier to apply than the source of income rule.

2. In our view, current rules are consistent with the residence-based approach only if the location of performance is equivalent to residence.

3. Under most treaties, if a corporation employs an independent contractor to perform personal services in another State, the income is taxable in that other State only if accompanied by an additional substantial presence (e.g., fixed base) in that State. Use of an employee rather than independent agent results in taxation of the income regardless of whether a fixed base exists, unless the services are of an auxiliary or preparatory nature.

I. What Will Happen to Type II Services?

1. Type II services should be taxed in accordance with rules applicable to royalties or sales of tangible or intangible personal property.
   a. royalty payments sourced in the jurisdiction in which the property on which the royalty is paid is exploited.
2. For many Type II services, it will be easy to determine where the ultimate "user" is located (e.g., charges for use of ATM machines).
3. There are still difficult situations, such as, blends of Type I and Type II services.
   a. For example, if a royalty approach is utilized in the case of mobile electronic trading of securities, the source of the income is where the customer's account is located. What happens if the trader takes his laptop computer and conducts

trades while in a plane over the ocean? Should a residence rule be applied in such cases?

VIII. State Taxation of Electronic Commerce

A. Issues in State Taxation of Electronic Commerce

1. Constitutional Issues

a. Due process issues

(1) Quill Corp. v. North Dakota, 504 U.S. 298 (1992) - the Due Process Clause requires only that a corporation have "minimum contacts" with the taxing state.

(2) When does a state have sufficient control over a defendant to exercise personal jurisdiction?

(a) For example, Bensuson Restaurant Corporation v. King, 937 F. Supp. 295, 1996 U.S. Dist. LEXIS 13035 (S.D.N.Y. 1996) - no personal jurisdiction where the defendant's only connection to New York was the establishment of a web site that was accessible from anywhere.

b. Commerce clause issues

(1) Quill Corp. v. North Dakota - The Interstate Commerce Clause requires corporate taxpayers have "substantial nexus" within the taxing state

(a) In the use tax area, the Court has required that a corporation be physically present in a state, for that state to impose collection responsibility on the corporation.

(b) It is not clear what degree of physical presence is required for the imposition of other taxes such as franchise, gross receipts and net income tax, although a greater nexus standard should apply to taxes which are being imposed.

(2) Is an Internet or online service provider's equipment attributable to an out-of-state vendor resulting in nexus to tax the vendor?

(3) Correspondingly, should it matter where the equipment which hosts the vendor's website is located?

(a) New York Department of Taxation and Finance has concluded that nexus is not created through a New York Internet service provider nor by advertising on a New York server. This applies to both corporate franchise and sales and use taxes. Memorandum, TSB-M-97(1)C,TSB-M-97(1)(s), January 24, 1997.

2. P.L. 86-272 issues (15 U.S.C. Section 381)

a. The statute provides that "No State, or political subdivision thereof, shall have the power to impose, for any taxable year ..., a net income tax on the income derived from within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both of the following:

(1) The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation by such person, or his representative in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

b. Should it matter whether solicitation (as permitted by the statute) is done by way of the Internet as opposed to the traditional method?

c. Does the creation of a website in a state mean the loss of protection under P.L. 86-272 (i.e., equivalent to an office)?

(1) Texas has ruled that where a customer responds to a taxpayer's advertisement on the Internet for taxable information services, which were downloaded from a computer, the location of which the taxpayer had no knowledge, the transaction was subject to sales tax in Texas because the information is considered picked up at a server located in Texas. Letter Ruling 9601L1389604 (1/8/96).

3. Significant State Developments

a. California - The California Board of Equalization has adopted a resolution calling for a moratorium on the importances of any new taxes or fees on Internet or any online activities (News Release No. 25-6, California State Board of Equalization, Apr. 15, 1997).

(1) The notice also authorizes publication of proposed regulations which provide that having a web page does not create nexus in California for tax purposes.

b. Connecticut - Internet services are considered a taxable computer service. Letter Ruling No. 96-7, Connecticut Dept. Rev. Services (Oct. 24, 1996).

c. Florida - Florida legislative recently passed a bill to prohibit the Department of Revenue from taxing Internet access service, e-mail, and other Internet services. Committee substitute for SBS 404 and 414 (approved May 2, 1997).

d. Massachusetts - Internet services are taxable as telecommunication services. See State Tax Review, pg. 3 (CCH Jan. 13, 1997). However, in a technical information release, the Massachusetts Department of Revenue has issued a temporary moratorium through December 31, 1998, on collection of sales and use tax on Internet access services and other related telecommunication services.

e. New Jersey - Internet services are currently exempt. State Tax Review, pg. 3 (CCH Jan 13, 1997).

f. New York - New York Office of Tax Policy has stated that Internet access and related services are not taxable as telecommunications, nor enumerated services or entertainment services. Office of Tax Policy, New York Department of Taxation and Finance, "Improving New York State's Telecommunication Taxes and Final Report and Recommendations (January 1997).

g. Pennsylvania - Internet services are taxable as computer services. State Tax Review, p. 3 (CCH Jan 13, 1997).

B. Internet Tax Freedom Act ("Act")-(S.442) as sponsored by Sen. Ron Wyden, D-Oregon - The Senate Commerce Committee reported out an amended version of the Act for floor debate on November 4, 1997. (Applicable to States and their political subdivisions)

1. The bill imposes a moratorium on the imposition, assessment, or attempt to collect any tax on the Internet, online services, or Internet access service by States and their political subdivisions prior to January 1, 2004.

2. The bill preserves state and local authority to

a. impose sales, use, or other transaction tax on online services, Internet access services, or communications or transactions using the Internet if the tax (including the rate) is the same as the tax generally imposed on similar sales and transactions which do not utilize the Internet (e.g., mail order sales), and where the tax obligation is placed on the same party in the case of each functionally similar transaction

b. impose taxes as measured by gross or net income derived from online services, Internet access service, or communications or transactions using

the Internet, or on value added, net worth, or capital stock

c. impose fairly apportioned business license taxes

d. impose taxes paid by a provider or user of online services or Internet access service as a consumer of goods and services not otherwise excluded from taxation by the Act

e. impose or assess property taxes on property owned or leased by an Internet or online service provider

f. impose taxes on a common carrier, as defined in the Communication Act of 1934, acting in its capacity as a common carrier

g. impose taxes on a provider of telecommunications service, as defined in section 3 of the Communications Act of 1934; and

h. impose franchise fees, pursuant to sections 622 or 653 of the Communications Act of 1934 for the provision of cable services

3. The bill provides that a consultive group composed of the Secretaries of the Treasury, Commerce, and State, appropriate committees of Congress, the National Tax Association-Sponsored Joint Committees and Electronic Commerce Tax Project ("NTA") and the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), consumer and business groups, States and political subdivisions thereof will

a. undertake an examination of U.S. domestic and international taxation of

(1) communications and transactions using the Internet

(2) online services and Internet access service

(3) infrastructure used by the Internet, online services, and Internet access service

b. consider any specific proposals made by the NTA and NCCUSL on a. above, and

c. jointly submit policy recommendations on taxation of online services, Internet access service and communications and transactions to the President within eighteen months after enactment. The President shall, to the extent deemed appropriate, transmit to the appropriate committees of Congress policy recommendations on taxation of online services, Internet access service and communications and transactions using the Internet no later than two years after enactment.

(1) the NTA has recently issued a draft report which suggests

(a) sales and use nexus be established in the state of the purchaser's billing address

(b) Where the purchaser's billing address cannot be determined by a vendor on the basis of reasonable and good faith

efforts, the sales tax base should be "thrown back" to a state where the vendor is taxable.

(c) An alternative to (b) would require that the vendor collect a sales tax equal to the average sales tax rate that the vendor collected on all sales of electronically transmitted information or services during the preceding year. This tax would then be paid to each of the states in which the vendor makes taxable sales of electronic goods and services, in the same proportion that the vendor's sales and use taxes on electronically transmitted information or services were paid to the states during the preceding calendar year.

(d) This approach cannot be implemented without congressional consent, due to the Commerce Clause. Even with congressional consent, it may be deemed to violate the Due Process Clause.

4. The bill also states that it is the sense of Congress that the President should seek bilateral and multilateral agreements through international trade and business organizations.

5. The House version, sponsored by Rep. Christopher Cox, R-California and offered as an Amendment in the Nature of a Substitute to H.R. 1054, was approved by two House subcommittees on October 9, 1997. The House Bill will now go to the full Commerce and Judiciary Committees of the House. Some key features of the House version are:

   a. the moratorium ending date in the House bill is the later of six years from the date of enactment or four years from the date on which the President submits any recommendations to Congress. Therefore, if the President does not act, the moratorium will run indefinitely

   b. The House Bill exempts sales or use taxes on <u>sales or other transactions</u> effected by use of the Internet provided certain conditions are met. This means sales and telecommunication excise taxes on Internet access services, online information services, web site hosting services, etc. would be precluded.

   c. The House bill contains an express prohibition on the assertion of nexus for sales and use tax purposes based on Internet contacts. However, the bill does not provide a retailer (who otherwise has substantial nexus in the State) relief from its tax responsibilities in the State.

d. The House bill exempts businesses from taxes measured by net income, gross receipts, or capital stock on business activity derived from the Internet or online services, unless other business entities are subject to the same tax.

(1) This provision would exempt regular corporations from corporate income taxes and corporate franchise taxes measured by net income derived from providing Internet-related or online services. Since partnerships and sole proprietorships are not subject to corporate income or franchise taxes, the same tax is not being imposed and collected in the case of all other business entities in that State. No such "same tax" language appears in the Senate Bill.

e. The House Bill does not apply to taxes imposed or measured on a value-added basis, (e.g., Michigan's Single Business Tax and New Hampshire Business Enterprise Tax) or a net worth basis.

6. Four State Governors have expressed support for the "Act." They are from -

a. New York

b. California

c. Virginia

d. Massachusetts