

OVERVIEW TO E-COMMERCE TAXATION ISSUES

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WHAT ARE SOME OF THE ISSUES?

Policy Focused

1. Should governments be allowed to tax Internet access fees? How broadly or narrowly should such fees be defined?
2. Will taxation of e-commerce hinder its growth?
3. Should state and local governments be allowed to collect sales and use tax from remote (non-present) vendors? (That is, should Congress reverse the 1992 *Quill* case decided by the U.S. Supreme Court?)
4. Will incomplete taxation of e-commerce hurt state and local government revenues and Main Street retailers?
5. What companies and transactions today are and should be subject to telecommunications taxes? Does this tax system need updating?

Practical Focused

6. A California software company has employees in California and Rhode Island and servers in Maine. Do any of these states require sales tax collection? Where is state income tax owed? What if employees sometimes enter other states where customers are located to help with software installation, but it is not more than 4 days per year in any one state? Similar issues exist at the international level for multinational companies – where should a transaction be taxed and how should it be characterized (sale of services or goods)?
7. Several states subject digitized products to sales and use tax. How is a company to know if its customers reside in such states?
8. A U.S. business sells software or other digitized products to a customer outside of the U.S. or vice versa? How should sales tax or VAT be assessed and for which country? Should the answer depend on whether the customer is a business or individual? How will collection be enforced?
9. Federal income tax issues also exist, such as when are costs to create a web site deductible rather than capitalizable? When is the sale of a domain name considered a sale of a capital asset? Do Internet brokers of products have to account for inventory? How should barter transactions (such as banner ad swaps) be valued and reported?

Reality Focused

10. Some of these issues have been around for decades (e.g. collecting sales tax on mail order sales) – can they be solved now? How? What should Congress do and what should the states do?

SOME FACTS AND FIGURES TO CONSIDER

1. Uncollected Sales and Use Tax (private studies): A June 1999 study concluded that 63% of business-to-consumer online sales were non-taxable (such as airline tickets, gambling, and interactive games). Of the remaining 37% of business-to-consumer sales, sales tax was paid on 4% (4% of the 100% of business-to-consumer sales), and 20% was a substitute for other remote sales for which no tax was collected, leaving 13% of total business-consumer sales untaxed. The study applied an average state and local sales tax rate of 6.5% to determine that the estimated sales tax loss was \$170 million for 1998, representing one-tenth of 1% of total state and local sales tax collections.¹
2. Uncollected Sales and Use Tax (government studies): A June 2000 General Accounting Office (GAO) study estimated that the state and local sales and use tax losses for all Internet sales for 2000 was between \$0.3 and \$3.8 billion (about 2% of projected sales tax revenue). This included both business-to-business and business-to-consumer Internet sales. The projected loss for 2003 was between \$1.0 and \$12.4 billion (5% of projected sales tax revenue). The differences between the high and low figures is due to varying assumptions as to business-to-business compliance rates and the estimated amount of e-commerce sales.²

In March 1999, the California Board of Equalization estimated that California's annual loss of sales and use tax from e-commerce was about \$18.5 million.³ The June 2000 GAO study projected sales and use tax losses in California from all Internet sales for 2000 as between \$23 and \$533 million. The GAO's projection of lost revenue for 2003 was between \$86 and \$1,720 million.⁴

3. Consumer Reaction to Tax on Internet Transactions: A September 1999 survey conducted by @plan and Gallup found that 58% of respondents taxing online purchases would hurt the overall growth of the Internet.⁵ A study by Professor Austan Goolsbee found that the number of online buyers could drop by 24% if sales tax were applied to Internet commerce.⁶
4. The Complexity of Multistate Sales Tax Compliance: A state's ability to impose use tax collection responsibility on a vendor only exists when that vendor has a physical presence in the state. For companies that do have collection responsibilities due to a physical presence in most, if not all, of the 46 states imposing a sales tax, compliance costs can be very high. A multistate company will need to hire several individuals to satisfy its compliance obligations, acquire software to assist in the process (which requires at least monthly updates), and to keep up with changes in the law in each state in which it does business. Large companies with many physical locations must budget the resources to comply with all of these tax systems. However, the Internet allows a company to have customers in many different locations while having very few physical locations. It also allows new companies to operate in many states without needing any capital for physical (bricks and mortar) expansion. Such new and small companies would likely be put out of business or not seek the market potential presented by the Internet, if faced with obligations to collect use tax from customers in 6,000+ jurisdictions.

Complexity, with its resultant compliance costs, also stems from the multitude of changes in state and local sales and use tax systems annually. For example, a provider of sales and use tax compliance software reported 598 instances in which changes were made to sales tax rates or that new sales taxes were added during 1999. This was an increase from 579 such changes in 1998, but less than the 707 changes that occurred in 1994.⁷

The task of reducing the existing complexities for multistate vendors are challenging because in some states, such as Colorado, cities define the tax base, which could (and does) differ from the state tax base. Also, local tax rates are not always bound by zip codes. Instead, some zip codes could include more than one local tax rate. In addition, definitions of items (such as handling costs) differs from state to state, as do exemptions from the tax. In addition, tax forms and due dates, as well as audit procedures vary from state to state.⁸

5. The Costs of Sales Tax Compliance: The costs to comply with the tax rules of multiple taxing jurisdictions can be quite high in terms of labor costs, training, computer systems, need for continual updates due changes in laws and regulations, audits, credit card fees, and risk of error. A 1998 study by the State of Washington on sales tax compliance costs reached the following conclusions:⁹

Costs as a percent of total state and local sales tax collections:

Small business	6.47%	(gross sales between \$150,000 and \$400,000)
Medium business	3.35%	(gross sales between \$400,000 and \$1,500,000)
Large business	0.97%	(gross sales over \$1,500,000)
Total cost weighted by number	4.23%	
Total cost weighted by dollars	1.42%	

6. Costs of Telecommunication Tax Compliance: The Committee on State Taxation (COST)¹⁰ has studied the complexity of federal, state and local telecommunications taxes in terms of compliance and tax liabilities. Their 2001 study found that the nationwide average effective rate of transaction taxes for sales of telecommunications services was 17.74% compared to the average effective rate on sales of goods of 6%. In addition, filing obligations in the states and local jurisdictions totaled 63,879 returns for telecommunications taxes compared to 8,951 returns for sellers of goods. Telecommunications companies have 350 types of taxes imposed upon them by state and local jurisdictions, compared to 117 for general businesses. The study also found that only 13 states have an exemption for communications equipment while 36 states have an exemption or reduced rate for manufacturing equipment¹¹

WHY THE INTERNET AND E-COMMERCE RAISE TAX ISSUES

E-commerce represents a new business model. As such, it creates some challenges to tax systems that were designed with a different model in mind. Some of the key reasons why e-commerce raises tax issues are explained below.

1. Location: Existing tax systems tend to determine tax consequences based on where the taxpayer is physically located. The e-commerce model enables businesses to operate with very few physical locations. An online vendor can easily sell to customers throughout the world from a single physical location. The e-commerce business model also involves more customized inventories so storage needs (and thus the need for many physical locations) are reduced. Also, the model involves less vertical integration and more outsourcing – again, fewer physical locations are used by a vendor. Also, some business assets, such as servers, are not necessarily tied to a single physical location, but can easily be relocated without any interruption to business operations. That is, the location of the server is not relevant for business purposes and thus, may not be a logical taxing point.

Location factors primarily raise tax issues at the international and state and local levels, rather than at the federal level. For example, the U.S. Supreme Court has ruled that a state may only require a vendor to collect sales and use tax if the vendor has a physical presence in the state.¹² Also, outsourcing raises issues as to the nature of the relationship between the company and the supplier to determine if the supplier is the company's agent creating a taxable presence (nexus) for the company in the state.

2. Nature of Products: E-commerce allows for some types of products, such as newspapers and music CDs, to be delivered in digitized (intangible) form, rather than in tangible form. Digitized products raise issues at the state level as to whether sales tax applies and in which state income is generated for state income tax purposes. Public Law 86-272, enacted in 1959 prohibits a state from taxing a foreign corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved, filled, and shipped from outside the state. This law is out-of-date today where the transfer of services and intangible items is a significant business activity. The nature of products can also raise income tax issues regarding the

type of revenue generated and how it is to be reported, as well as whether digitized products are subject to traditional inventory accounting rules.

3. New Marketing Techniques: The Internet has allowed for new ways of selling and buying goods and services. For example, individuals can offer their unwanted items to a worldwide group of potential buyers via auction sites, such as E-Bay. The Internet can also be used to easily link business buyers and sellers through exchange web sites where buyers post what they have to sell and sellers match up with them, or vice versa. Such sites can almost operate without human intervention for the matching function. In addition, the Internet has increased the use of bartering, most notably with respect to exchange of web banners that serve as advertisements. These new techniques raise various tax issues at all levels. For income tax purposes, issues include whether an exchange intermediary or broker should be accounting for inventory, and what amount of information reporting should be required for low-value bartering transactions, and how such transactions should be valued. At the international level, the source of the income generated (which country) might be uncertain. At the state and local level, issues exist as to when individuals have sold enough goods to be required to become sales tax collectors and how to enforce such rules. Another issue raised by changes or elimination of intermediaries is that some intermediaries collected excise tax, such as sellers of fishing equipment. When buyers interact directly with a foreign manufacturer, rather than a domestic retailer, the excise tax may go uncollected.
4. New Types of Assets: Some of the new assets created by commercial use of the Internet are domain names (URLs) and web sites. For income tax purposes, issues exist as to how to treat the costs of creating or acquiring such assets, as well as the characterization of any gain or loss generated upon disposition of the asset. Sellers of such assets may face uncertainty in the law as to how to characterize the gain or loss generated from the disposition (capital or ordinary).
5. Remote Workforce: The workforce of an Internet company may be scattered throughout a state or country, rather than working in a single work location together. This can raise issues as to whether the presence of the employee in a particular state creates tax obligations for the employer in that state. Also, cities may find that employers owe business license taxes due to the presence of an employee in the city or that if the worker is not an employee that the worker owes business license taxes.
6. Making Optimal Use of the Internet May Challenge Old Rules: One area where use of the Internet has potentially raised some tax issues involves how some tax-exempt organizations are using the Internet. For example, a tax-exempt organization might allow donors to be listed on the organization's Web site. This may cause the entity to face issues as to whether the listing is merely an acknowledgement or whether it is advertising that may result in unrelated business taxable income (UBTI) for the organization. Another issue may exist where an organization that primarily operates on the web, such as a non-profit information exchange, meets the tax definition of a tax-exempt organization. Also, the Internet may allow for more efficient interactions between a tax-exempt organization and its donors, yet existing rules were not written with such interactions in mind. For example, a receipt is required for certain donations in order for the donor to be entitled to a deduction. Will a receipt generated by and printable from a Web site constitute an appropriate acknowledgement for tax purposes? In October 2000, the Service issued Announcement 2000-84, 2000-42 I.R.B. 385, which lists various issues that tax-exempt organizations may face related to the Internet. The Service asked for input from interested parties as to whether additional guidance is needed for tax-exempt organizations.
7. Nature of Transactions: The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concerns for the Internal Revenue Service as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed. In a speech entitled, "Tax Administration in a Global Era," (former) Treasury Secretary Summers stated:

"The Internet provides new ways for tax administrations, such as the IRS, to improve the ease and transparency of tax collection. But new technology also raises certain problems. In a world where cyber-

transactions are growing at a rapid pace, tax administrations face the challenge of adapting existing tax systems to an economy that increasingly ignores physical borders.

In such a world, it will be easier for companies to avoid tax collectors by operating worldwide through web-sites based in jurisdictions that are unwilling to share taxpayer information.”¹³

WHAT’S CURRENTLY ON THE TABLE TO ADDRESS E-COMMERCE TAXATION ISSUES

Streamlined Sales Tax Project (SSTP): A group of representatives from over 35 states met throughout 2000 to create a Model Act and Agreement for a uniform and simplified sales and use tax system. The language was approved by the participating states in December 2000. While additional work is needed to fill in some missing pieces, many states will review the Model Act and Agreement to see if they want to adopt the uniform rules. Several states have already enacted legislation. In addition, multistate vendors will also review the SSTP proposal to understand what it might mean for them should states in which they have customers (whether or not the vendor has nexus (taxable presence) in the state) adopt the SSTP proposal.

The SSTP proposal simplifies the sales tax system for all types of vendors, rather than only for on-line vendors. Features of the SSTP proposal include state level administration of sales and use tax collections, uniformity in the state and local tax bases, a central electronic registration system, uniform sourcing rules, uniform definitions, simplified tax returns, and consumer privacy protections.

Legislative Proposals: Various federal and state legislative proposals to address e-commerce taxation issues have been introduced in the past five years. At the federal level, bills have been introduced to extend the Internet Tax Freedom Act moratorium, to provide a federal level tax on e-commerce sales, to provide nexus standards for business taxes, and to provide a framework for what a streamlined sales tax system would look like.

COMMON MYTHS REGARDING E-COMMERCE TAXATION

Myth: The ITFA exempts e-commerce transactions from taxation.

Reality: The ITFA provides a temporary moratorium on state and local taxes on Internet access, and multiple or discriminatory taxes on e-commerce. The ITFA preserves state and local taxing authority to the extent a particular tax is not covered under the moratorium. Thus, sales and use taxes still apply to sales of taxable items made via e-commerce.

Myth: The ITFA prevents states from imposing use tax collection obligations on remote sellers.

Reality: The *Quill* decision (504 U.S. 298 (1992)) prevents states from imposing use tax collection obligations on remote sellers, not the ITFA.

Myth: Loss of sales and use taxes on e-commerce transactions will not hurt state and local governments. Other revenue sources exist.

Reality: The impact of the loss of sales and use tax revenues varies across jurisdictions. In California, sales and use taxes represent 32% of tax collections at the state level, and for cities, these taxes represent 27% of general revenues. For states without an income tax, the loss is even more significant. For example, Nevada and Texas obtain over 50% of their tax revenues from the sales tax. Even in states with a corporate and personal income tax, most local governments neither have an income tax nor receive income tax revenue from the state government. Of course, many types of on-line transactions are not subject to sales tax, such as travel, stock purchases, and in some states (such as California) – software downloads.

Myth: The sales tax problem would be resolved if Congress would pass a law overturning the *Quill* decision.

Reality: The Internet allows a company to have customers in many different locations while having very few physical locations. It also allows new companies to operate in many states without needing any capital for physical (bricks and mortar) expansion. Such new and small companies would likely be put out of business or not seek the market potential presented by the Internet, if faced with obligations to collect use tax from customers in 6,000+ jurisdictions. Thus, it is unlikely that we will see the *Quill* physical presence standard eliminated by Congress under its Commerce Clause authority without significant simplification of the sales and use tax systems in the 46 states and hundreds of local jurisdictions that impose such taxes. Also, while Congress could allow states to collect sales and use tax from remote vendors located in the U.S., it would not be so easy or possible to get vendors in foreign countries to collect state sales tax. Thus, there would still be uncollected sales and use tax unless states can get consumers to voluntarily remit the tax.

Myth: Online vendors have less infrastructure needs than Main Street Retailers so it does not make sense to make them collect sales and use taxes.

Reality: Many online vendors still use the roads to deliver goods. Also, the consumer resides in the state and the sales tax is a consumption tax to be collected in the state of consumption (market activity). However, many would argue that requiring remote vendors to collect sales tax is taxation without representation. But, it is easier to collect the tax from vendors, rather than consumers. Is there an effective way to make the sales tax system work?

MORE INFORMATION AND HOW TO GET INVOLVED LOCALLY

For reports further explaining e-commerce taxation issues and links to legislative proposals and many other sources of information see:

http://www.cob.sjsu.edu/facstaff/nellen_a/e-links.html

Joint Venture Silicon Valley Network's Tax Policy Group has been working since 1997 to help promote understanding and discussion of the various issues raised by e-commerce. These reports can be found at:

http://www.jointventure.org/initiatives/tax/tax_pubs.html

The Tax Policy Group welcomes participation of the San Jose Silicon Valley Chamber of Commerce. To find out about upcoming meetings, please contact Annette Nellen at anellen@email.sjsu.edu.

¹ Ernst & Young, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by The Internet in 1998*, June 18, 1999.

² GAO, *Sales Taxes – Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000.

³ California Senate, *E-Commerce - Taxing Internet Sales and Access*, Pub. #99-1, September 1999.

⁴ GAO, *Sales Taxes – Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, Table V.1 and Table V.2.

⁵ New @plan Internet Poll™ Reveals Widespread Opposition to Internet Sales Tax, available at <http://www.webplan.net/home/investor/investor.htm>; September 14, 1999.

⁶ "In a World Without Borders: The Impact of Taxes on Internet Commerce," November 1999; see <http://gsbwww.uchicago.edu/fac/austan.goolsbee/research/intertax.pdf>.

⁷ Information provided by Vertex, Inc.; www.vertexinc.com/taxcybrary20/salestax_chronicle/taxfacts_main.asp.

⁸ For further discussion of sales and use tax complexities, see Joint Venture's Internet Taxation Briefing Paper 2000-4 at http://www.jointventure.org/initiatives/tax/tax_brief4.html.

⁹ Washington State Department of Revenue, *Retailers' Cost of Collecting and Remitting Sales Tax*, December 1998; <http://www.wa.gov/dor/reports/retail/retailsum.htm>. The report also notes that the costs of collection can be offset somewhat by the float that retailers enjoy due to the lag between collection and remittance of the tax, and the ability to deduct these costs on their income tax returns.

¹⁰ COST is a nonprofit organization of over 500 major multistate corporations. "COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities." See <http://www.statetax.org/>.

¹¹ The COST Telecommunications Tax Study is available at the COST website at <http://www.statetax.org/>.

¹² *Quill*, 504 U.S. 298 (1992).

¹³ From a speech to the 34th General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.