OLD AND NEW ISSUES IN THE TAXATION OF ELECTRONIC COMMERCE

By David L. Forst †

To date, the response of the world's taxing authorities to the rise of electronic commerce can best be characterized as "hurry up and wait." Conferences have been convened; white papers have been issued; commissions have been appointed, but there is still precious little concrete advice that tax advisors can give to their clients.

While black letter rules have yet to materialize, statements of principle have abounded. Certain of these stated principles are more or less self-evident, such as the idea that electronic commerce taxing regimes need to be fair, consistent, administrable, and the like. However, other principles are neither self-evident nor harmonious, suggesting that the real work of developing an electronic commerce taxing regime will be neither easy nor quick.

The principal difficulty in developing an electronic commerce taxing regime is that the Internet is still a new medium whose full ramifications are not close to being understood. Accordingly, at least for now, governments at all levels are not eager to commit to rules that could potentially erode their tax bases. Business is not pushing for new rules either, since existing rules can be interpreted favorably.[1] Thus, it seems that electronic commerce tax law will not be a radical departure from existing rules, but instead will develop piecemeal and reactively to cure perceived taxpayer abuses or revenue misallocations.

This paper will discuss the development of electronic commerce tax law from the perspectives of international taxation and U.S. state taxation —the two most fertile areas. It will identify the firm rules that have dribbled out so far, the principal points of tension that have prevented further

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† Attorney, Fenwick & West LLP, Palo Alto, CA.

1. Under existing rules, the right of a jurisdiction to tax usually does not arise unless and until a taxpayer has some sort of physical connection with that jurisdiction. Since the consummation of an electronic transaction does not necessarily require a physical connection with the purchaser or its jurisdiction, businesses can reasonably take the position that they should not be subject to tax under taxing regimes that require a physical presence. *See* David L. Forst, *The Continuing Vitality of Source Based Taxation in the Electronic Age*, 15 TAX NOTES INT'L 1455, 1467-71 (1997).

progress, and the areas where progress is most likely in the foreseeable future.

I. INTERNATIONAL TAXATION

A. The Continuing Vitality of Source Based Taxation

In the international arena the most concrete principle that has emerged so far is that traditional source based taxation rules continue to be robust. Since the beginning of this century, the world's nations have basically agreed that the country with the primary right to tax the profits of an enterprise is the country in which the enterprise earns the income (the "source country").[2] In so doing, they have rejected an alternative residence based taxing regime, in which the enterprise's country of residence has primary taxing jurisdiction over business profits. This consensus is reflected most completely in the international network of some 1,500 bilateral income tax treaties for the avoidance of double taxation.[3] The issue of residence based taxation eclipsing source based taxation in the context of electronic commerce was brought to the forefront by the U.S. Treasury Department more than two years ago. In November 1996, the U.S. Treasury Department issued a paper entitled *Selected Tax Policy Implications of Global Electronic Commerce*,[4] which stated that source based taxation could be rendered obsolete by electronic commerce:

> The growth of new communications technologies and electronic commerce will likely require that the principle of residence based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore source based taxation could lose its rationale and be rendered obsolete by electronic commerce.[5]

However, the ascendancy of residence based taxation now appears to be a dead letter. Since the Treasury Department issued its November 1996

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2. *See* The Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital, art. 7(1) (1992), 1 Tax Treaties (CCH) ¶ *191 [hereinafter OECD Model Tax Convention*].

3. *See id.*

4. Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implication of Global Electronic Commerce* (visited Nov. 1, 1997) <http://www.fedworld.gov/pub/tel/internet.txt>.

5. *Id.* at 19.

Report, major international organizations, such as the Organization for Economic Cooperation and Development ("OECD"), have not endorsed residence based taxation over source based taxation, and to this author's knowledge neither has the taxing authority of any individual government.[6] Even the Treasury Department itself has not pushed the issue further, and instead (as discussed more fully below) has begun to apply existing tax principles to transactions effected via electronic commerce.

In hindsight, the rejection of residence based taxation was inevitable. Residence based taxation is simply not necessary as a technical matter because traditional source based rules can be applied to transactions effected via electronic commerce.[7] Furthermore, countries historically have been unwilling to cede their right to tax the foreigner.[8] This unwillingness is exacerbated in the case of electronic commerce where most of the world's electronic merchants are, and at least for the foreseeable future will be, U.S. residents.[9]

B. Future Significance of Source Based Taxation

With source based taxation secure, the issue has shifted away from whether taxation at the source should be retracted to whether taxation at the source should be expanded. The world's taxing authorities could end up concluding that source based principles will need to be liberalized to insure that all countries receive a fair share of electronic commerce tax revenue.

This issue is best illustrated by the tension between two policy goals set forth by the OECD. In October 1998 the OECD's Committee on Fiscal Affairs issued a report entitled *Electronic Commerce: Taxation Framework Conditions*,[10] which set forth certain broad, but potentially incompatible, policy goals.

One policy goal stated in the OECD Ministerial Report is that existing tax principles should apply to the taxation of electronic commerce:

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6. *See* Organization for Economic Cooperation and Development, *Electronic Commerce: Taxation Framework Conditions* (visited Jan. 8, 1999) <http://www.oecd.org/daf/fa/e_com/framewke.pdf> [*hereinafter OECD Ministerial Report*].

7. *See* Forst, *supra* note 1

8. *See supra*, note 2 and accompanying text.

9. *See U.S. Could Gain Income if Current Policies Apply to Electronic Commerce, Attorneys Say*, TRANSFER PRICING REP., July 16, 1997, at 178.

10. *See OECD Ministerial Report*, *supra* note 6.

> The taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. The [Committee on Fiscal Affairs] believes that at this state of development in the technological and commercial environment, existing taxation rules can implement these principles.[11]

To this end, the OECD has stated that it would clarify the Commentary to its Model Tax Convention to take into account certain issues related to electronic commerce, such as how the current definition of permanent establishment[12] applies where electronic commerce transactions are conducted through a website on a server located in a given country and how income earned from certain electronic transactions should be classified for the purposes of taxation.[13] Similarly, the U.S. Treasury Department has announced that that it will apply traditional title passage rules in determining the source of income from the electronic transmission of inventory property.[14]

However, another of the OECD Ministerial Report's policy goals, the maintenance of sovereignty and fairness, could conflict with the goal of preserving existing principles. The Ministerial Report states:

> Any arrangements for the application of [existing] principles to electronic commerce adopted domestically and any adaptation of existing international tax principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce and to avoid double taxation and unintentional nontaxation.[15]

What the OECD appears to be saying is that the fiscal sovereignty of countries and a fair sharing of the tax base from electronic commerce is more important than a strict (or possibly even loose) adherence to existing

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11. *Id.* at 4.

12. The permanent establishment concept generally provides that a country cannot tax a non-resident unless the non-resident has a permanent presence in the country, e.g., through an office, factory, workshop or the like. The permanent establishment concept was developed before the era of electronic commerce, and thus, as presently conceived, does not take into account whether a country can tax a non-resident if the non-resident's sole contact with the country is an electronic one. *See* Forst, *supra* note 1, at 1467-71.

13. *See* Organization for Economic Cooperation and Development, *Electronic Commerce: A Discussion Paper on Taxation Issues* (visited Jan. 8, 1999) <http://www.oecd.org/daf/fa/e_com/discusse.pdf> [hereinafter *OECD Discussion Paper*].

14. *See* T.D. 8785, 63 F.R. 52971-52983 (1998).

15. *OECD Ministerial Report*, *supra* note 6, at 4.

technical tax principles. As a political matter, the OECD's statement cannot be disputed. Any international tax regime governing electronic commerce will have to be consistently applied, and consistent application will not occur if certain countries believe that they are being denied their fair share of tax revenue.

An issue of particular concern in this regard is disintermediation, or the removal of the middleman from business transactions. An international example of disintermediation is a U.K. person purchasing a book from an Amazon.com website or an airline ticket from a Travelocity website rather than from a local bookseller or a local travel agent. In both cases, the U.K. middleman is cut out, and the U.K. loses tax revenue. However, whether disintermediation will result in a material reallocation of the world's tax revenue is unclear. It has been suggested the process of reintermediation, or the rising of new types of middlemen who help facilitate the online flow of goods and services, will make up for any dislocations caused by disintermediation.[16] But right now, it is simply too early to tell what effect disintermediation or other consequences of electronic commerce will have on worldwide taxation.

As a result, caution is the order of the day. The OECD is unwilling to propose any far-reaching changes to the international tax regime. The OECD's Committee on Fiscal Affairs recently concluded that "it would be premature to reach any conclusion as to the effect of electronic commerce on the sharing of tax revenues between source and residence countries or to put forward alternatives to the present rules of tax conventions concerning the tax of business profits."[17]

Industry has also discouraged new rule making. Existing rules prohibit a country from asserting taxing jurisdiction over a foreigner unless that foreigner has some sort of physical presence in the country.[18] Thus, a business with an electronic, but not a physical, presence in a country can reasonably take the position that it should not be subject to taxation in that

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16. Online escrow agents are good examples of reintermediators. An online escrow agent facilitates online sales by holding the buyer's cash until the buyer receives and is satisfied with the goods that it has purchased. *See* Jamie Beckett, *Rise of the Online Middleman; Escrow Services in Demand as Net Auction Sites Proliferate*, S.F. CHRON., Jan. 14, 1999, at B1.

17. *See OECD Discussion Paper*, *supra* note 13, at 25.

18. *See, e.g.*, OECD Model Tax Convention, *supra* note 2 (providing that the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein).

country. Industry is opposed to new rules because it believes (probably correctly) that any changes to existing rules would lower the threshold on countries' ability to tax the foreigner. IBM Chairman Louis Gerstner recently told the OECD, "I would ... encourage you to consider an official time-out.... Let's commit to allow this new kind of commerce to chart its natural pattern and then explore how a predictable and neutral tax regime might be superimposed on it."[19]

The caution expressed by government and industry is compounded by their mutual desire not to retard the growth of electronic commerce. There has been widespread rejection of taxes targeted specifically at electronic commerce. The leading example of this type of tax is a bit tax, which would tax every item of digital data—or "bit"—that flows over the Internet. The OECD has not endorsed this type of tax, and in a recent report the U.S. government trumpeted its role in defeating worldwide endorsement of the tax, stating that it would have discriminated against electronic commerce.[20]

With the number and variety of goals expressed, change will almost certainly be incremental. The most realistic prospect for change is relaxation of barriers to countries taxing at the source, through, for example, expanded use of consumption taxes or liberalization of the permanent establishment principle in bilateral income tax treaties. This type of change would use existing principles as a starting point and would ameliorate any deviations from the current allocation of the world's taxing revenues. However, this type of change also could subject businesses without a permanent establishment (as that term is currently understood) in a particular country to taxation in that country. Thus, prospects for even this type of change are far from certain.

II. STATE AND LOCAL TAXATION

In the state and local arena even incremental change has been temporarily halted. In October 1998, Congress passed the Internet Tax Freedom Act,[21] which prohibits states or political subdivisions from imposing from October 1, 1998 through October 21, 2001 taxes on Internet access and

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19. Peter Menyasz, *OECD Joint Declaration Stresses Use of Consumption Point as Locus for Taxation*, DAILY TAX REP., 196 DTR G-2 (Oct. 9, 1998).

20. *See* U.S. GOVERNMENT WORKING GROUP ON ELECTRONIC COMMERCE, FIRST ANNUAL REPORT (Nov. 30, 1998), *reprinted in* BNA DAILY TAX REP., Dec. 1, 1998, *available at* <http://www.doc.gov/ecommerce/E-comm.pdf>.

21. Pub. L. No. 105-277, 112 Stat. 2681 (1998).

multiple or discriminatory taxes on electronic commerce. The Act also calls for the establishment of a nineteen member Advisory Commission on Electronic Commerce to conduct a study and submit findings in the year 2000. A grandfather clause protects taxes imposed and enforced before October 1, 1998. Accordingly, states and localities are essentially barred from imposing any new types of taxes on electronic commerce until late 2001. In the meantime, there has been no shortage of discussion on the issue.

Like international taxation, a predominant issue in state and local taxation is whether barriers to taxing out-of-state sellers should be relaxed. The current standard, set forth by the Supreme Court, is that a seller must have some physical presence in a state, whether through property, employees or independent contractors, before a state can subject the seller to its taxing laws.[22] For example, if a resident of California purchases a book from a local bookstore, the seller has an obligation to collect California sales tax on the transaction. But if the same person purchases the same book from an electronic book merchant who does not have a physical presence in California, the seller does not have an obligation to collect California sales tax on the transaction.

As of now, it is unclear whether, or to what extent, this discrepancy will continue. The current system has been criticized as economically distorting because it provides a tax incentive to purchase goods over the Internet rather than through conventional means. It also has been criticized as inadequate to meet states' and localities' revenue needs. On the other hand, it has been argued that if current rules were relaxed, it would be too burdensome for electronic merchants to comply with the different sales tax regimes of the 50 states and countless localities. Technical issues also would arise, such as where delivery would take place when a seller transmits a good electronically.

In the meantime, states seem to be of the dual view that taxation should not hinder the development of electronic commerce and that electronic commerce should not erode their tax bases. The actions of California in this regard are instructive. In August 1998, California adopted its

22. *See* Quill Corp. v. North Dakota, 504 U.S. 298 (1992). In *Quill,* the taxpayer sold goods to customers in North Dakota through a mail order catalogue. The taxpayer did not have any employees in North Dakota, or otherwise have a physical presence in North Dakota. At issue was the whether the corporation was required to collect North Dakota use tax on sales made to residents of North Dakota. The Supreme Court held that a corporation must have some physical presence in the state for the state to be able to impose the obligation to collect use taxes.

own Internet Tax Freedom Act,[23] which imposes a moratorium on certain taxes relating to electronic commerce. The legislature stated that its intent was to place the greatest possible barrier on the creation of discriminatory taxes.[24] Consistent with this sentiment, the California Franchise Tax Board ruled that a person having a mere electronic presence in a state, e.g. through a server, does not have sufficient nexus with the state to be subject to the state's taxing laws.[25] However, the Electronic Commerce Advisory Council, appointed by former California governor Pete Wilson, recommended in December 1998 that the federal government compel out-of-state vendors to collect sales tax under a simplified, streamlined system that would reduce compliance burdens.[26]

Thus, the outlook for state and local taxation seems to be some sort of relaxation in the rules restricting the taxation of remote sellers, but nothing is certain in this regard. It is certain that nothing material will be accomplished until at least 2001 after the current federal moratorium is lifted.

III. CONCLUSION

With black letter rules on electronic commerce taxation in short supply, the onus is squarely on governments at all levels to develop a coherent and well thought-out taxing regime. A prerequisite for the development of international rules is the agreement of the world's nations on what those rules should be. Specifically, the world's nations need to agree on how the basic principles of international taxation—that income should be subject neither to double taxation nor nontaxation—should be adapted to income derived from international electronic transactions. Such a consensus will not develop if certain nations believe that they are being denied their fair share of electronic commerce taxing revenue. Thus, it is likely that a worldwide consensus will not develop at least until the world's nations are secure in their understanding of how the Internet will effect their economies.

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23. CAL. REV. & TAX. § 65001 (West 1998).

24. *See* Kathleen Wright, *States of Mind: Logging onto the New Tax World: California Passes its Tax Freedom Act*, 98 STATE TAX NOTES 197-3 (1998).

25. *See, e.g.*, CAL. CODE REGS. tit. 18, § 1684 (West 1999), which provides that the use of a server on the Internet to create or maintain a Web page or site by an out-of-state retailer is not considered as a factor in determining whether the retailer has substantial nexus with California.

26. *See* Jeremy Holmes, *Council Issues Report on E-Commerce, Urging Simpler Rules, Out-of-State Collection*, 240 DAILY TAX REP. H-1 (1998).

Under present state and local sales and use tax law electronic merchants who have no physical presence in a particular state need not collect sales and use tax on behalf of that state. Federal action will be necessary for states and localities to collect more vigorously sales and use tax. Such action will not be forthcoming until at least late 2001 when the current federal moratorium on the imposition of Internet-related taxes expires. In the meantime, businesses will continue to interpret existing rules to their advantage, and state and local governments will continue to leave valuable sources of revenue untapped.