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# International Taxation of Internet Commerce

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I. The Internet: A Brief History

1989 Tim Berners-Lee, a consultant at the European Laboratory for Particle Physics in Geneva proposed a new method of structuring the organization’s internal information system called “multiply connected web.” The system relied on hypertext. Hypertext (developed by Doug Engelbart and named by Ted Nelson) allowed a document to link instantly to another point on the document or to other documents. Berners-Lee had previously developed software called Enquire to track random pieces of information and to allow multiple user access. (Some historians source the Internet’s origins to 1969 when the first computer network known as ARPANET (Advanced Research Projects Agency Network) was created by the U.S. Defense Department. ARPANET was designed to provide computer-to-computer communications between research centers.)

1990 A prototype of the system was initially run on a NeXT computer. The system was called “World-wide Web” by Berners-Lee. With a browser and mouse, a user could now access any document within the system.

1991 The first web server in the U.S. was installed at Stanford’s Linear Accelerator Center.

1991 The Geneva group (called “Cern”) began to distribute its text-based browser at no cost. Other labs in Europe and the U.S. set up their own web servers.

1993 Mosaic (the first graphical Web browser) was developed by the National Center for Supercomputing Applications and the University of Illinois. With free distribution, popular interest began to grow. There were 250 web servers in place by the end of 1993.

1994 Marc Andreessen (a developer of Mosaic) joined up with Jim Clark and co-founded Mosaic Communications Corp., later renamed Netscape. By the end of 1994, there were approximately 2,500 web servers.

1995 Microsoft started focusing on the Web and the “Microsoft Internet Explorer” was developed. Sun Microsystems developed HotJava and interactive components were developed. Netscape went public in August 1995. In September 1995, Internet addresses were no longer free - the initial price was $50.

1996 “Push technology” became popular (pre-set published materials are delivered automatically to subscriber).

1997 Browser wars between Netscape and Microsoft commenced.

1998 The U.S. Department of Justice commences action against Microsoft. Ken Starr publishes the Independent Counsel’s Report on President Clinton’s “low-tech” activities creating a new form of “Rush Politics.”
II. Internet Definitions and Terms

Internet
The Internet or “Net” is a vast international network of networks that enables computers of all kinds to share services and communicate directly with each other.

World Wide Web (“WWW”)
The graphical, hypertext portion of the Internet. The “Web” blends text, images, video and audio instead of displaying simple text.

Electronic Commerce
Consumer and business transactions conducted over a network, using computers and telecommunications.

Browser
A program used to access the WWW.

Cyberspace
The three-dimensional expanse of computer networks in which all audio and video electronic signals travel and users can, with the proper addresses and codes, explore and download information.

Hypertext
Text that contains embedded links to other documents or information.

HTML
Hypertext Markup Language. Hypertext is text that contains embedded links to other documents or information.

Shrink Wrap License
SWL is a business rather than legal term referring to the nature and extent of rights being transferred in the context of mass marketed or “off the shelf” software.

Internet Service Providers (“ISP’s”)
Organizations which provide individuals and businesses with access to the Internet (including commercial web sites). ISPs may be wholesalers or retailers or both. A wholesaler normally resells bandwidth and certain other services to smaller ISPs who act as retailers. The most significant component of the sale price is the amount of bandwidth purchased.

Internet Access
Customers of ISPs access the Internet through a modem connection or direct line from their computer to the ISP server.

Bandwidth
Bandwidth or “capacity” is how much information or traffic can be carried on the Internet in a given amount of time. The greater the bandwidth, the greater the ability to expand e-commerce applications. For example, low bandwidth prevents music from being transferred. High bandwidth would allow movies to be transferred.

Server
Computers which store information for access by users of a network, including the Internet.

URL
Universal resource locator or Internet ID Number
III. Geopolitical Tax Implications

Commercial activities on the Internet are predicted to rise dramatically over the coming years. With it, international tax policy will take up the growing concerns that billions in tax revenues will disappear as a result of the Internet’s ability to shift both the location of a transaction, and the paperless means of completing a transaction. Commerce will shift in the following manner:

a. Products (tangible and intangible products, intellectual property and services) will take the form of digitized information; and

b. The source or residence of both the provider and user can, if needed, be relocated almost at will.

The Internet has been compared to the ancient “Silk Roads” of China in the 2nd Century BC where vast new sources of products and commerce were discovered. The “how and where” to tax profits on exchange of goods and commerce on the Net should follow traditional rules in many situations. However, the fundamental change in how many aspects of Internet commerce differ from traditional forms of business will mean that existing domestic laws and international tax treaties will not always work. In some cases, the struggle will be define or fit new methods of transacting business within traditional rules of taxation. New tax legislation will inevitably need to be drafted.

The Internet will have major impacts on the following:

International tax policy harmonization, including:

♦ National systems of income tax
♦ Treaty negotiations
♦ Tax credit mechanisms
♦ Communication taxes and similar excise

Local tax policy concerns, including:

♦ Local and regional income taxes
♦ Sales and use taxes
♦ Value added axes

The information below will summarize several concerns and approaches which tax policy authorities have identified. A study of the current state of affairs leads one to conclude:

1. Tax laws and interpretations will be much more susceptible to challenge. Inconsistency in how new and existing rules are applied may undermine tax policy and create tensions at the international level. The debates within the U.S. involving the Internet Tax Freedom Act (a complete copy of the act is available at www.rowbotham.com under “Internet Commerce”) offer evidence that taxing authorities will see themselves as winners and losers depending on the outcome of how existing statutes are applied as well as how new laws are enacted; and

2. Governments at all levels are very concerned about the potential loss of revenue through legitimate planning and through tax avoidance schemes due to difficulties in auditing and tracking commerce conducted over the Net.
The U.S. government has encouraged a laissez-faire approach to taxing Internet commerce, and has promoted restraint at the local and international level. While this may reflect the best interests of the country’s new economic juggernaut, the concerns at the international level will only grow as the volume of e-commerce increases.

IV. Selected Tax Policy Implications of Global Electronic Commerce

The comments below summarize the U.S. Treasury’s concerns about federal and international tax policy related to electronic commerce. The comments are based on a Department of Treasury report issued in November 1996.

A. Overview

1. To insure technologies would not be impeded, there must be a system of neutrality which means (a) no new taxes would be imposed; and (2) the tax system would tax e-commerce transactions in a manner which does not discriminate.

2. Problems will most likely arise concerning which country or jurisdiction is entitled to levy tax on e-commerce transactions.

3. To clarify the proper jurisdiction, “source based” taxation (where the income is generated) will be less important than “residence based” taxation (residence of provider and user). This area is particularly complicated due to the fact that no real hub for the Internet exists. Communications via the Internet can travel over cable, satellite links and through the World Wide Web.

4. Problems will occur in classifying the nature of income (i.e. sale of goods vs. royalty vs. provision of services).

5. Compliance with tax laws and reporting is a great concern, since transactions conducted over the Net are harder to trace or audit. “Cybercash” will eliminate traditional forms of documentation.

6. The commercial transactions currently being conducted over the web now include:

   a. Retailing and wholesaling (replacing catalogues)
   b. Computer software transfers without the need for disks or CD-Roms
   c. Photographs and movie sales
   d. On-line information
   e. Services
   f. Health care
   g. Video conferencing
   h. Gambling
   i. Stock trading

B. Tax Policy Considerations

1. Tax neutrality. Neutrality requires that the tax system treat economically similar income equally regardless of whether earned is earned through electronic means or through more conventional channels of commerce. By leaving e-commerce in a tax neutral position, it will succeed or fail based on market economic factors only. As we shall see, many of the internet-related questions can be resolved using traditional tax analysis. However, the lack of central control and lack of a physical location will present new issues.
2. International tax issues will include the need to define:
   a. a trade or business within a country;
   b. source of income concepts; and
   c. residence of a taxpayer.

3. Income derived from the use of intellectual property (“IP”) is sourced where the economic activity occurs. For example, the source of income from IP is based on where the IP is being used (Internal Revenue Code § 861(a)(4)). [All sections refer to the Internal Revenue Code of 1986.]

4. Compensation for labor or personal services has its source in the location where the labor or personal services are performed. (§ 861(a)(3)).

5. Residence-based source rules have been adopted for certain types of income such as capital gains and swap income because the country of residence represent the location where the economic activity that produces the income occurs. The nature of the income is also important for determining the source. In general, the source will flow from the nature of the income. For example, royalty will be sourced where the copyright or patent is used.

6. Treaties will be impacted by the Net. The U.S. currently has treaties with over 50 countries. Countries which tax income based on source of income (most do) give up the right to tax income if there is no “permanent establishment” or fixed base of operations in the host country. Since income generated in cyberspace will be difficult to tie a particular jurisdiction, the residence issues will increase in importance.

   (The Internet will add a level of complexity with the use of “mirror sites”. A mirror site is a site with a duplicated batch of information stored in locations which are closer to the end user. The purpose may be to allow faster access to the information. The mirror site may be updated periodically or very frequently from the main storage site, depending on the information needed and the customer requirements.)

7. In 1986, Congress adopted the residence-based concept for sales of personal property (§ 865). However, with the sale of personal property, the location of the economic activity would be determinative (Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Gong. 1st Session (May 7, 1987), referred to as “Bluebook”).

C. Digitized Information

Digitized information may blur the lines since the right to purchase ten goods “on-line” or to reproduce ten goods from one master downloaded may involve different rights. At the time of the Treasury’s study, proposed regulations on computer programs were issued. The regulations classified transactions as being:

- Transfers of copyright rights;
- Transfers of copies of the copyrighted program;
- The provision of services for the development or modification of a computer Program; or
- The provision of know-how regarding computer programming techniques (Prop Treas. Reg. S 1.861-18(b)(1)). [See discussion on final IRS Regulations below.]
Products such as music, books, images and programs can now be digitized and transmitted and downloaded via the Internet. The user may acquire the right to a single copy, to multiple copies or for mass circulation. The facts will determine whether the transactions involve a payment for the purchase of property or a royalty for the use. Payments (generally structures as a license fee) or the use of copyrights, patents and other intellectual property (IP) may be taxable in the U.S. (§ 861 (a)(4), 871(a)(1)and 881(a)(1)). The tax rules need to operate in a “neutral” form so that the manner of taxation is not impacted merely by the form in which the information is being distributed.

In general:

1. Payments made for the use of for the privilege of using copyrights are considered royalties (§ 861(a)(4), Treasury Regulation 1.861-5).
2. Payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work are royalties (U.S. Model Treaty note 54, Article 12, paragraph 2).

D. Effect on Controlled Foreign Corporation Rules

The Internal Revenue Code includes: “Subpart F” rules (§ 951 - 964) which restrict the ability to defer tax by shifting income to controlled foreign companies. The Subpart F provisions generally disregard tax income earned by the CFC as though the parent company actually earned it. The IRS may have more difficulty to enforce compliance if highly mobile income is shifted to tax haven jurisdictions:

1. There is difficulty in verifying the income “owner”;
2. The source of income can be shifted to zero tax jurisdictions with present technology; and
3. Existing transfer pricing rules (transfer pricing requires arms length pricing between related parties (§482)) may not work properly where transfers of intangibles over the Internet are involved.

E. Tax Administration

Concerns about tax administration involve:

1. Use of electronic money;
2. Identity verification;
3. Record keeping and verification for electronic transmissions; and
4. Information reporting.

Further study by the Treasury will be needed.

V. Tax Treaty Implications

A. Permanent Establishments and the Question of Residency

The Treasury has had problems with determining whether a foreign “person” is engaged in a U.S. trade or business, particularly if the activities conducted “within” the U.S. are the solicitation of new business. The engaging of such activities by employees or through agents have been enough to attract taxation.
The Treaties will possibly need rewriting to deal with the new concepts in cyberspace transactions.

Consider the following case study of Gainger & Son v. Gough, which considered the following cross-border activities:

This case considered whether a business was carried on in the United Kingdom. The case involved a French wine merchant. He had sales agents in Britain who transmitted orders to the merchant in France. Since the contracts were executed in France, and title or delivery was made in France, the merchant was not taxable as a nonresident conducting business in the U.K. This would be consistent with the permanent establishment provisions of the treaty between France and the U.K.

How will the following facts be interpreted if the same commerce is conducted via the web:

Assume that the merchant has a web page with the host computer in France and the ultimate buyer (of downloaded software in this case) is in the United Kingdom. The software is, prior to being sold, stored on the host computer in France. If the place of contract completion and point of delivery are determinative, will the software company be carrying on business and taxable in the U.K.? The answer is more difficult since the point of delivery, the computer in the U.K., does not represent any physical activity by the software vendor in France. In several jurisdictions, commentators agree that such a transaction would subject the French vendor to local country taxation (i.e. a permanent establishment exists).

Consider a software developer who sells directly to a distributor in India. The U.S. seller is taxed on all revenues. If the U.S. company established a subsidiary company in a zero tax jurisdiction, income in the U.S. can be arbitrarily moved to the offshore jurisdiction through manipulating the price.

B. OECD Model Treaty

The Organization of Economic Cooperation and Development (“OECD”) is a Paris-based organization of 24 industrialized countries which coordinates member state’s economic policy strategies. The OECD superseded the Organization for European Economic Cooperation (created in 1948 to promote recovery of Europe under the Marshall Plan).

The OECD Model Treaty adopted by the has a higher threshold before taxation can occur through a “permanent establishment” (Model Tax Convention on Income and Capital, OECD Committee on Fiscal Affairs, hereinafter referred to as OECD Model Treaty). Under the OECD Model Treaty, a person will not be taxed on income derived from U.S. sources that are not attributable to a permanent establishment in the U.S.

Questions:

a) What forms of e-commerce constitute activities beyond mere solicitation activities?

b) When will e-commerce create a physical presence in the U.S.?

For example, servers can be located anywhere in the world. Will a server create presence in the U.S.? If a U.S. server creates a U.S. presence, a non-U.S. server will be utilized. Several states, e.g. Texas, have attempted to impose tax jurisdiction when a server is present in the state. A company originating in India will need to carefully consider state tax issues. Unfortunately, states do not abide by income tax treaties negotiated by the federal government.
A permanent establishment generally requires a fixed place of business unless it is created through imputation through an agent (OECD Model Treaty) or by a partnership or joint venture (§ 875). Existing commercial activities need to be reviewed. For example, a PE generally does not include an activity solely for purpose of display, storage or delivery of goods or merchandise. It might however, be conceivable that a server could be considered a “data warehouse” although no cases are on record. The PE concept may need to be reviewed in light of e-commerce.

A PE may arise by imputations of an agent’s activities (U.S. Model Treaty, note 55, Article 5 paragraph 23). Take the example where a foreign researcher is selling information. The seller has a web site using a U.S. based ISP. Since the foreign person’s relationship with the U.S. ISP would be considered independent in most instances, there should not be a U.S. PE (see OECD Model Treaty note 5, Article 5, paragraph 5).

Article 7 of the Model Treaty provides that “an enterprise of a Contracting State generally is exempt from tax on its profits derived from business carried on in the other Contracting State unless those profits are attributable to a permanent establishment located in that other Contracting State”

Article 5 defines a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partially carried out.

A business enterprise which constitutes a permanent establishment includes “a place of management, a branch, an office, a factory, a workshop, a mine, an oil/gas well, and a quarry or other place of extraction of natural resources.”

1. It would appear that a physical presence is necessary for a PE to exist.
2. In addition, it would appear that, by definition, permanence of some sort should exist.

The Internet seems to meet these tests in theory only. Does a web page have physical presence? If a physical presence does exist via a host computer, it is likely that this host will be wherever the computer resides.

C. The UN Model Treaty

Permanent establishment: The definition includes dependent agents that maintain a stock of goods from which they make deliveries on behalf of principals. Thus a web page might be considered an electronic agent.

In many existing treaties, an exception to the definition of permanent establishment exists if a resident of one contracting state only advertises its products and services, or maintains a know-how or patent agreement in the first country. (See U.S./India Income Tax Treaty Article 5().) The current model treaties for the U.S. and OECD revise this with the phrase “any other activity of a preparatory or auxiliary character.” An Internet activity which merely advertises, e.g. in a home page format, would seem to come within this definition. However, with new forms of “push technology” and with the ability to obtain local purchasing and local support through the web site, the application of this language may get stretched.

D. Income Classification: Sales or Royalty?

In 1992, the OECD published a report which provided guidelines on transactions dealing with computer software. The principles of the guidelines are summarized as follows:
1. Payments made in connection with software represent royalties where there is a limited grant of rights (i.e. there has been no change in ownership).

2. Payments for software which is acquired for business use or personal use do not represent royalty payments.

3. Payments made for the alienation of all rights attached to software do not represent royalties.

4. Purchase of less than all the rights attached to the software will depend on the particular circumstances, and the payment may not represent a royalty.

5. Where “mixed payment” contracts are executed (e.g. hardware sales with built-in software), the payments should be apportioned to parts and treated accordingly. Where payments for certain parts are insignificant or ancillary, the treatment of the principal component should prevail.

6. Where double taxation agreements provides for source taxation in respect of some, but not all, royalties, software payment that have royalty characteristics will normally be characterized as paid in respect of copyright.

Where royalty treatment does not apply, payment will most likely be treated as capital gains, business income or personal service income depending on the circumstances.

VI. IRS Final Regulations on Classification of Certain Transactions Involving Computer Programs

(T.D. 8785) Issued October 2, 1998

Regulations distinguish between transfers of copyright rights and transfers of copyrighted articles based on the type of rights transferred to the transferee. Copyright laws grant certain exclusive rights to a copyright owner.

Proposed Regulations were issued on November 13, 1996, and public comments were heard on March 19, 1997. The Proposed Regulations focused in part on whether transaction concerning computer software should be considered a sale or a royalty arrangement. While copyright law will be important, it will not be determinative. Some commentators requested that the definition of computer program be expanded to include databases and other forms of digitized information. The final regulations issued in October, 1998, retained the 1996 definition of computer programs which include: any media, user manuals or documentation or similar times (in addition to databases) if incidental to and routinely transferred along with the computer program.

The final regulations apply only to cross border transactions. Foreign law is not relevant when classifying a transaction involving computer programs since U.S. tax law is not dependent upon foreign copyright law. The regulations do not modify any of the foreign tax credit provisions nor do they modify the rules regarding the creditability of a foreign tax, for the timing of the credit as a foreign tax.

The final regulations treat transactions involving computer programs into one of four categories:

1. A transfer of a copyright right in the computer program;
2. A transfer of a copy of the computer program (a copyrighted article);
3. The provision of services for the development or modification of the computer program; or
4. The provision of know-how relating to computer programming techniques (Treas. Reg. 1.861-18(b)(1)(i - iv)).

The Final Regulations include 18 examples which are helpful in determining the source of income. The Regulations are produced in full under “Internet Commerce” at www.rowbotham.com.

VII. State and Local Sales & Use Taxes

There are three taxes currently imposed at the state level on sales over the Internet:

1. Taxes on Internet access charges.
2. Taxes involving the sale of goods.
3. The purchase of software which is downloaded from the Internet.

A. Nexus is required for taxes to be imposed by local taxing authorities

1. Connection or physical contact is usually required.

The Federal Constitution limits the ability of the 50 states to tax:

♦ Due Process Clause - linkage or minimum connection must exist that income which is taxed is “rationally” related to the connection. “Substantial Nexus” is required.

♦ Commerce Clause - prohibits states from burdening or interfering with state commerce.

2. Tangible personal property

a. Nexus exists if tangible property is owned, leased or licensed.

Cases

♦ National Geographic v. California Board of Equalization - nexus created by employees in state where advertising activities were carried out.
♦ Nelson v. Montgomery Ward, Nelson v. Sears Roebuck & Co. - nexus was created by store activities re: mail order sales

b. Nexus may exist if there are agents or employees in the state.

Cases

♦ Reader’s Digest v. Main (Illinois 1970)
♦ Pearle Health Services, Inc.
♦ General Trading v. State Tax Commission (U.S. Supreme Court, 1944)
♦ Tyler Pipe Ind. V. Washington State Department of Revenue
c. Independent contractor in state can create nexus.

Cases

♦ Scripto Inc. V. Carson (U.S. Supreme Court, 1975)
♦ Scholastic Book v. State Board of Equalization (AC 1989)

d. Public Law 86-272

♦ PL 86-272 is a federal statute which prohibits states from imposing tax on the sale of tangible property if the seller’s activity is limited to solicitation of sales and sales are shipped from outside of the state.
♦ Only sales of tangible property are protected by PL 86-272 (i.e. Geoffrey is not impacted).
♦ Independent contractor may be able to solicit sales.
♦ In many internet situations, the “seller” does not know which state the product is going to in the case of intangibles or when products are downloaded.

B. Quill v. North Dakota

1. Quill is a leading case for mail order businesses. The issue litigated was whether a company could be liable for collection of use tax if its only connection with a state (North Dakota) was a common carrier.

♦ The Supreme Court stated that the “Due Process Clause of the Constitution was not violated by the tax since the company had “purposefully availed itself of the benefits of an economic market in the state.”
♦ Supreme Court ruled in favor of Quill that out of state calls was insufficient to collect use tax on purchasers in state.
♦ Court cited National Bellas Hess (National Bellas Hess, Inc. v. Department of Revenue of Illinois), a 1967 Supreme Court Case that physical presence is necessary for use tax to apply. In National Bellas, the Court found a seller whose only connection with customers in a state is by common carrier or the mail lacked the requisite minimum contacts. However, the Court set aside this test as being determinative.
♦ The Court ruled in favor of Quill. While a mail order business itself did not create nexus, absent a physical presence, there was not “substantial nexus”.
♦ Several states laws creating nexus were invalidated due to Quill but still remain on the books. They typically involve out of state solicitation or mail order activities.

2. In Quill, the company also licensed software to clients in North Dakota. The state also attempted to treat this activity as creating nexus. However, the Supreme Court ruled that this activity did not meet the constitutional test of nexus. However, this case involved only minor sales on discs. States may argue that Quill does not apply if substantial licensing activities take place.

3. In a recent case in New York, the U.S. District Court ruled that advertising on the web site located on a server (located in Missouri) did not establish nexus in New York (Bensusan Restaurant Corp V. King, 96 Civ. 3992 (SDNY 1996)).
C. Nexus might apply as a result of activities of an affiliate company.

♦ Levitz Furniture Co. of Eastern Region, Inc. (NY 1986) In this case, a subsidiary of the parent company was formed in New Jersey. Deliveries were made into New York. This company created enough Nexus for the parent company.
♦ Current Inc. v. California State Board of Equalization - An out of state stationary store with in state companies was taxable under the theory of same line of business or controlled by the same interests.

D. Computer Software

1. Many states impose tax on sale or lease of software. Software in these circumstances is treated as tangible property (e.g. California).

2. Service and sales representatives within a state will create nexus in most states.
   
   Cases
   ♦ Cally Curtis (CT 1990) - video tapes leased to CT residents from out of state did not create CT nexus.
   ♦ Quill - licensed software did not create nexus in North Dakota.

3. States often distinguish between canned and custom software
   ♦ Canned is usually off the shelf and is usually taxable.
   ♦ Modified or custom software is usually a service and not taxable.

E. Intangible Property and Sales and Use Taxes

1. Geoffrey (Geoffrey, Inc. v. South Carolina Tax Commission) is a leading case.
   a. Company was a wholly owned subsidiary of Toys R Us of Delaware. It had no employees or offices or tangible property in South Carolina. In 1984, Geoffrey executed a license Agreement which allowed TRU to use its trade name and other trademarks in all states except New York, Texas, Pennsylvania, Massachusetts, and New Jersey. Geoffreys would receive a one percent license. In 1985, the TRU company began making royalty payments to Geoffrey and deducted the cost.
   b. The Supreme Court of South Carolina found that the company had purposefully directed its activities to South Carolina. The Court found that Geoffreys had presence due to the intangibles used in the state and that this created nexus. The Commission held that Geoffrey was required to pay the tax.
   c. Other states are looking to Geoffrey as a basis for taxing intangibles and Internet commerce.

VIII. California Taxation of Internet Commerce

A. California AB 1614 (Revenue & Taxation Code Section 65001 through 65004) was signed by Governor Wilson on August 24, 1998:

1. Effective January 1, 1999
2. Act places a 3-year moratorium on imposition or assessment of Internet access or on-line service charges.
3. The new statute does not provide any exemption if nexus exists.
4. The statute clarifies that taking orders over the Internet or advertising over the Internet does not create a nexus.

**Sales of goods over the Internet**

1. Treatment of sale of tangible goods is the same as for sales of tangible personal property though traditional channels.
2. Nexus will determine the application of sales or use taxes.
3. The purchaser will remain liable for the tax if the seller has no nexus. The purchaser will remain liable until the tax is paid.

**Software downloaded**

Information or software which is downloaded from the Internet is exempt (California Revenue & Taxation Section 1502(f)(1)(D).

**IX. Internet Access Charges**

The Internet Tax Freedom Act was incorporated into the Omnibus Spending Bill and was signed into law this year.

The highlights of the bill are:

- A three-year moratorium on new taxes imposed on all states, effective October 1, 1998. The restriction applies to taxes on internet access and multiple or discriminatory taxes on electronic commerce. Taxes in existence as of October 1 are not impacted by this bill.

- The moratorium will not apply, however, if an individual or entity makes harmful or pornographic materials available to minors over the world wide web without taking reasonable measures to avoid distribution of such materials to minors.

- The legislation is the first to provide a definition of the “Web” as “…computer based server based file archives (which is) publicly accessible, over the internet, using hypertext transfer protocol, file transfer protocol, or other similar protocols.”

- “Internet means collectively, the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected worldwide network of networks that employ the transmission control protocol/internet protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.”

- The Bill establishes a 19 member commission (which will exist for 18 months) to include: Secretaries of Commerce and Treasury and a U.S. Trade representative, 8 state and local government representatives and 8 members from electronic commerce industry.

The Commission’s purpose is to conduct a thorough study of Federal, State and local and international taxation treatment of internet taxation.
♦ The Bill also included a declaration that the Internet should be free of any new Federal taxes.

X. Electronic Commerce: U.K. Taxation policy

On October 6, 1998, the U.K. Inland Revenue and U.K. Customs and Excise authorities published a joint policy paper regarding the taxation of electronic commerce. This paper was the product of a May 1998, meeting in Birmingham, U.K. between the G8 Finance and Foreign Ministers.

The U.K. e-commerce taxation policy aims to ensure the following:

1. That taxation policy and administration must keep pace with the scope of electronic commerce and with the growth of the global market place;
2. That opportunities, both domestically and internationally, will not be stifled by taxation; and
3. That tax revenues remain secure so that public services can be adequately funded.

For U.K. businesses, tax priorities include:

♦ Certainty about the tax rules,
♦ Neutrality between electronic and conventional commerce,
♦ No double or unintentional non-taxation,
♦ As low as possible compliance costs,
♦ No new taxes on electronic commerce, and
♦ The use of modern technology by the tax administrations to improve the service they offer their customers.

In terms of the international arena, there is a recognition that effective international co-operation is necessary to avoid the risk of individual countries taking unilateral action. The OECD is the most appropriate international forum for bringing together examination of all the tax issues with also, for VAT, the European Community.

The broad policy principles guiding these policies are neutrality; certainty and transparency; effectiveness; and efficiency.

Neutrality: The taxation of electronic commerce should seek to be technology neutral.

Certainty and Transparency: The rules for the taxation of electronic commerce should be clear and simple so that businesses can anticipate, so far as possible, the tax consequences of the transactions into which they enter.

Effectiveness: The tax rules should not result in either double or unintentional non-taxation, and risks from increased evasion and avoidance should be kept to a minimum.

Efficiency: The tax rules should be efficient, keeping the compliance costs of business and the administration costs of government to be the minimum compatible with effective tax administration. Measures to counter evasion or avoidance should be proportionate to the risks which they seek to address.

Wherever possible, it is important to reduce costs to business and Government and encourage voluntary compliance. Modern methods of communication provide opportunities for improved customer service. For example, the Departments have developed systems for the electronic filing of returns. In addition, they will continue to develop their websites and, as cryptography systems and other technologies advance, will
consider wider use of e-mail communication. The Departments will aim to provide clear, easily accessible guidance on tax obligations.

As technology develops, the Revenue Departments will explore, together with the private sector, how new technologies might be used by businesses to collect and process information relevant to their tax liabilities. Less time will be spent by both business and the tax administrations in correcting errors and tracking down missing information, and compliance costs will be driven down.

**Tax Administration and Compliance Issues**

The Departments are looking very carefully at certain areas where electronic commerce has the potential to significantly amplify risk to tax compliance. These areas include:

- Taxpayers using the Internet to conceal their identity, their location and/or prior transactions;
- Encryption of documents and financial records or the holding of them in other jurisdictions to prevent the tax administrations gaining access to them; and
- Any electronic record keeping system which allows transactions to take place without leaving an audit trail or where the trail may be easy to alter or destroy.

**Direct Tax Issues**

The Inland Revenue is working with business and through the OECD to find solutions to a number of direct tax issues. The U.K., like many other countries, requires tax to be withheld from royalty payments in some circumstances, i.e. payments for the use of, or the right to use, a copyright. The current rules which distinguish between such payments and payments for goods and services, from which tax does not usually need to be withheld, were developed in relation to physical products.

It is increasingly possible for images of certain products to be transmitted electronically rather than in physical form, e.g. various forms of written text (such as newspapers, or magazines, or reference material) and photographs. Customers may have to pay a fee before being allowed to view the images; and, in any event, usually will have to pay a fee before being allowed to download a copy of the product. The operation of computer software can be viewed in a similar way before customers download a copy after payment of a fee. In the future, it may also be possible to download music easily. Customers may be allowed to modify downloaded products or to incorporate them into in products which they develop themselves, either for their own use or to sell to others. It is not always clear whether payments to view and download such products for those various uses are, in whole or in part, payments for the purchase of goods or services. If they are the former, practical issues arise concerning whether, under U.K. law, the customer should deduct and account for tax when making the payment.

OECD is reviewing the guidance which it has already given on the nature of payments for computer software in the OECD Model Convention on Income and on Capital.

**Permanent Establishment**

The U.K. taxes nonresidents on their U.K. source income. But where we have a tax treaty with the person’s country of residence, we only exercise our taxing rights if the person has a permanent establishment here as defined in the tax treaty (the U.K. generally adopts the definition of permanent establishment in the OECD Model Tax Convention). Questions have been raised about the continuing relevance of the permanent establishment concept.
The use of permanent establishment as a threshold for taxation is a long-standing and widely supported one, and the Government sees no need at the present time to depart from it. To do so could have far reaching implications for all types of businesses, and for U.K. businesses trading abroad as well as for non-residents trading in the U.K. The Inland Revenue will instead continue to work closely with the OECD to keep under review the continuing appropriateness of the concept.

The Government does, however, believe that the detailed application of the permanent establishment concept to electronic commerce needs clarifying. In particular, the U.K. is aware that business is concerned to know whether a web-site on a server could be a permanent establishment and, if so, in what circumstances. The U.K. is therefore working with OECD to up-date the explanatory commentary to the OECD Model Tax Convention.

**Transfer Pricing and Attribution of Income to Permanent Establishments**

Electronic commerce is likely to have the effect of increasing the complexity of arrangements required to be examined under the arms length principle used to determine the appropriate prices for transactions between associated persons in different jurisdictions. The number of such complex arrangements is also likely to increase. It could become more difficult to identify where relevant functions have been performed, to quantify the value added in relation to business conducted over the Internet, and to establish where any such value has been added.

In addition, the Inland Revenue also is contributing to the work currently being done by OECD on the subject of the attribution of profits to permanent establishments, and taking into account situations likely to arise in the electronic commerce field.

**Indirect Tax Issues**

For VAT, the implications of the development of electronic commerce can be examined in relation to three broad categories of transaction, namely:

- Supplies of physical goods to both business and private consumers;
- Business to business supplies of services; and
- Business to private supplies of services and of ‘digitized’ products.

At present the vast majority of electronic commerce based supplies fall into the first category of supplies of physical goods, and most are business to business transactions within a single country. Typically in these cases the Internet is used as a means of communication to place an order. Existing VAT rules (including those applicable to intra-EC and international trade) are, in general, readily applicable to such physical deliveries of goods purchased using electronic means.

The second category of transactions – business to business supplies of services – should similarly be capable of accommodation within existing rules. In particular, where U.K. businesses buy certain services from existing suppliers based outside the U.K., they already make use of an existing VAT accounting mechanism (‘reverse charge’) whereby the U.K. business customer accounts for VAT. This mechanism ensures that U.K. suppliers are not unfairly disadvantaged (as compared with non-U.K. suppliers), that VAT is properly accounted for, and that the non-U.K. supplier is not required to register in the U.K. Such arrangements could usefully be extended to take account of the likely growth in provision of services over the Internet.

The third category of transactions – supplies of services to private consumers – presents potentially the greatest tests to effective tax administration. But it is also the least well developed and so remains very small. Trading models in this sector are still evolving in tandem with technological developments.
Satisfactory VAT arrangements for this category of transactions will have to be developed. The U.K. is working with all interested parties including software developers.

In addition to the principles outlined earlier in this paper, the EC has recently agreed a set of general principles which provide a useful foundation for further, more detailed work. In summary, these are:

1. The focus of activity should be in adapting existing VAT provisions to accommodate electronic commerce based on internationally established guidelines. In this context, no new taxes are envisaged at this stage;

2. ‘Digitized’ products supplied by electronic means should be treated, for VAT purposes, as supplies of services;

3. The place of taxation of services supplied by electronic means should, in principle, be the place of consumption;

4. The tax system should be readily enforceable by tax administrations;

**Customs Duties**

A distinction needs to be drawn between goods ordered electronically but delivered by traditional means and direct on-line delivery of digitized products.

In line with the WTO Declaration on Global Electronic Commerce, goods ordered and supplied electronically will continue to be treated as ‘services’ and as such be free of import duties, but remain liable to VAT. Goods ordered electronically but delivered physically from outside the EU will continue to attract the rate of duty appropriate to that commodity. However, no additional import duties will be introduced relating to electronic transmissions.

**Betting and Gaming Duties**

Electronic commerce has the potential to facilitate the growth of Internet-based betting and gaming, so threatening the tax base of certain of the U.K.’s duties in this sector. For example, ‘virtual casinos’ on the Internet, when not established in the U.K., currently escape U.K. duties. International co-operation to examine the implications of this and identify suitable safeguards, is vital. The U.K. intends to play an active role in these discussions.

There is still much work to be done both domestically and at an international level. The Inland Revenue and Customs and Excise authorities will continue this work, particularly within OECD, and for VAT, within the EC.