OVERVIEW OF ISSUES RELATED TO THE INTERNET TAX FREEDOM ACT AND OF PROPOSALS TO EXTEND OR MODIFY THE ACT

Scheduled for a Hearing
Before the
SENATE COMMITTEE ON FINANCE
on August 1, 2001

Prepared by the Staff
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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Finance Committee has scheduled a hearing on August 1, 2001, to examine issues related to the Internet Tax Freedom Act. The Internet Tax Freedom Act provides a moratorium on certain State and local government taxes on Internet access and electronic commerce. The moratorium is scheduled to expire after October 21, 2001. This document[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the Internet Tax Freedom Act, and of related developments and proposals to extend or modify the Act.

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Issues Related to the Internet Tax Freedom Act and of Proposals to Extend or Modify the Act* (JCX-64-01), July 30, 2001.

I. OVERVIEW OF PRESENT-LAW FEDERAL TAX PROVISIONS RELATING TO THE INTERNET, AND STATE AND LOCAL GOVERNMENT TAXATION OF INTERNET AND SIMILAR INTERSTATE SALES ACTIVITIES

Federal tax provisions

Income taxation of the Internet

There are no special Federal income taxes on Internet services. The Federal income tax applies to Internet services in the same manner that it applies to any other provision of services. Accordingly, the income received by an Internet service provider is includible in that provider's income for Federal income tax purposes. Similarly, a business that pays amounts to an Internet service provider generally may deduct or capitalize and recover (as appropriate) those amounts as an ordinary and necessary business expense (assuming the other prerequisites are satisfied).

Federal excise taxation of the Internet

Present law imposes no special excise taxes on Internet services. Access to and transactions conducted on the Internet are subject to generally applicable Federal excise taxes in the same manner as other taxable activities. For example, present law imposes a three-percent excise tax on certain communications services (i.e., local and long distance telephone service). Thus, amounts paid for telephone service connecting users to the Internet are subject to this excise tax in the same manner as other payments for telephone service. Charges for actual Internet service are not subject to this tax, as long as the service provided does not otherwise fall within the statutory provisions governing the communications excise tax (e.g., voice quality local or toll service).

International tax provisions

Cross-border Internet transactions generally are subject to the same set of Federal income tax rules and tax treaty provisions that apply to other cross-border transactions. Accordingly, U.S.-based Internet service providers are subject to U.S. tax on all income, whether derived in the United States or abroad (with, subject to certain limitations, credits allowed for foreign taxes paid on foreign-source income). Foreign-based Internet service providers are subject to U.S. tax only if their income has a sufficient nexus to the United States.

Present law generally does not provide special income tax rules for Internet-based transactions and activities and, as a result, issues may arise as to the proper application of general U.S. tax concepts to these activities in the cross-border context. These issues may include the determination of whether Internet-based business activities rise to the level of a taxable presence in the United States (e.g., a U.S. trade or business under Federal income tax principles or a U.S. “permanent establishment” under tax treaty principles), as well as the determination of the geographic “source” of income from Internet-based transactions.

State and local government taxation of interstate transactions

Under the Constitution, a State or local government may impose taxes on sales that occur within its jurisdiction or on the use of property within its jurisdiction. Forty-five States and the District of Columbia impose sales and use taxes.[2] Approximately 7,500 local jurisdictions impose these taxes.[3]

The sales and use tax authority of a State or local government extends to mail order sales by out-of-State vendors to residents of the State.[4] There are, however, limitations on the methods State and local jurisdictions may employ to collect sales and use taxes. State and local sales taxes are levied on final purchasers, but are collected primarily through vendors. Use taxes commonly are complimentary taxes to sales taxes, imposed where vendors cannot be required to collect and remit sales tax. Use taxes typically are imposed on and collected from purchasers (who are expected voluntarily to report their use tax liability).

In the case of a sale by an out-of-State vendor, the U.S. Supreme Court has held that a State or local government cannot constitutionally require the vendor to collect and remit sales taxes unless the vendor has a substantial business nexus with the State.[5] In National Bellas Hess, the Court found that the required nexus was not present if the vendor's only connection with customers in the State was by common carriers or the United States mail.[6] The Court based its conclusion on the Due Process and Commerce clauses of the United States Constitution. The Commerce Clause reserves to Congress the power to regulate and control interstate commerce.[7] The required nexus has been held to exist when the vendor arranges sales through local agents or maintains retail stores in the taxing jurisdiction.[8]

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[2] The five States that do not impose State sales taxes are Delaware, Montana, New Hampshire, Oregon, and Alaska. In all but Alaska, no local sales taxes are imposed either. See, Congressional Research Service, RL30667, *Internet Tax Legislation: Distinguishing Issues* (January 11, 2001), note 6.

[3] *Id.* at 3.

[4] See, e.g., *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944).

[5] *National Bellas Hess, Inc., v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967) (henceforth referred to as National Bellas Hess).

[6] *Id.* at 754.

[7] *Id.* at 760.

[8] *Scripto, Inc. v. Carson*, 382 U.S. 207 (1960) (tax on out-of-state seller upheld despite the fact that all of the seller's in-state solicitation was performed by independent contractors); *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (out-of-state mail order business maintained two offices in California that were unrelated to the mail-order operation but still provided a sufficient nexus).

Subsequently, in 1992, the U.S. Supreme Court ruled that an out-of-state mail-order house with neither outlets nor sales representatives in the State is not required to collect and pay tax on goods purchased for use in the State.[9] The Court ruled that the Due Process Clause did not bar enforcement of the State's tax, but held that enforcing the State's tax would be inconsistent with the Court's Commerce Clause jurisprudence. The Court concluded by stating that "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."[10]

<u>The "Internet Tax Freedom Act"</u>

<u>Moratorium on certain taxes</u>

The "Internet Tax Freedom Act"[11] provides a three-year moratorium on the following taxes on electronic commerce:

(1) Taxes on Internet access, unless the tax was generally imposed and actually enforced prior to October 1, 1998; and

(2) Multiple or discriminatory taxes on electronic commerce.

Taxes are eligible for the exception for generally imposed and actually enforced taxes, if before October 1, 1998, Internet service providers had a reasonable opportunity to know that the State or local tax administration agency and applied the taxes to Internet access services or generally collected the tax on Internet access charges before that date.

In general, a tax is a prohibited multiple tax if it is imposed by a State or local government on the "same or essentially the same" electronic commerce that also is subject to another tax imposed by another governmental entity unless a credit for taxes paid in other jurisdictions is allowed. Prohibited discriminatory taxes are defined as taxes on electronic commerce that (a) are not generally imposed on non-electronic transactions involving similar property or services that are accomplished by other means, (b) are not imposed at the same rate as similar taxes on transactions conducted by other means, or (c) are not imposed on the same party to the transaction as taxes on transactions conducted by other means. For example, a sales tax imposed on Internet purchases of widgets, but not on purchases of the same product at local stores on the taxing jurisdiction would be a discriminating tax.

The moratorium is scheduled to expire after October 21, 2001. The Internet Tax Freedom Act states that its provisions do not affect any State and local government taxes other than those described in the Act. The Act contains specific exceptions regarding taxes on Internet access that does not include or make available "screening" or similar exclusionary protections against material not suitable for minors.

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[9] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[10] *Id.* at 318.

[11] Title XI of P.L. 105-277, the Omnibus Appropriations Act of 1998.

Advisory Commission on Electronic Commerce

The Internet Tax Freedom Act established an Advisory Commission on Electronic Commerce to study the domestic and international tax (and international trade) issues related to use of the Internet and other comparable sales activities. The Commission submitted its report to the Congress in April 2000. For a discussion of the Commission's report, see section II, below.

II. OVERVIEW OF THE REPORT OF THE ADVISORY COMISSION ON ELECTRONIC COMMERCE

The Advisory Commission on Electronic Commerce (the "Advisory Commission") was established by the Internet Tax Freedom Act to study Federal, State, local, and international tax and tariff treatment of transactions using the Internet and Internet access, and other comparable intrastate, interstate or international sales activities. The Internet Tax Freedom Act required the Advisory Commission to submit a report of its findings, with recommendations, to the Congress within 18 months of the enactment of the Act. The Advisory Commission was composed of 19 commissioners appointed by the Congress. The commissioners included: the Secretary of Commerce, the Secretary of the Treasury, the United States Trade Representative, eight representatives from State and local governments, and eight representatives from the electronic commerce industry, telecommunications carriers, local retail businesses and consumer groups.

The domestic issues studied include sales and use taxes, business activity taxes, Internet access taxes, taxation of telecommunications services and providers, Constitutional redress of interstate disputes, the digital divide (disparity between individuals with access to the Internet and those without such access), and privacy implications of Internet taxation. The Advisory Commission also studied international tax and tariff issues.

The Advisory Commission held four meetings in various cities throughout the United States. At the final meeting in Dallas, on March 20 and 21, 2000, the Advisory Commission voted on a number of proposals. Pursuant to the Internet Tax Freedom Act, those proposals that received at least a two-thirds vote constituted the findings and recommendations of the Advisory Commission. The findings, recommendations and certain other proposals were presented in a report to the Congress in April 2000.[12]

In addressing how the Internet should be subject to taxation, the Advisory Commission recommended that removing barriers to access should be a major priority and that simplification of existing State sales and use tax systems also is essential. The commissioners agreed that State and local tax systems should be examined to determine whether they can be restructured, in light of technological changes, into systems that are more simple, efficient and fair, while maintaining revenue neutrality in their overall State sales and use tax collections.

The Advisory Commission also found that an international consensus for the taxation of electronic commerce should be established, with the Organisation for Economic Co-operation and Development ("OECD") as the appropriate forum to establish such consensus. The Advisory Commission believed that the adoption of proposals included in the report would facilitate the necessary international dialogue.

As required by the Internet Tax Freedom Act, the Advisory Commission's taxation recommendations address all forms of remote commerce. Under the Internet Tax Freedom Act, no finding or recommendation could be included in the report unless agreed to by at least two-thirds of the Advisory Commission. The proposals that address interstate commerce tax issues

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[12] Advisory Commission on Electronic Commerce, *Report to Congress* (April 2000).

did not receive the requisite two-thirds vote, and therefore are not formal findings and recommendations of the Advisory Commission. Although not receiving the two-thirds vote necessary to constitute a formal recommendation, a number of tax recommendations did receive a majority vote and are included in the report, as discussed below. The recommendations that received the requisite vote to constitute formal finding or recommendations generally address broad non-tax policy issues.

A. Formal Recommendations

The formal recommendations made by the Advisory Commission address the areas of the digital divide, privacy implications, and international taxes and tariffs. With respect to the digital divide, the Advisory Commission recommended that States and localities should be encouraged to join with private technology companies to make computers and the Internet widely accessible, through incentives including Federal and State tax incentives and Federal matching funds for State and local expenditures. Additionally, the Advisory Commission recommended that Federal welfare guidelines should be clarified and that the Administration and the Congress should continue gathering data for research that will inform policymakers on measures that will lead to the elimination of the digital divide.

The Advisory Commission made two recommendations in the area of privacy implications of Internet taxation: (1) explore the privacy issues involved in the collection and administration of taxes on electronic commerce; and (2) take great care in crafting laws pertaining to online privacy.

In the area of international taxes and tariffs, the Advisory Commission recommended implementing and making permanent a ban on tariffs on the Internet.

B. Other Proposals

No policy proposals affecting the taxation of interstate commerce and the Internet reviewed by the Advisory Commission received the requisite vote to constitute formal recommendations. The Advisory Commission included those policy proposals receiving a majority vote in their report ("majority proposals"). Even though the majority proposals are not formal findings or recommendations of the Advisory Commission, they are the only indications of the Advisory Commission's position on interstate commerce taxation issues.

Sales and use taxes

One majority proposal recommended extension of the current moratorium of the Internet Tax Freedom Act for five years, giving the States time to simplify their State and local transaction tax systems, and prohibition of sales tax on sales of products available in both digital and tangible forms during the moratorium period. Another majority proposal recommended clarification of which factors establish a seller's physical presence in a State for purposes of determining whether there is sufficient nexus to impose sales and use tax collection obligations. The report lists several factors that a majority of the Advisory Commission believed should not, by themselves, establish a seller's physical presence in a State for purposes of establishing sufficient nexus for a seller. These include: use of an Internet Service Provider that has a physical presence in the State; the placement of digital data on a server located in the State; use of telecommunications services through a provider that has physical presence in the State; ownership of intangibles present in the State; the presence of customers in the State; affiliation with another taxpayer that has physical presence in the State; the performance of warranties or repairs; a contractual relationship that permits products purchased through the seller's web site to be returned to another party's physical location within the State; and advertising.

A third majority proposal recommended encouraging States and local governments to work with and through the National Conference of Commissioners on Uniform State Laws ("NCCUSL") to draft a uniform sales and use tax act that would simplify State and local sales and use systems to create parity of collection costs between remote sellers and comparable single-jurisdiction vendors that do not offer remote sales. The report outlined several provisions that should be part of such act, including: uniform tax base definitions and vendor discounts; uniform and simple sourcing rules; one sales and use tax rate per state and uniform limitations on state rate changes; uniform audit procedures, tax forms, electronic filing, remittance methods, and exemption administration rules; and methodologies for approving software and maintaining revenue neutrality.

A majority of the Advisory Commission also recommended establishing a new advisory commission, required to report to Congress, to oversee the NCCUSL's efforts to create a uniform sales and use tax act.

Business activity and corporate income taxes

A majority of the Advisory Commission recommended that the circumstances that determine whether a seller has sufficient nexus with a State to be required to comply with business activity and corporate income tax, such as franchise tax, reporting and payment obligations of that State should be clarified. As stated in the report, circumstances that should not, by themselves, constitute nexus include: use of an Internet Service Provider that has physical presence in the State; the placement of a seller's digital data on a server located in the State; use of communications services from a provider located in the State; ownership of intangible property present in the State; presence of customers in the State; certain affiliations with persons in the State; the performance of warranty or repair services; a contractual relationship that permits products purchased through the seller's Web site to be returned to another party's physical location within the State; advertising; and a seller's sales and use tax registration with a State or remittance of use tax for the State.

Internet access

Another majority proposal recommended making permanent the current moratorium on any transaction taxes on the sale of Internet access.

Taxation of telecommunications services and providers

A majority of the Advisory Commission recommended that the three percent Federal excise tax on communications services be repealed. Additionally, these commissioners recommended that disparate tax burdens on telecommunications real, tangible, and intangible property be eliminated, including unfair and inconsistent market valuations, different statutory levels of assessment, different property tax rates, and selective repeals of property taxes.

Furthermore, this proposal suggested that States that provide exemptions for purchases of certain types of business equipment from sales and use taxes should apply similar exemptions to telecommunications infrastructure. A majority also proposed that State and local governments should be encouraged to work with and through the NCCUSL in drafting a uniform telecommunications State and local excise tax act that would require States to follow one of two simplified tax structure models outlined in the report.

International taxes and tariffs

Finally, several proposals regarding international taxes and tariffs received majority approval. First, a majority proposed support of the World Trade Organization's current moratorium on tariffs and duties for electronic transmissions. Second, a majority recommended the recognition of the OECD's leadership role in coordinating the international dialogue concerning the taxation of electronic commerce, the support of the OECD's framework of conditions for the taxation of electronic commerce, and the support of the OECD's continued role as the appropriate forum for fostering effective international dialogues and building international consensus, based on principles outlined in the report. These principles include the following: no new taxes should be applied to electronic commerce; new or modified tax rules should be crafted to achieved neutrality by treating economically similar transactions similarly; any taxation of the Internet should not distort or hinder traditional commerce or electronic commerce and should be simple and efficient; the OECD should continue its involvement in developing a system of taxation of electronic commerce; any modifications to the tax system should be discussed with the business community; and nations should defer modifications of their tax systems until after an international consensus is reached.

Third, a majority further recommended the encouragement and support of the U.S. Government's efforts to further international dialogue concerning the taxation of electronic commerce consistent with the principles outlined above, and that the Congress should (1) refrain from adopting legislative proposals affecting international transactions or activities that are inconsistent with the outlined principles, and (2) increase its oversight of the international ramifications of domestic Internet commerce decisions.

III. OVERVIEW OF STREAMLINED SALES TAX SYSTEM

Compliance issues

As noted above, the Supreme Court has held that a State cannot require a vendor to withhold that State's sales and use taxes unless the vendor has a "substantial nexus" with the taxing State.[13] Most States require that consumers who purchase products from out-of-State vendors file "use tax" forms and remit their taxes based on the prevailing State and local rate. According to the Congressional Research Service, compliance with this requirement by consumers is low.[14] It has also been reported that States anticipate that as Internet retail sales grow as a proportion of total retail sales, sales tax revenue will decline as a result.[15]

Congress, under its power to regulate interstate commerce, could grant authority to the States to require vendors without a substantial nexus to the taxing State to collect these taxes. Vendors, however, could find it difficult to comply with such a requirement.[16] For example, tax rates widely vary among the States. Consequently, a vendor could be required to determine the prevailing State and local tax rates of each taxing jurisdiction in the United States.[17] In addition to the different rates, there also are variations in the sales tax base of the 45 States with a sales tax. For example, some States exempt certain types of clothing. Some States have reduced rates on food, which may or may not include snacks. Vendors also would be required to determine and authenticate the State tax-exempt status of customers for exempt transactions. Some assert that these administrative issues could be overcome through the use of technology and by simplifying State and local government sales tax systems.

Streamlined Sales Tax Project

The Streamlined Sales Tax Project seeks to facilitate the simplification of State sales and use tax collection. It is a voluntary and cooperative effort among State governments. Currently, 38 States are involved in the Streamlined Sales Tax Project, 32 as voting participants

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[13] ". . .[The Supreme Court] will sustain a tax against a Commerce Clause challenge so long as the `tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.'" *Quill Corp. v. North Dakota*, 504 U.S. at 311 (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

[14] Congressional Research Service, *Taxing Internet Transactions,* Taxation Briefing Book (May 10, 2001) <http://www.congress.gov/brbk/html/ebtxr70.html>.

[15] *Id*.

[16] *Id*.

[17] Forty-five States and the District of Columbia levy sales and use taxes. As of May 2000, approximately 7,500 local jurisdictions levied a sales tax. Congressional Research Service, RL30667, *Internet Tax Legislation: Distinguishing Issues* (January 11, 2001) at 3.

("participating States") and six as nonvoting participants ("observer States").[18] Participating States are those States in which the Governor has signed an Executive Order or the State legislature has passed legislation authorizing State personnel to participate in the discussions of the Streamlined Sales Tax Project. Observer States are those States that have an interest in the Streamlined Sales Tax Project's mission but have not received executive or legislative authority to become a Participating State. The Streamlined Sales Tax Project formally began its work in March 2000.

The Streamlined Sales Tax Project's objectives include simplifying State and local sales and use taxes and standardizing their administration among the States, and identifying both the computer software and a financial transmission system that could be used to implement the collection of use taxes on out-of-State sales at a reasonable cost. In addition to a steering committee, the Streamlined Sales Tax Project has four working groups to address various issues: (1) Tax Base and Exemption Administration; (2) Tax Rates, Registration, Returns and Remittances; (3) Technology, Audit, Privacy, and Paying for the System; and (4) Sourcing and Other Simplifications.

The Streamlined Sales Tax Project asserts that the key features of a simplified sales tax system are as follows: uniform definitions within tax bases; simplified administration for exempt transactions (purchasers would be responsible for incorrect exemptions claimed); rate simplification; uniform sourcing rules; and uniform audit procedures.[19] To reduce the financial burden on sellers, the Streamlined Sales Tax Project asserts that States should assume the responsibility for implementing the streamlined sales tax system.[20]

Under the Streamlined Sales Tax Project, participation in the simplified sales tax system by both vendors and States would be voluntary. Also, registration by the vendors in the simplified sales tax system would not infer nexus for State business activity or State income tax purposes.[21] In order to take part, States would be required to adopt authorizing legislation and enact certain simplification measures.[22] Under the simplified sales tax system, vendors would use State-certified, specially designed software to calculate, collect, and remit use taxes for transactions in States in which they do not have a substantial nexus or use a certified service

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[18] The participating States are: Alabama, Arkansas, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Nevada, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. The observer States are: California, Colorado, Connecticut, Georgia, Idaho, and Pennsylvania. Streamlined Sales Tax Project, *Executive Summary* (March 1, 2001).

[19] Streamlined Sales Tax Project, *Executive Summary* (March 1, 2001).

[20] *Id*.

[21] *Id*.

[22] *Id*.

provider to perform all of the vendor's sales tax functions.[23] Large vendors with nationwide sales also would be able to request that States certify the vendors' own tax software.[24]

Pilot to test tax collection software

In September 2000, the Streamlined Sales Tax Project began a pilot project to test tax collection software under the current State sales tax laws. The State participants in this pilot project are Kansas, Michigan, North Carolina, and Wisconsin. The pilot project has four primary goals:

(1) Research, develop, and test automated State transaction tax registration, calculation, collection, remittances, and reporting systems;

(2) Evaluate the efficiency and costs of these systems under the current laws and practices among their respective States;

(3) Evaluate methods for ensuring the privacy protections for individuals and businesses relating to their purchases of goods and services; and

(4) Make recommendations to all interested States for the adoption of uniform laws and practices in order to develop systems that will substantially reduce State transaction tax compliance burdens for consumers and sellers.[25]

Passage of model acts and agreements

On December 22, 2000, State representatives to the Streamlined Sales Tax Project voted to approve two pieces of model legislation, the Streamlined Sales Tax Agreement (the "Agreement") and the Uniform Sales and Use Tax Administration Act (the "Act"), for consideration by State legislatures. The Act provides authority for a State to enter into an agreement with other States to implement the new system and lists the general requirements for what the Agreement must contain. The Agreement sets forth the specific elements of the new sales and use tax system. The model legislation addresses several simplification measures, including common definitions of what is taxable, and uniform rules for sourcing, determining exemption processes, handling bad debts, and establishing a way to finance the system. A State must enact all of the Agreement in order to become a participant in the new system.

In January 2001, the National Conference of State Legislatures ("NCSL") endorsed the Uniform Sales and Use Tax Administration Act and the Streamlined Sales Tax Agreement with

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[23] *Id.*

[24] *Id.*

[25] Streamlined Sales Tax Project, *Pilot Status Report* (May 2001) <http://www.geocities.com/streamlined2000/pilotstatus5_2001.html>.

certain modifications and deletions.[26] The modifications related to governance and uniform base and rate. The following items were deleted pending further review: uniform definitions for items in the tax base, uniform bad debt provisions, the uniform rounding rule, and limitations on caps, thresholds, and sales tax holidays for State and local governments.

As of July 16, 2001, 15 States had enacted the Streamlined Sales Tax Project's model legislation, the model as endorsed by the National Conference of State Legislatures, or a modified version of such legislation.[27] In addition, South Dakota has created a task force to study the Streamlined Sales Tax Project.

In 2001, the Streamlined Sales Tax Project is continuing its work to resolve specific definitions, procedures and other issues.

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[26] See, National Conference of State Legislatures, *Resolution to the NCLS Executive Committee from the Special Task Force on State and Local Taxation of Telecommunications and Electronic Commerce* (January 27, 2001) <http://www.ncsl.org/programs/press/2001/resolution.htm>; and Doug Sheppard, *NCSL Executive Panel Approves Amended Streamlined Legislation*, Tax Notes Today, 2001 TNT 20-6 (January 30, 2001).

[27] Four States enacted model legislation as recommended by the Streamlined Sales Tax Project: Arkansas (Project Act only), Minnesota (Project Act and Agreement), Nebraska (Project Act and Agreement), and Wyoming (Project Act and Agreement). Kentucky adopted an amended version of the Streamlined Sales Tax Project's Act only. Seven States adopted the model Act as recommended by the National Conference of State Legislatures: Florida, Indiana, Maryland, Nevada, Oklahoma, Tennessee, and Texas. Three States, North Dakota, Louisiana, and Utah, enacted a modified version of the Act recommended by the National Conference of State Legislatures. National Conference of State Legislatures, *2001 State Action on Streamlined Sales Tax System* (July 16, 2001) <http://www.ncsl.org/statefed/stateaction.htm>.

IV. OVERVIEW OF DEVELOPMENTS RELATING TO TAXATION OF CROSS-BORDER ELECTRONIC COMMERCE

A. U. S. Developments

In November 1996, the U.S. Treasury Department released a study entitled "Selected Tax Policy Implications of Global Electronic Commerce" ("Treasury E-Commerce Report"). The Treasury E-Commerce Report concluded that the application of the U.S. tax rules to international transactions in the context of electronic commerce must be guided by the principle of neutrality. In other words, similarly situated taxpayers should be treated similarly, whether they derive their income from electronic commerce or from more traditional modes of commerce. The tax system should neither advantage nor disadvantage Internet-based businesses relative to other businesses.

The Treasury E-Commerce Report identified two main problem areas with respect to substantive tax policy: (1) identifying the country or countries that have jurisdiction to tax the income from electronic commerce (for example, determining whether Internet-related activities touching a particular country rise to the level of a "permanent establishment" in that country under relevant treaty law); and (2) classifying the income generated by electronic commerce (for example, as services income, sales income, or royalty income). The Treasury E-Commerce Report also identified several major problem areas with respect to tax administration and compliance: (1) the possibility that electronic money (or "e-cash") might create the potential for anonymous and untraceable transactions on the Internet; (2) identifying parties to communications and transactions utilizing the new technologies; and (3) verifying records when transactions are conducted electronically.

The Treasury E-Commerce Report determined that in classifying income arising from transactions in digitized information (such as computer programs downloaded over the Internet), the analysis should focus on the substance of the rights transferred as opposed to the form of the transaction. By analyzing the substance of the rights transferred, the Treasury E-Commerce Report stated that neutrality would be achieved between the taxation of transactions in digitized information and the taxation of transactions in traditional forms of information (such as hard copy books).

In late 1998, Treasury promulgated final regulations classifying income from transactions relating to computer programs (whether or not delivered by electronic means).[28] A "computer program," which is one type of digitized information, is defined as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. Under the regulations, a transaction involving computer programs is classified into one of the following four categories (with the rights under copyright law being used as a starting analysis): (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. Thus, the regulations attempt to fit transactions involving computer programs into the existing conceptual framework instead of developing an entirely new

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[28] Treas. Reg. sec. 1.861-18 (1998).

approach. In the preamble to the regulations, Treasury stated that it may consider whether to apply the principles of the regulations to all transactions in digitized information as part of a separate guidance project.

In December 2000, the U.S. Treasury Department released its study of subpart F entitled "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations" ("Treasury Subpart F Study"). The Treasury Subpart F Study noted that the ability of taxpayers to provide services and goods over the Internet will increase the challenges to the current subpart F regime.[29] The Treasury Subpart F Study identified two major issues raised by electronic commerce with respect to the subpart F regime. First, electronic commerce makes it more difficult to determine the location of transactions or activities. Such determinations are critical under the subpart F regime. For example, the technologies underlying electronic commerce make the remote provision of services much easier, such as remote database access and videoconferencing. As a result, it becomes much more difficult to determine or assign the place of performance of services utilizing the new technologies. Second, electronic commerce makes the classification of income more difficult. For example, payments for digitized products may be treated as payments for a good, a right, or a service. Under the subpart F regime, different rules apply to different types of income. The Treasury Subpart F Study also acknowledged enforcement and administrative concerns raised by electronic commerce but did not address them.

In January 2001, Treasury issued proposed regulations under sections 863(a), (d), and (e) relating to the source of income from certain communications activity.[30] Under the proposed regulations, "communications activity" consists solely of the delivery by transmission of communications or data. It includes delivery of communications or data over the Internet, but does not include delivery by, for example, physical packages and letters. Generally, the source of income from communications activity depends on whether the income is international communications income, U.S. communications income, foreign communications income, space/ocean communications income, or communications income in which the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication. For example,[31] if a U.S.-based Internet access provider receives a payment from a customer for Internet access, and the customer makes a call from France to England over the Internet and the U.S. company does not maintain records as to the beginning and end points of the transmission, then the income will be classified as communications income in which the taxpayer cannot establish the two points between which it is paid to transmit the communication. The income will therefore be treated as income from U.S. sources. The growth of electronic commerce will put increased pressure on the application of these admittedly complex sourcing rules. The scope of the issues that may arise in the future is difficult to assess.

[29] Under the subpart F regime, the United States generally taxes the U.S. 10-percent shareholders of a U.S.-controlled foreign corporation on their pro rata shares of certain income of the foreign corporation, which is typically passive or mobile income.

[30] Notice of Proposed Rulemaking and Notice of Public Hearing, REG-106030-98, 66 Fed. Reg. 3903 (January 17, 2001).

[31] Prop. Reg. sec. 1.863-9(f), Example 7 (2001).

B. OECD Developments

In general

The OECD, consisting of 30 member countries including the United States, has also actively studied the challenges that electronic commerce poses to a country's taxation of international transactions. Like the Treasury E-Commerce Report, the OECD has stated that neutrality between electronic and "conventional" commerce should be a guiding principle. The OECD maintains that existing norms of cross-border taxation are essentially sufficient to govern electronic commerce, but that some guidance must be provided as to how these norms should apply in this context. In particular, the OECD has initiated projects focusing on three different areas with respect to electronic commerce: direct taxes (including income taxes), consumption taxes, and tax administration.[32]

Direct taxes

In the area of direct taxes, the OECD has initiated a number of projects relating to various fundamental tax principles involving electronic commerce. In some cases there has been a consensus among the member countries on a number of fundamental tax principles involving electronic commerce; however, a number of issues remain unresolved.

One OECD project relates to the application of the current definition of permanent establishment in the context of electronic commerce. In general, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. A tax treaty generally provides that the country within which business profits are derived has primary jurisdiction to tax such profits to the extent they are attributable to a permanent establishment in that country. The OECD has developed a general consensus among its member countries that: (1) a web site cannot, in itself, constitute a permanent establishment; (2) a web site hosting arrangement typically does not result in a permanent establishment for the enterprise carrying on business through the web site; (3) an Internet service provider will not, except in

[32] The OECD is composed of a number of directorates, including the Directorate for Financial, Fiscal and Enterprise Affairs ("DAFFE"). DAFFE's prime objective is to promote the efficient functioning of markets and enterprises in a global economy. DAFFE is composed of seven divisions or units, including the Committee on Fiscal Affairs ("CFA"). The CFA is responsible for formulating and implementing tax policies. The work of the CFA is carried out primarily by a number of working parties each responsible for a specific area of tax law. For example, Working Party No. 1 is responsible for tax treaty issues while Working Party No. 9 examines consumption tax issues. A working party may be assisted by a technical advisory group ("TAG") composed of up to 25 government and private sector tax experts from both member and non-member countries. A TAG makes recommendations to the working party to which it is assigned. The working party generally accepts some or all of the recommendations from the TAG. The working party presents its recommendations in a report to the CFA. The CFA then presents the report to all of the member countries, which eventually may vote on whether to accept or reject the report. If the report is accepted, a member country can dissent from portions of the report or the entire report. A member country also can accept the report with its own modifications.

very unusual circumstances, constitute a dependent agent of another enterprise for permanent establishment purposes; and (4) computer equipment, such as a server, in certain cases, can perform functions beyond what is preparatory or auxiliary, and therefore possibly constitute a permanent establishment.[33]

The OECD is currently working on the issue of determining the manner in which profits are attributed, using the arm's-length principle, to a permanent establishment in the context of electronic commerce retailing.[34] Generally, the amount of profit attributable to a permanent establishment will be related to the nature of the functions that the permanent establishment performs (taking into account the assets used and risks assumed). In making this determination, it is important to determine which part of the enterprise economically owns or has created the intangible assets used by the permanent establishment, as these intangible assets are generally important in the generation of profits from electronic commerce activities. For example, in the case of a stand-alone computer server performing automated functions without the presence of personnel in the permanent establishment, it is unlikely that a substantial share of the profits will be attributed to the permanent establishment. If, however, the development of the server and web site of the permanent establishment was entirely performed in the permanent establishment, then it is likely that a more substantial share of the profits will be attributed to the permanent establishment.

The OECD also is working on the issue of characterizing, for treaty purposes, various types of electronic commerce payments.[35] Generally, characterization issues fall into one of five categories: (1) distinguishing business profits from payments for the use of, or the right to use, a copyright; (2) distinguishing business profits from payments for know-how; (3) distinguishing business profits from payments for the use of, or the right to use, industrial, commercial, or

[33] OECD Committee on Fiscal Affairs, "Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5" (December 22, 2000). Spain and Portugal dissented from the general consensus, believing that physical presence is not a requirement for a permanent establishment to exist in the context of electronic commerce, and therefore, in some circumstances, an enterprise carrying on business in a country through a web site could be treated as having a permanent establishment in that country. The United Kingdom dissented from the general consensus as to whether servers, in certain cases, can constitute a permanent establishment. The United Kingdom has taken the view that under no circumstances can servers, of themselves or together with web sites, constitute a permanent establishment of an electronic commerce retailer.

[34] Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" (February 2001).

[35] Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments, Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs, "Tax Treaty Characterization Issues Arising from E-Commerce" (February 1, 2001).

scientific equipment;[36] (4) distinguishing the provision of services from the acquisition of property; and (5) distinguishing technical services from other types of services. In distinguishing between business profits and payments for the use of, or right to use, a copyright, which the OECD has recognized as being one of the most important characterization issues arising from electronic commerce, it generally has been determined that if a customer electronically downloads a digital product for that customer's own use or enjoyment, then the payment should be treated as business profits to the provider. If, however, the customer is paying for the right to reproduce and distribute the digitized product, as opposed to merely acquiring the digital content, then the payment should be treated as a royalty to the provider.

The OECD also is currently working on the issue of applying the concept of "place of effective management" in the context of electronic commerce.[37] In certain cases, a company may be treated as a resident of both treaty countries under their domestic laws. Such a company generally is referred to as a dual resident company. A tie-breaker rule applies in the OECD Model Tax Convention to treat the company as a resident of the treaty country in which its place of effective management is located.[38] The OECD defines the term "place of effective management" as the place where key management and commercial decisions that are necessary for the conduct of the enterprise's business are, in substance, made. This definition, however, is becoming more difficult to apply with new technologies, such as videoconferencing and electronic discussion group applications through the Internet. In fact, application of the traditional definition of "place of effective management" may lead to results that do not reflect the intention of the tie-breaker rule. As a result, the OECD has identified the following options with respect to the tie-breaker rule: (1) replace the concept of place of effective management; (2) refine the concept of place of effective management; (3) establish a hierarchy of tests so that if one test does not provide an outcome, then the next test will apply (similar in concept to the tie-breaker rules for individuals); (4) combine the approaches of refining the test and establishing a hierarchy of tests; or (5) deny dual resident companies benefits under the treaty.

[36] A number of bilateral tax treaties include in the definition of royalties "payments for the use of, or the right to use, industrial, commercial, or scientific equipment." However, this phrase is no longer part of the definition of royalties in the OECD Model Tax Convention.

[37] Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule" (February 2001).

[38] Under the United States Model Income Tax Convention (dated September 20, 1996), the tie-breaker rule treats the company as a resident of the treaty country under the laws of which it is created or organized (as opposed to the OECD tie-breaker rule of place of effective management).

Consumption taxes

The OECD has developed four core principles in the area of consumption tax aspects of electronic commerce.[39] First, rules for the consumption tax of cross-border trade should result in taxation in the jurisdiction where consumption takes place. In the case of business-to-business transactions, consumption takes place where the recipient has located its business presence. In the case of business-to-consumer transactions, consumption takes place at the recipient's usual jurisdiction of residence. Second, the supply of digitized products should not be treated as a supply of goods for consumption tax purposes. Third, where business and other organizations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment, or other equivalent mechanisms for collection.[40] Finally, countries should ensure that appropriate systems are developed in cooperation with the World Customs Organization and in consultation with carriers and other interested parties to collect tax on the importation of physical goods. In addition, countries should ensure that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers.

The OECD recognizes that further work is necessary in a number of areas involving consumption taxes and electronic commerce. These areas of further study include: (1) verification of the declared jurisdiction of residence of the consumer in a business-to-consumer electronic commerce transaction; (2) verification of the status of the consumer (e.g., distinguishing between business and private consumers); (3) establishment of registration thresholds to minimize compliance requirements on non-resident suppliers; (4) development and use of technology-based and technology-facilitated collection mechanisms; (5) promotion of international administrative cooperation; (6) identification and evaluation of simplification options; (7) identification of areas of risk with respect to effective compliance; and (8) exploration of long-term strategies for applying technology-based mechanisms to a wider range of transactions (e.g., goods and services generally).

Tax administration

In the area of tax administration, the OECD has determined that the information reporting requirements and tax collection procedures being developed must be fair and neutral so that the level and standard is comparable to what is required for traditional commerce.[41] The OECD

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[39] Working Party No. 9 on Consumption Taxes, "Consumption Tax Aspects of Electronic Commerce" (February 2001).

[40] For example, in the case of business-to-business transactions, the most viable collection mechanism is a reverse charge or self-assessment mechanism; however, in the case of business-to consumer transactions, the most viable mechanism, in the near term, is some form of registration-based mechanism. Under a reverse charge or self-assessment system, the customer pays the tax directly to the tax authority. Under a registration-based system, the vendor registers with the tax authority and, depending on the design of the tax, pays the tax due on the transaction to the tax authority or collects the tax from the customer and remits it to the tax authority.

[41] Report from the Forum on Strategic Management, "Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities" (February 2001).

recognizes, however, that different means may be necessary to achieve these goals. In addition, the OECD has recognized a number of options utilizing new technologies to improve taxpayer service.

C. Other Developments in Electronic Commerce

The Commission of the European Communities, on June 7, 2000, issued a proposed Council Directive on applying value added taxes ("VATs") to services delivered by electronic means.[42] A VAT is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. The VAT taxable base is generally defined as the amount of value added, which is the difference between the value of sales (outputs) and purchases (inputs) of an enterprise.

The proposed directive was designed to level the playing field for European Union ("EU") and non-EU vendors, such as U.S. vendors, of digital products. Under existing EU laws, an EU vendor must charge VAT on digital products sold to a customer, regardless of whether the customer is located in the EU or elsewhere. A U.S. vendor, however, is not obligated to charge VAT on digital products sold to a private customer in the EU. The proposed directive would remove the obligation of the EU vendor to charge VAT on the sale of digital products to a customer outside the EU. It also would impose the obligation to charge VAT on the sale of digital products by a U.S. (or other non-EU) vendor to a private customer in the EU if the U.S. vendor's annual sales to private customers of digital products in the EU exceeded 100,000 euros. To facilitate registration, a U.S. vendor would need to register in only one of the EU member countries to conduct business in the entire EU and would apply tax at the rate of VAT levied by that country.

The fate of the proposed EU directive is uncertain, particularly in light of the work of the OECD promoting the application of fundamental principles in the area of consumption taxes and electronic commerce (as discussed above) and the close cooperation between the EU and the OECD in this area.

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[42] Commission of the European Communities, Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean (June 7, 2000).

V. DESCRIPTION OF PENDING BILLS

Several Internet-related tax proposals have been introduced in the Senate in the 107th Congress. A brief description of each bill is below.

A. S. 245

On February 6, 2001, Senator Smith of New Hampshire introduced S. 245. The bill would make permanent the present-law moratorium on the Federal imposition of taxes on the Internet.

B. S. 246

On February 6, 2001, Senator Smith of New Hampshire introduced S. 246. The bill would extend for an additional five years the present-law moratorium on the imposition of taxes on the Internet.

C. S. 288, the "Internet Tax Nondiscrimination Act"

On February 8, 2001, Senator Wyden, for himself and others, introduced S. 288, the "Internet Tax Nondiscrimination Act." The bill would:

- Extend through 2006 the moratorium enacted by the Internet Tax Freedom Act and provide a permanent ban on taxes on Internet access.
- Provide criteria that would be required as elements of any State law providing for a simplified sales and use tax system for remote sales, including: (1) a centralized, one-stop, multi-state registration system for sellers; (2) uniform definitions for goods and services that are included in the tax base; (3) uniform and simple rules for attributing transactions to particular jurisdictions; (4) uniform rules for the designation and identification of purchasers and transactions exempt from sales and use taxes, including a database of all exempt entities and a rule ensuring that reliance on that database immunizes sellers from liability; (5) uniform procedures for the certification of software used to determine tax rates and taxability; (6) uniform bad debt rules; (7) uniform tax returns and tax remittance forms; (8) uniform electronic filing and remittance methods; (9) State administration of all State and local sales tax and a single rate and single filing for all sales; (10) uniform audit procedures; (11) reasonable compensation for tax collection by sellers; (12) an exemption from use tax collection requirements for out-of-State sellers whose gross annual sales are less than a specified threshold of not less than $5,000,000; (13) protection for consumer privacy; (14) a single uniform Statewide sales and use tax rate on all transactions on which a sales or use tax is assessed; (15) an origin State default rule; (16) clear and limiting nexus standards; and (17) other features that will achieve a simplified and uniform sales and use tax system.
- Provide that no State may require a seller who lacks nexus with, or owes no tax obligation to, the State to collect or remit sales or use tax on any sales in that State until Congress provides such authority to the States.

- Provide that the Congress may authorize the States, only through joint resolution, to require sellers to collect a sales or use tax on sales of goods and services under a law that meets the criteria specified in the bill.

D. S. 512, the "Internet Tax Moratorium and Equity Act"

On March 9, 2001, Senator Dorgan, for himself and others,[43] introduced S. 512, the "Internet Tax Moratorium and Equity Act." The bill would:

- Extend through 2005 the moratorium enacted by the Internet Tax Freedom Act.
- Encourage States to develop and implement streamlined sales and use tax systems that are simple, fair, efficient and nondiscriminatory. Features of such system would include: (1) a centralized, one-stop, multi-state registration system for sellers; (2) uniform definitions of goods and services; (3) uniform rules for attributing transactions to particular taxing jurisdictions; (4) uniform procedures for the treatment of exempt purchasers and relief from liability for sellers that rely on such State procedures; (5) uniform procedures for the certification of software used to determine sales and use tax rates and taxability; (6) a uniform format for tax returns and remittance forms; (7) consistent electronic filing and remittance methods; (8) State administration of all State and local sales and use taxes; (9) uniform audit procedures; (10) reasonable compensation for tax collection by sellers; (11) an exemption from use tax collection requirements for remote sellers falling below a de minimis threshold of $5,000,000 in gross annual sales; (12) appropriate protections for consumer privacy; and (13) such features that the States deem warranted to promote simplicity, uniformity, neutrality, efficiency, and fairness.
- Authorize States to enter into an Interstate Sales and Use Tax Compact (before January 1, 2006) that describes a sales and use tax system consistent with that described in the bill, and require that States joining the Compact must adopt the system. To be formed, the Compact must be ratified by 20 States.
- Require States that adopt the Compact to impose a single, uniform Statewide use tax rate on all remote sales on which it assesses a tax, and allow the use of a weighted averages tax rate.
- Provide that a State that adopts the simplified sales and use tax system described in the Compact, so that a remote seller can use information provided by the State to identify the single applicable rate for each sale, may require a remote seller to collect the actual applicable State and local sales and use tax due on each sale made in the State if the State provides the seller relief from liability to the State for relying on the information provided by the State.
- Provide that States that adopt the system described in the Compact may require collection of sales and use taxes on remote sales to purchasers located in the State.

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[43] The bill was co-sponsored by Senators Breaux, Graham, Lincoln, Rockefeller, Thomas, Daschle, and others.

E. S. 589

On March 21, 2001, Senator Smith of New Hampshire introduced S. 589. The bill would make permanent the present-law moratorium on the imposition of taxes on the Internet.

F. S. 664, the "New Economy Tax Fairness Act or NET FAIR Act"

On March 29, 2001, Senator Gregg, for himself and others, introduced S. 664, the "New Economy Tax Fairness Act or NET FAIR Act." The bill would provide jurisdictional standards for the imposition of State and local tax obligations on interstate commerce. Specifically, the bill would:

- Provide that no State shall have the power to impose a business activity tax or a duty to collect and remit a sales or use tax on the income derived within the State from interstate commerce unless such person has a substantial physical presence in the State.
- Provide a list of business activities that do not establish substantial physical presence, including: (1) solicitation of orders or contracts, if certain conditions are satisfied; (2) the presence or use of intangible personal property in the State; (3) the use of the Internet to create a World Wide Web site accessible by persons in the State; (4) the use of an Internet service provider within the State to maintain, take, or process orders; (5) the use of a service provider for the transmission of communications; and (6) affiliation with a person within the State or the use of an unaffiliated representative or independent contractor in the State.
- Provide that substantial physical presence of any person shall not be attributed to any other person absent the establishment of a relationship that: (1) results from the consent by both persons that one person act on the other's behalf or subject to their control; and (2) relates to the activities of the person within the State.
- Prohibit a State from assessing any business activity tax that was imposed prior to the bill, if imposition of such tax is prohibited by the bill.
- Terminate a person's obligation to pay State-imposed business activity, sales, or use tax if such person no longer has a substantial physical presence in the State.

G. S. 777, the "Internet Tax Nondiscrimination Act"

On April 25, 2001, Senator Allen, for himself and others, introduced S. 777, the "Internet Tax Nondiscrimination Act." The bill would permanently extend the moratorium enacted by the Internet Tax Freedom Act.