

# Lurking E-Commerce Taxation Issues

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## Introduction

While talk about e-commerce tax issues has decreased in the past few years, the existence, and perhaps extent, of such issues has not decreased. Some of these issues are "lurking" because any degree of exposure or interest in issuing guidance likely depends on the time of federal and state tax agencies, political will and the reality of today's compliance and administrative systems that may make enforcement difficult. Some of these issues include identifying business relationships that may create nexus for otherwise remote sellers, sales that go beyond the occasional sales rules, unreported gains, and drop shipments. Also lurking are matters we may see addressed legislatively such as nexus, the future of the Internet Tax Freedom Act, the disappearing 3% telephone excise tax (and utility user tax), broadband deployment, and the tax treatment of DSL, VoIP and other relatively new technologies. In addition to an overview of the lurking issues, the presentation will focus on possible solutions.

The lurking issues will be discussed within groupings that tie the issues together by the following broad root causes.

1. Legislators want to play a role
2. Changes in ways of doing business challenge old-business tax rules
3. Changes in technology make some tax rules obsolete or difficult to apply or may open new tax opportunities

## Significance of Trends in E-Commerce

The data and trends raise a variety of tax considerations including the following.

- § As e-commerce continues to grow, tax bases will continue to shrink, particularly in states, such as California, that do not subject materials transferred online to sales and use tax.
- § As e-commerce continues to grow, tax collections will continue to decline as more sales are from remote vendors and consumers are not 100% compliant with their use tax obligations.
- § With more individuals using broadband, more people will be able to download larger files such as movies and music. Thus, the number of on-line transactions will grow. In states with a broad base sales tax, the amount of uncollected use tax will increase due to having more sales by remote vendors. In states, such as California, that do not tax intangible items, such as ones transferred via telecommunications, the tax base will shrink as more items, such as software, books and movies, move from a taxable category to a non-taxable category.
- § The ease and reduced cost of micropayments will enable more types of items to be transferred via the Internet which may increase sales and use tax collection problems.
- § Many vendors have and will create nexus in more and more states as customers demand opportunities to view products in person and/or to return them in person. This will cause more vendors to no longer be remote vendors but instead be ones that will have sales tax collection obligations. However, it is unlikely that all vendors will create nexus in all states.
- § New business opportunities arise from the constant change in technology. This includes hardware and software development, a variety of web services for personal and business use, new uses for new types of

assets (such as with domain names<sup>1</sup>), and growing usage of the new technologies that opens up even more business opportunities.

- § The large number of individuals with Internet access should lead states to look for technological solutions to some of the tax problems. For example, could states make arrangements with online vendors that purchasers have the option of charging their sales tax (such as could be done by having state links on order pages where customers could have their use tax calculated and billed simultaneously with their product purchase).
- § The increased amount of online transactions will reduce paper trails and documents (although some online vendors (such as Amazon.com) maintain detailed and complete purchase records accessible by customers).
- § Governments must decide what the value would be of incentives for broadband deployment such as by considering whether they would get a new wave of people online or if there are other distractions that would be overcome by incentives.
- § Governments need to determine how changes in telecommunications, such as VoIP and service arrangements that are not subject to the 3% excise tax affect tax bases and how rules can be modernized to better reflect today's technology and industries. Consideration should also be given to whether special taxes are appropriate given the nature of the changes in regulation and technology in communications in the past decade.
- § Continual changes in ways of doing business, new types of assets, and new technologies will continue to challenge tax rules that were mostly written for a different era.

### **Issues Stemming from Legislative Desire to Be Involved**

#### **The Three Time Temporary Internet Tax Moratorium**

The Internet Tax Freedom Act<sup>2</sup> (ITFA, P.L. 105-277, 10/21/98) imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) on state and local taxes on Internet access, unless such tax was generally imposed and actually enforced before October 1, 1998, and multiple or discriminatory taxes on e-commerce. The ITFA preserved state and local taxing authority to the extent a particular tax was not covered under the moratorium. Thus, sales and use taxes still applied to sales of taxable items made via e-commerce. In 2001, the moratorium was extended to November 1, 2003 (P.L. 107-75; 11/28/01). It was extended once more, retroactively, to November 1, 2007 (Internet Tax Nondiscrimination Act, P.L. 108-435; 12/3/04).<sup>3</sup> The 2004 extension also included the following provisions:

- § The term 'Internet access service' "does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access."  
  
This change is due to confusion over whether DSL services are covered by the original moratorium language. Some states tax DSL on the basis that it consists of both Internet access services and telecom services. DSL providers argue that such treatment puts them at competitive disadvantage with cable modem and direct satellite providers.
- § "Nothing in this Act shall be construed to affect the imposition of tax on a charge for voice or similar service utilizing Internet Protocol or any successor protocol. This section shall not apply to any services that are incidental to Internet access, such as voice-capable e-mail or instant messaging."
- § The grandfather provision was modified and may terminate prior to November 1, 2007 (see Act for specific dates and details).

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<sup>1</sup> In the late 1990s, there were some stories of individuals selling one-word domain names, such as computers.com for large sums. Today, there are stories of individuals and website companies having created new markets by using the domain names for advertising purposes. For an interesting overview to this market, see Paul Sloan, "Masters of their Domains, *Business 2.0*, Dec. 2005, pages 137 – 146.

<sup>2</sup> Full text of ITFA available at <http://www.ecommercecommission.org/ITFA.htm>.

<sup>3</sup> The California Internet Tax Moratorium expired on January 1, 2004.

§ The GAO is required to conduct a study due November 1, 2005 of the impact of the moratorium on state and local governments and broadband deployment.<sup>4</sup>

The ITFA raises a few “lurking” issues including whether it should be made permanent and if so, with or without a grandfather provision. Also “lurking” here is the reality of how misunderstood this law seems to be. It has been described by some as crucial to the growth of the Internet, yet it primarily only prohibits state and local governments to tax Internet access fees unless previously grandfathered (language on “discriminatory” taxes may also affect some nexus interpretations at the state and local levels). The debate on the ITFA thus might not be the best use of time of policymakers given that few states even tax such fees and a few grandfathered states stopped taxing the fees.<sup>5</sup> Also, changes in how the Internet is accessed raises issues on how to define “Internet access fees” which Congress dealt with in the 2005 legislation, but will continue if further extension is called for. Also “lurking” is the necessary debate on federalism and how much control the federal government should have on the tax base decisions of state and local governments. Also “lurking” is a discussion on whether government assistance is needed to promote Internet access and if so, what is the best form. The ITFA attempts to promote access via prohibition of some state and local taxes rather than looking at prohibition of federal tax (such as excise tax on airline tickets purchased online) or a federal incentive (tax credit for certain access fees or technology).

### Tax Incentives

In addition the Internet Tax Freedom Act and its possible extension, there have been other federal and state proposals and actions to provide incentives to increase the number of Internet users and what they can do on the Internet.

Policymakers at all levels of governments have concerns as to whether all citizens will have access to broadband so that providers of services over broadband can maximize their market potential and that citizens can access information and other needed services. With the potential for a significant amount and variety of information to be provided online for education, entertainment, medical treatment, and other purposes, such access may become as essential as a telephone has been for years.

Examples of incentive proposals at the federal level are H.R. 1479 and S. 1147 (109<sup>th</sup> Cong.) to allow certain equipment that provides broadband services to be expensed rather than capitalized. The rationale for such incentives at the federal level is to better ensure that rural areas will be served and to help minimize the digital divide.<sup>6</sup> Opponents of such tax incentives argue that the government might not pick the best technology to incentivize, the competition in the field indicates that incentives are not warranted, and regulatory issues would remain an impediment to greater deployment of certain technologies.<sup>7</sup>

In extending the Internet access tax moratorium in December 2004, Congress called upon the GAO to conduct a study on the impact of the moratorium on “the deployment and adoption of broadband technologies for Internet access throughout the United States, including the impact of the [Act] on build-out of broadband technology resources in rural underserved areas of the country.” [P.L. 108-435; Sec. 7]

States are also interested in helping to ensure broadband deployment. In September 2002, California lawmakers enacted SB 1563 (Chapter 674). It calls upon the CA Public Utilities Commission (CPUC) to investigate and report on a plan to encourage widespread availability and use of advanced communications so that more people have access to state-of-the-art technologies. The required report was released in May 2005 and provides a detailed analysis of broadband technology, markets, benefits, barriers, existing incentives, what some other states are doing, and recommendations for California policymakers.<sup>8</sup>

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<sup>4</sup> The GAO issued a report in January 2006 on the revenue impacts. *Internet Access Tax Moratorium – Revenue Impacts Will Vary by State*, GAO 06-273; available at <http://www.gao.gov/new.items/d06273.pdf>. The report in covering broadband deployment was issued in May 2006. *Broadband Deployment is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas*, GAO-06-426; available at <http://www.gao.gov/new.items/d06426.pdf>.

<sup>5</sup> An October 2003 Congressional Research Service report notes that the trend has been for states to repeal their taxes on Internet access fees as Connecticut, Iowa and the District of Columbia did. Nonna A. Noto, *Internet Tax Bills in the 108<sup>th</sup> Congress*, Nov. 10, 2003, page 3; available at <http://usinfo.state.gov/usa/infousa/trade/ecommm/taxbills.pdf>.

<sup>6</sup> See, for example, a 2000 press release from Senator Rockefeller at <http://www.senate.gov/~rockefeller/news/2000/pr032100.html>.

<sup>7</sup> Adam Thierer, “Broadband Tax Credits: The High-Tech Pork Barrel Begins,” Cato Institute, 7/13/01; available at <http://www.cato.org/tech/tk/010713-tk.html>.

<sup>8</sup> The CPUC final report can be found at <http://www.cpuc.ca.gov/Static/telco/reports/broadbandreport.htm>.

Points made in comments submitted to the CPUC in June 2003 (Proceeding R0304003) include:<sup>9</sup>

- The dominant broadband providers are unregulated cable providers, not regulated telcos. There are a variety of ways for broadband capabilities to achieve high-speed Internet access including cable modem, DSL, satellite, wireless, and electric power lines. Consumers mostly see these technologies as equivalents in terms of capabilities.
- The infrastructure should be both competitively and technologically neutral. This is necessary in order that technology advance as it should and to enable companies to have an incentive to innovate and provide services – that they will be able to get a market return on their investment. The CPUC should be sure not to regulate in a manner that will defeat this goal. All broadband providers should be treated similarly.
- Competition should be encouraged as it leads to technological improvements, better service, and price reductions.
- A service provided testified to the CPUC: “Since broadband competition is already robust, direct government intervention is unnecessary and would impede market growth.”<sup>10</sup> However, TURN did not view the market as having robust competition because in some markets, such as DSL, there are few providers.<sup>11</sup>
- “Widespread broadband availability will require the investment of staggering amounts of capital into California’s telecommunications infrastructure. Investors can be encouraged to risk billions of dollars to build a broadband network if they are confident that future regulation will not limit the rewards by giving their gains to competitors.”<sup>12</sup>
- Tax incentives can be helpful in encouraging broadband deployment.
- “In its report to the Legislature, the Commission can and should include a recommendation that municipalities not be permitted to impose unreasonable fees for providers to enter the market, for example, by imposing non-cost based licensing, permitting, and application fees; or unreasonable right-of-way access requirements, tower siting restrictions, and zoning requirements. All such fees and requirements raise the cost of providing service, hinder investment in broadband infrastructure, and are at odds with the Commission’s vision of widespread broadband availability.”<sup>13</sup>
- The digital divide will not be eliminated solely by having a larger telecommunications system. Issues of illiteracy and lack of training to use hardware and software are also problems that create the divide.

The GAO issued its report in May 2006. It noted some technological and market issues affecting broadband deployment, particularly in rural areas. It also noted that based on its economic models, the “imposition of taxes was not a statistically significant factor influencing the deployment of broadband.” Broadband is more likely to be obtained by individuals with higher incomes and college degrees. The types of services offered and desired also ties to likelihood of pursuing access with file sharing and gaming being highly desired services.<sup>14</sup> Similarly, the Congressional Budget Office noted in a 2003 report that nothing in the residential broadband market indicated that subsidies would produce large economic gains. However, CBO noted that although just looking at economic efficiency did not lead to a need for subsidies, equity and regional development issues might lead to a different conclusion.<sup>15</sup>

The CPUC report<sup>16</sup> recommends legislation or an executive order making broadband deployment and access a priority, create a task force to address access and removal of barriers to access, have the government lead by example (such as enabling forms to be filed online and webcasting public meetings), provide incentives to get

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<sup>9</sup> See <http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm>.

<sup>10</sup> Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 15.

<sup>11</sup> Opening comments of TURN (The Utility Reform Network) to the CPUC hearings related to SB 1563, June 2003.

<sup>12</sup> Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 18.

<sup>13</sup> Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 5.

<sup>14</sup> *Broadband Deployment is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas*, GAO-06-426, pages 4 and 5; available at <http://www.gao.gov/new.items/d06426.pdf>.

<sup>15</sup> CBO, *Does the Residential Broadband Market Need Fixing?* Dec. 2003, pages ix - x; available at <http://www.cbo.gov/ftpdocs/48xx/doc4868/12-03-Broadband.pdf>.

<sup>16</sup> CPUC, *Broadband Deployment in California*, May 2005; available at <http://www.cpuc.ca.gov/static/telco/reports/broadbandreport.htm>. The recommendations are in Chapter 9 of the report.

broader use in communities where use is currently low, address rights-of-way issues, reform cable franchise rules, encourage broadband over power lines, and keep VoIP and other new technologies free from regulation.

The “lurking” issues in promoting broadband and other technologies include:

1. Whether any type of tax incentive is needed for more widespread broadband deployment (rather than a more direct subsidy).
2. If an incentive is needed, what should it be and what level of government should provide it?

### **Protecting Revenue**

Since e-commerce started to emerge in the late 1990s with the start of pure online vendors, such as Amazon.com (which began business in 1995 and went public in 1997) and bricks-and-mortar vendors adding online purchase options, the concern of state and local governments about uncollected sales and use tax have continued to grow as has the amount of the lost revenue. The problem of uncollected sales and use tax from sales by remote vendors (ones not present in the customer’s state) has existed for decades due to mail order sales. In fact, the problem was noted in the “Willis Commission” report of Congress in 1965.

The loss and decline of sales and use tax revenues stems from two main sources:

1. The increase in the number and total dollar amount of transactions where sales and use tax is not collected.<sup>17</sup> A significant trait of e-commerce is that it allows vendors to have customers throughout the world without having to have a physical presence (a store or sales staff or warehouse) in the jurisdiction. These vendors include large ones, such as Amazon.com, as well as many small ones who sell items through online auction sites, such as EBay.

The U.S. Supreme Court’s interpretation of the due process and commerce clauses of the U.S. Constitution provides the guidance on when a vendor must collect sales and use tax from customers. In *Quill Corporation v. North Dakota*, the Court interpreted the due process clause to mean that if an out-of-state business purposefully avails itself of the benefits of an economic market in the state, it need not have a physical presence in the state to be subject to tax collection requirements in the state.<sup>18</sup>

Despite the Court’s due process interpretation though, the Court stated that North Dakota’s enforcement of the tax against Quill was an unconstitutional burden on interstate commerce in violation of the Commerce Clause. However, the Court pointed out that because the Constitution gives Congress the right to regulate interstate commerce, Congress could provide a mechanism to allow states to collect sales and use tax from an interstate mail-order business that was not physically present in the state, without violating the Commerce Clause. To date, Congress has not exercised its power under the Commerce Clause to allow state and local governments to collect sales and use tax from remote vendors. The ruling does not mean that purchases from remote (non-present) vendors is exempt from sales and use tax, it just means that the state must look to the purchaser to calculate and remit the use tax. While compliance by businesses, particularly those that already file sales tax reports because they collect sales tax, compliance by consumers is problematic.

Consumer failure to report and remit use tax on purchases made from remote vendors is not uncommon. Collecting use tax from consumers is difficult because many consumers are not aware of the requirement, poor recordkeeping, complexity in sales and use tax laws as to what is taxable, and government cost of administration relative to the tax owed which can lead to lax enforcement.

In addition to online vendors, other areas where sales and use tax may go uncollected involve sellers who do not register to collect sales tax thinking they are not subject to the rules and confusion that may exist in drop shipments as to who is to collect the tax. These topics are discussed further in the section on changes in ways of doing business.

*Solutions:* Collection of the growing amount of uncollected use tax could occur through better compliance by consumers. This is an unrealistic solution due to the recordkeeping, reality that auditing for compliance is too costly, and the difficulty of knowing what is taxable. A better solution for states would be for

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<sup>17</sup> Amazon.com, one of the leading pure online vendors reports that its annual 5-year revenue growth rate is 25.18% (<http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-fundsnapshot>).

<sup>18</sup> *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992). In *National Bella Hess .v Department of Revenue of Illinois*, 386 U.S. 753 (1967), the Court held that physical presence was required under the due process clause. It changed this interpretation in Quill due to changes in business practices from 1967 that did not require that a vendor have a physical presence in order to make a market in a state.

Congress to exercise its power under the commerce clause and allow states to collect sales and use tax from remote vendors. [SSTP] Another solution, albeit a partial one, would be for states to stretch their nexus rules and interpretations as far as they can to perhaps find that some “remote” vendors are really present due to some connection in the state, such as someone assisting with sales or returns (discussed later in this article).

2. Knowledge-economy transactions that are not taxable transactions in many states or where the Internet Tax Freedom Act prohibits collection of sales and use tax. A 2004 Entrepreneur.com article noted that the best “product” to sell online is information. Such information products may take for form of digital books, newsletters and software. Factors that make information a great product are the ease and low cost of advertising and delivery, the fact that inventory is not needed, and low start-up costs.<sup>19</sup> The Internet also allows for other types of knowledge-economy transactions such as digital products (music, movies, books, software) and services (web-cam views, medical advice, and others). The Internet Tax Freedom Act prohibits state and local governments from taxing Internet access fees unless covered by a grandfather provision (discussed earlier).

In most states, many of these intangible and service purchases are not subject to sales and use tax. Thus, they do not pose a collection problem, but they pose a revenue problem for state and local governments as the dollar volume of such transactions grows, particularly as they replace consumption of taxable products.

*Solutions:* To help maintain their sales and use tax base, states that do not currently tax the digital equivalent of tangible personal property, will need to change their laws to bring digital goods into the base. States might also want to consider brining other forms of consumption in such as services. Of course, this solution is not politically popular.

*How much is lost?* Estimates of the amount lost from the failure to collect sales and use tax on remote sales vary greatly due to differences in the expected growth of such transactions, the current level of compliance and assumptions made about business compliance. 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 are due to varying assumptions as to business-to-business compliance rates and the estimated amount of e-commerce sales.<sup>20</sup>

The June 2000 report from the GAO indicated a wide range of estimates on what consumer and business compliance rates was with respect to paying use tax. In its estimates, GAO used a consumer compliance rate of between 0% and 5% and 50% to 90% for business purchases with the exception of auto purchases.<sup>21</sup> Because cars must be registered, the use tax can be collected and use tax compliance is about 100%.<sup>22</sup>

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.<sup>23</sup> 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.<sup>24</sup>

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<sup>19</sup> Tim Knox, “The Best Product to Sell Online: Making money from so-called “info products” is easier than you think,” Entrepreneur.com, Aug. 23, 2004; available at <http://www.entrepreneur.com/article/0,4621,316820,00.html>.

<sup>20</sup> GAO, *Sales Taxes – Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000.

<sup>21</sup> GAO, *Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, pages 34 - 35.

<sup>22</sup> Some states, including California, have begun to collect excise and use taxes from consumers on on-line purchases of tobacco products with the help of a 50 year old federal law that requires reporting of purchaser names. David Streitfeld, “Online Tobacco Sales Ignite Fight Over Taxes,” *The Washington Post*, August 29, 2000, page A1.

<sup>23</sup> California Senate, *E-Commerce - Taxing Internet Sales and Access*, Pub. #99-1, September 1999.

<sup>24</sup> 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.

The BOE notes that the loss of use tax from retail e-commerce may not be as large as might be expected when one looks solely at online sales. This is because some of the online sales are substitutions for what would have otherwise been a mail order sale with the same use tax problem.<sup>25</sup>

### **Search (Stretch) for Nexus**

To address concerns about new business practices that may reduce the number of jurisdictions where a business is a taxpayer, legislators and tax agencies have taken a closer look at the nature of relationships that businesses have to find if any rise to the level of nexus or could with legislative changes. For example, some established businesses, such as Barnes & Noble, expanded into Internet sales by creating a new entity that had physical presence in far fewer states than the bricks-and-mortar business in order to reduce the need to charge sales tax to all customers. Such practices have been scrutinized by legislators and tax agencies. Similarly, efforts to use third parties to provide services to customers who buy from a business and structuring the arrangement to avoid having the third party by an agent of the business creating nexus have also been scrutinized by tax agencies and some courts.

States sometimes seem quite eager to find some way to label a vendor as having nexus in the state so that the vendor must collect sales and use tax rather than having the state hope that the consumer will voluntarily remit the use tax. A few states have changed their laws to expand the reach of what it means to be a vendor doing business in the state for sales tax purposes. (Proposals for contracting nexus are discussed in a later section.)

### *Use of Affiliates*

In 2004, the Multistate Tax Commission (MTC) drafted an affiliate nexus proposal<sup>26</sup> under which a remote vendor would have substantial nexus in a State for collection of use tax if (1) the vendor is related to an in-state business that maintains one or more locations within the state, and (2) the vendor and the in-state business “use an identical or substantially similar name, tradename, trademark or goodwill to develop, promote, or maintain sales, or the in-state business and the out-of-state vendor share a common business plan or substantially coordinate their business plans, or the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market.” The proposal also includes a definition for “related.”

This proposal is similar to a California proposal introduced in 2000 - AB 2412 (Migden and Aroner). AB 2412 proposed to clarify the sales and use tax rules to provide that a retailer is responsible to collect sales tax if engaged in business in the state who processes orders electronically (by fax, via Internet, etc.). AB 2412 would also “prospectively clarify” that “a retailer is presumed to have an agent within the state,” if it meets both of the following conditions. “(A) The retailer holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in California or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof; and (B) The retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to California purchasers”. Thus, a company with an affiliate, subsidiary or related entity in the state would have the same nexus as the related entity if they sell the same type of products and there is a substantial ownership interest. A substantial ownership interest was defined by reference to federal law under Title 15, §78p (federal securities law) which refers to an ownership level in excess of 10%.

The apparent goal was to address the sponsor’s concern that some bricks and mortar stores established separate legal entities for their e-commerce activities which did not have a physical presence in California and were therefore not required to collect sales tax from customers. However, case law supports the view that a separate legal entity does not have nexus of a related entity attributed to it. For example, in *Current, Inc. v. SBE*, 24 Cal. App 4th 382, 29 Cal Rptr.2d 407 (Ct. Appeal 1994), the court held that a remote seller could not be treated as having nexus due to the physical presence of a parent corporation where the corporations were separate and distinct entities, did not have integrated operations and did not act as the alter ego or agent of the other for any purpose. The court noted that in similar cases, courts have “relied upon the fundamental principle of corporate law that the parent corporation and its subsidiary are to be treated as separate and distinct legal persons in the absence of a showing that corporate assets have been intermingled, that the formalities of separate corporate procedure have been ignored, or where the corporation is inadequately financed.”

In the *Current* case, the court found that R&T §6203(g) (as it existed then) was unconstitutional under the commerce clause. This provision imposed a tax collection responsibility upon “any retailer owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business in this state.” The language found to be unconstitutional in the *Current* case is quite similar to the proposed language of AB 2412.

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<sup>25</sup> SBE, *Economic Perspective*, August 2004, page 3; available at <http://www.boe.ca.gov/news/pdf/EP804.pdf>.

<sup>26</sup> Available at <http://www.mtc.gov/MEETINGS/Uniformity%20Materials/AffiliateNexusPropos07-13-04.pdf>.

Similarly, see *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (SCt Ohio 1995), and *Bloomington v. Dept. of Revenue*, 567 A.2d 773 (1989), aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992).

In contrast, in *The Reader's Digest Association, Inc. v. Mahin*, 255 N.E.2d 458 (S Ct Ill 1970), cert denied 399 U.S. 919 (1970), the presence of subsidiaries in Illinois was attributed to the parent corporation. One of the subsidiaries solicited advertising for the parent corporation's magazine, thus acting as the parent's agent.

The difference between the approach of AB 2412 and existing law is that AB 2412 would label two corporations as being in an agency relationship without looking at what the one does for the other to indicate an agency relationship. Ownership and similar business activities do not create an agency relationship. In the *Reader's Digest* case, the subsidiary solicited advertising on behalf of the parent corporation, creating an agency relationship. In the other cases cited above, the situation was similar to that laid out in AB 2412 and attribution of one corporation's presence to another corporation was found to be unconstitutional. Rather than describing an agency relationship, AB 2412 seemed to take the approach that two legal entities are deemed to be just one entity if a substantial ownership relationship exists and they sell the same products or assist in advertising. This ignored many years of case law that treat separate legal entities as separate taxpayers unless there is a basis for piercing the corporate veil due to insufficient financing or independence.

AB 2412 passed in the Assembly on May 30, 2000 and in the Senate on August 30. Governor Davis vetoed the bill on September 25, 2000. Governor Davis stated, "In order for the Internet to reach its full potential as a marketing medium and job creator it must be given time to mature. At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California's international role as the incubator of the dot-com community. . . . AB 2412 singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject."<sup>27</sup>

Despite the implication from Governor Davis that AB 2412 imposes a new tax, the bill attempts to get certain Internet retailers to collect sales tax that is already an obligation of the customer (to self-assess use tax). AB 2412 was reintroduced as AB 81 in 2001, but subsequently changed to address energy issues. Similar legislation was introduced in 2003 (SB 103), but was not successful.

In 2001, Arkansas passed legislation similar in effect to AB 2412.<sup>28</sup> In 2003, similar legislation passed in Alabama (H.B. 650). Kansas, Louisiana and Minnesota have similar new rules.<sup>29</sup>

In 2001, Nevada expanded its definition of "retailer maintaining a place of business in this State" at §372.728 of its Sales and Use Tax Act by adding the words underlined in the following excerpt:<sup>30</sup>

A retailer soliciting orders for tangible personal property through a system for shopping by means of telecommunication or television, using toll-free telephone numbers, which is intended by the retailer to be broadcast by cable television or other means of broadcasting to persons located in this state or through a website on the Internet or other electronic means of communication to provide solicitations to persons in this state.  
[372.728(4)]

New perspectives on defining when a retailer has nexus in a state don't only arise from state legislators, but also from interpretations of existing law by state tax agencies and the courts. In 2003 in the *Matter of the Petition for Redetermination under the Sales and Use Tax Law of Borders Online, Inc.* (SC OHA 97-638364), the California Board of Equalization found that because Borders accepted returns of purchases from Borders.com, nexus existed. The statement was found on-line in July 1999, but was removed in August 1999. The Board found such activities to be an integral part of the selling process (people are more likely to buy online if they can return to a store) and that Borders.com had a physical presence in California (through the in-state affiliate). The appeal was heard and decided by the First Appellate District in May 2005 and affirmed.

Borders Online was formed in 2001 as a Delaware corporation, headquartered in Michigan, to be Internet Company for Borders (it is a successor in interest to Borders Online, Inc.). Online and Borders are affiliated corporations owned by the same corporation. Most likely, one of the reasons why Online was set up as a separate corporation was to limit the number of states in which it would have to collect sales tax, based on such precedent as *SFA Folio*

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<sup>27</sup> Office of the Governor, press release of 9/25/00.

<sup>28</sup> Arkansas Act 922 (HB 1440), see <http://www.arkleg.state.ar.us/ftp/prot/bills/2001/htm/hb1440.pdf>.

<sup>29</sup> MTC, *Sales & Use Tax Compliance Work Group Final Report and Proposed Initiatives*, June 17, 2004, page 10; available at <http://www.mtc.gov/MEETINGS/SalesUseTaxWGFinalReport.pdf>.

<sup>30</sup> Nevada Assembly Bill No. 445, Chapter 364, June 6, 2001.

*Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (SCt Ohio 1995), and *Bloomingtondale's v. Dept. of Revenue*, 567 A.2d 773 (1989), aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992). Online had no employees or property in CA.

In 1998 and 1999, Online sold over \$1.5 million of merchandise over the Internet to CA consumers. Its website noted that goods could be returned to any Borders (physical) store. Borders did not charge Online for this service. This note was removed from Online's website on 8/11/99. Borders also included a notation on its sales receipts to "visit us online at [www.borders.com](http://www.borders.com)).

Issues before the court were (1) whether Border's activities were "for the purpose of selling" Online's goods, and (2) whether Online had sufficient presence in the state, through Borders, to justify that it was required to collect sales/use tax.

The court agreed with the SBE that since Borders only handled returns for Online per the terms on Online's website, it was acting as Online's authorized agent. A formal arrangement is not needed because an agency relationship can be implied based on conduct and circumstances and no written agreement is needed.

The handling of returns for Online caused Borders to be "selling" for purposes of §6203(c)(2), because it was an integral part of getting customers to buy online. Online argued that it was not allowed to produce evidence that Border's reason for taking the returns was unrelated to encouraging sales. No evidence was produced when required and the court noted that even if the return policy provided some benefit to Borders (for example, it got a customer into their store), it could have still induce Online customers to buy from Online.

Online noted that unlike the situations in *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232 (1987) and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), Borders was not actually making any sales for Online. The court viewed that perspective as too narrow noting that per *Tyler Pipe* one is to look at whether the activities of the retailer's in-state people are "significantly associated with [its] ability to establish and maintain a market in [the] state for the sales."

The court did not find the returns policy here similar to *SFA Folio Collection* where the store took returns from the catalog operation under its own policy and for its benefit.

*Queries:* Is this holding a proper interpretation under R&T §6203(c)(2)? R&T §6203(a) provides that "every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state, not exempted ... shall ... collect the tax from the purchaser." R&T §6203(c)(2) provides that "retailer engaged in business in this state" includes "any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property." Clearly, Online is a retailer. Also, noting on its website that Borders will handle returns appears to make it an agent or representative, but was Borders "selling" for Online?

The court stated "The Board appears to have thoroughly considered the meaning of the term, and its reasoning that the act of 'selling' encompasses offering other inducements to purchase is consistent with at least one later pronouncement. (*Board's Boarder Opn.*, *supra*, Cal. Tax Rptr. (CCH) ¶403-191 at p. 29,974; *In the Matter of the Petn. For Redetermination Under the Sales and Use Tax Law of Barnes & Noble.Com* (Sept. 12, 2002) [2000-2003 Transfer Binder] Cal. Tax Rptr. (CCH) ¶403-325, pp. 30,447, 30,450 [bookstore's distribution of discount coupon on behalf of affiliated Internet retailer was integral to selling efforts and thus constituted 'selling'].)"

There was no evidence of whether sales occurred at Online due to the return policy. Is an offer to handle a return the same sales inducement as providing a coupon (which in *Barnes & Noble.Com*, the Board found to be more than advertising)? Does "selling" mean offering inducements to sales, or actually making sales, as was done in *Scripto* (independent contractors taking orders) and *Scholastic* (teachers taking orders and collecting payment for the bookseller)<sup>31</sup>? Of course, those cases were looking at the in-state person's actions and relationship with the out-of-state retailer to determine if an agency relationship existed, not whether "selling" was involved (because taking orders is unquestionably selling).

Does R&T §6203 need to be modified again to be clearer? Should it say "selling or inducing or promoting sales" rather than just "selling"? Of course, given the 2005 *Borders Online* decision, there would appear to be no need to clarify it other than to avoid litigation in the future. Such a change would appear to be permissible within the Due Process and Commerce Clause given that §6203 requires the physical presence of an agent or representative in the state. Also, this language ties to maintaining a market in the state as required by the U.S. Supreme Court. (In *Tyler Pipe, supra*, the Court stated: "The crucial factor governing nexus is whether the activities performed in this state on

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<sup>31</sup> *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal App 3d 734, 255 Cal Rptr 77 (CA Ct App, 1989).

behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.")

*Query:* Some vendors with limited locations, perhaps with only a physical location in one state, rely on certain technological mechanisms in order to have sales. Such mechanisms include auction websites and online payment systems. For example, for years Sam operated a single antique store and all customers were ones who visited the store and made a purchase. A few years ago, Sam started listing many items in his store on an on-line auction site and sales grew tremendously with customers throughout the U.S. Does Sam have nexus in any of these states? The on-line auction site is headquartered in Michigan. Does Sam have nexus in Michigan? Arguably, the relationship between Sam and the Michigan online auction company is not an agency one since the auction company cannot act for Sam. Instead, it provides a service to help connect buyers and sellers, but not to actually make a sale. Is Sam selling in Michigan? Under a statute similar to CA R&T §6203 and the Borders decision, "selling" could arguably be interpreted as meaning facilitating a sale. Without the online auction site, Sam would not have sales in Michigan (or other states). How clear are state statutes in addressing these arrangements and what terms in the arrangements might lead to a result of nexus thereby creating additional sales tax collection obligations for Sam?

#### *Use of Third Party Service Providers*

Another situation that has caught the attention of state tax agencies is the use of third parties in a structure that enables services to be provided to customers, but without nexus for the seller of the goods that require services. The results have been mixed as illustrated by some decisions involving the selling practices of Dell.

In *Dell Catalog Sales v. Commissioner, Department of Revenue Services*, 834 A2d 812 48 Conn Supp 170 (July 2003), Dell Catalog Sales was found not to have nexus in Connecticut from its relationship with BancTec which provided services to Dell's customers. Dell Catalog has not presence in the state. Its customers may purchase a service contract from BancTec. Dell typically sold the service contract at the time it sold the computer and contracts could not be purchased from Dell without also buying a computer. About 75% of customers also purchased a service contract. Dell collected sales tax on the service contract, but not on the computer and remitted the tax to the state. The "the terms of the Service Contract Sales Brokerage Agreements provided that Dell Catalog Sales would act as BancTec's agent and broker in marketing BancTec's service contracts, and Dell entities would provide certain technical assistance to BancTec in connection with BancTec's service contracts, in exchange for the contract commission." Dell received about 90% of the service contract revenue because it provided the bulk of the services via the phone through Dell Tech Support outside of the state. The court noted that this situation indicated that "BancTec's effort in going on-site in Connecticut to service the consumer's computer had to be minimal."

Dell Catalog was registered to do business in Texas, Florida, Kentucky and Nevada, but the Connecticut Tax Commissioner registered Dell (involuntarily) to do business in Connecticut. The Commissioner argued, based on *Scripto* (362 US 207 (1960)), that Dell owes use tax on computer sales in the state because BancTec is its representative in the state. The court noted that the Commissioner's position was also supported by the Multistate Tax Commission's (MTC) Nexus Program Bulletin 95-1.

The court noted: "Although it appears that BancTec was operating in Connecticut on Dell's behalf, in fact the parties have stipulated that BancTec was an independent computer service provider throughout the United States, and that on-site service was performed solely by BancTec or its subcontractors. (Joint Stipulation of Facts, ¶¶35-36.) his stipulation of the parties negates the claim of the Commissioner that BancTec was the agent of the plaintiff in Connecticut. By stipulating that BancTec was an independent service provider, the Commissioner acknowledged that Dell had no right to direct and control the work of BancTec. *Beckenstein v. Potter & Carrier, Inc.*, 191 Conn. 120 , 132-33, 464 A.2d 6 (1983) . We also find credible the testimony of Michael Burns, vice president of sales and marketing of BancTec that servicing computers was their expertise and that Dell did not control or interfere in BancTec's dealings with the customer. This lack of control by Dell substantiates the stipulation of the parties that BancTec was not an agent for Dell."

Further, "We note that Dell provides service to the consumer under the terms of the service contract only by telephone in Texas, and BancTec, for its part, performs only on-site service to the consumer in Connecticut. We further note that Dell markets and sells the service contract to its own customer at the time that it sells the customer a computer; that Dell sets the price of the contract to the consumer; that Dell earns a substantial portion of the cost of the contract; and that Dell performs a substantial part of the service required under the terms of the service contract. Although Dell's name does not appear on the service contract as a contracting party, Dell is an integral part and a major ingredient in the performance of the contract. Cases dealing with the issue of whether the use of independent service representatives provides the in-state physical contacts required to establish nexus by an out-of state seller focus on the extent of the activities of the in-state independent service representative. In *Scripto*, ten independent service representatives conducting continuous local solicitation in Florida and forwarding the orders to the out-of-state seller for acceptance of the orders was sufficient nexus for the state of Florida to require the out-of-state seller to collect a state use tax upon the sale of the goods shipped to customers in Florida. *Scripto v. Carson*,

supra, 362 U.S. 211- 212 . In *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 251, 107 S. Ct. 2810 (1987) , the U.S. Supreme Court held that having resident sales representatives in the taxing jurisdiction to establish and maintain the seller's market constituted physical contacts that established a nexus sufficient to impose a business and occupation tax on sales upon the out-of-state seller. The Tyler court stated: “[T]he crucial factor governing nexus is whether the activities performed [in Washington] on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.” *Id.*, 250-251. The Tyler case was a direct tax case, not a sales and use tax case, but we see the principle of nexus associated with the extent of the in-state activity to apply with equal force to cases involving sales and use taxes.” The court also discussed *In re the Appeal of Intercard*, 270 Kan. 346 , 14 P.3d 1111 (2000), where the court found 11 visits to the state to not create a substantial nexus in the state.

Thus, the court found that Dell Catalog did not have sales tax nexus in the state. “The missing ingredient in determining whether BancTec's on-site service established nexus in Connecticut as a representative of Dell would be the frequency, if any, of the number of on-site service calls.

However, in 2006, a Louisiana court took a different interpretation and found that Dell did have substantial nexus in the state for sales and use tax purposes due to its arrangement with BancTec. In *State of Louisiana and Secretary of the Dept. of Revenue and Taxation v. Dell Int'l, Inc., et al*, 922 So 2d 1257 (2006), the appeals court reversed the trial court decision to find that Dell did have sufficient connection through a third party acting on its behalf in the state to create physical presence for sales and use tax purposes. Dell itself has no facilities or employees in Louisiana (L). Its customers in L order products via the Internet or catalogs with orders accepted in Texas and products shipped from either Texas or Tennessee by common carrier or the US Postal Service. Dell had a contract with BancTec (B) for B to provide on-site service for Dell products in L. B does not work exclusively for Dell, but also had repair contracts with other computer providers.

Dell designed the repair service program and copyrighted it. Customers bought the service contracts at the time they purchased a Dell product or after the purchase. The service was emphasized in Dell's marketing literature. B employees were trained by Dell and Dell told B, based on calls Dell received from its customers, when to service a customer's machine. Dell set the service prices and paid B based on the number of on-site service calls it had. Dell also provides all of the service parts to B. However, the service contracts themselves were between a Dell customer and B. Yet, if B did not perform to Dell's standards, Dell had the right to hire a different third party to handle the service. The court noted: “The record establishes that Dell through BancTec is clearly in control of the on-site computer repairs.”

L's tax agency sought payment from Dell for use tax and income and franchise taxes, plus interest and penalties. Only the use tax claim survived to trial. L argued that Dell had a physical presence in L through its repair agent, B. Dell countered that B was not an agent, but an independent party performing work under contracts between customers and B and that B was not acting on behalf of Dell. To support its case, Dell submitted various affidavits and documents including the decision of a Connecticut court (48 Conn. Supp. 170, 834 A.2d 812 (2003)) that found that the arrangement did not cause Dell to have a physical presence in that state. The L court noted though that the decision states that the “court's finding was based primarily on the lack of evidence in the record to establish the focus and extent of the activities of BankTec's independent service representatives in Connecticut, particularly evidence regarding the frequency or number of the on-site services actually performed in Connecticut.”

In finding that Dell did have a physical presence in L through B, the court referred to the old U.S. Supreme Court decisions of *Scripto* (362 U.S. 207 (1960)) and *Tyler Pipe* (483 U.S. 232 (1987)), as well as a L case, *Quantex* (809 So. 2d 246 (2000)). The court noted that unlike in *Quantex*, the present case provides “both documentary evidence and deposition testimony detailing the contractual relationship between Dell and BancTec as well as the nature and extent of the services provided by BancTec and most significantly, evidence regarding the significance of BancTec's services on Dell's ‘ability to establish and maintain a market in Louisiana.’”

The court questioned the semantics of terms such as “agent,” “broker” and “on behalf of” seeking to look at the substance of the arrangements. The court noted that “the trial court and Dell both ignore the Supreme Court's admonition in *Scripto*, that the ‘contractual tagging’ of a third party as an independent contractor or salesman is simply insufficient to change the function of the third party ‘nor bears on its effectiveness in securing a substantial flow of goods into [the state].’ 362 U.S. at 211. The nature and extent of the activities (*Scripto*, 362 U.S. at 211) and whether those activities are significantly associated with the taxpayer's ability to establish and maintain a market in this state (*Tyler Pipe Industries, Inc.*, 483 U.S. at p. 250 ; *Quantex*, 809 So.2d 252 ) are the determinative factors of whether Dell's contractual dealings with BancTec constitute a sufficient physical nexus for the purpose of justifying the imposition of a use tax.” The court found Dell's involvement in all parts of the contractual arrangement to be significant from writing the contracts, to requiring customers to call Dell first, training B's employees and providing initial diagnosis and scripts for B's employees. Also, Dell includes the availability of on-site service in its

advertising. Dell also hired a third party to determine how satisfied customers were with B and could terminate the arrangement with B if B didn't meet Dell's expectations.

Dell argued that it was not legally obligated to provide repair services. Thus, when B provides the services, it is not acting on behalf of Dell. The court noted that the contractual "tag" of being a non-agent to avoid taxation in the state was forbidden by the U.S. Supreme Court per *Scripto* and *Tyler Pipe*. The court also noted that without the arrangement for B to provide services, it would have been difficult for Dell to establish and maintain a market in L. The court referred to the following excerpt from CEO Michael Dell's book – *Direct from Dell: Strategies that Revolutionized an Industry*:

"Pretty early on in the company's life, we concluded that we wanted to earn a reputation for providing *great customer service*, as well as great products. ... What was really important was sustaining loyalty among customers and employees, and that could only be derived from *having the highest level of service* and very high-performing products. ...

From the very beginning, we saw a *huge opportunity to provide extraordinary service* where our competitors saw none — and *designated it as one of the company's early objectives*. In 1986, we offered the *very first program in our industry for on-site service as a kind of "house call" service for sick computers*. If your computer had a problem, you didn't have to go anywhere; we came to you — to your business, house, or hotel room.... What the competition initially assumed would be a disadvantage for us *turned out to be a massive advantage*."

The court concluded: "The trier of fact could clearly find for the purpose of taxation that Dell hid behind the fact that it hired a third party to provide this service in state or tag that third party as "independent" to destroy nexus with this state which is contrary to law and to the mandates and admonitions of the Supreme Court of the United States."

A dissenting judge noted that B does not solicit sales for Dell but instead only provides services to Dell customers who purchase an optional service contract from B. This judge did not find that the optional service contract, Dell's efforts in ensuring quality control, and its insistence that B did not disparage Dell when providing services, did "not rise to the level of activities sufficient to find that BancTec was acting on behalf of Dell." This judge also did not put much credence in an un-sworn statement from a mass marketed book.

### Issues Stemming from Changes in Ways of Doing Business

The new ways of doing business allowed by the Internet also challenge existing tax rules. Online transactions allow for larger markets, ease of entry into markets (selling online out of your home, for example), new types of assets (such as domain names), reduced paperwork, and digitized goods. These and other changes in business practices can raise tax issues and lead to actions by legislators and tax agencies.

#### Audit Trails, Compliance and Unreported Income

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," then 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."<sup>32</sup>

In the annual report to Congress, the National Taxpayer Advocate (NTA) calls attention to the growing tax gap. The 2005 report included a significant discussion on the cash economy, which the NTA notes "may grow faster as cash transactions move to the Internet." The report notes IRS research and forums that found that practitioners believe that Internet sales, such as through eBay, have generated a lot of unreported income.<sup>33</sup>

<sup>32</sup> From a speech to the 34<sup>th</sup> General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.

<sup>33</sup> National Taxpayer Advocate, 2005 Annual Report to Congress, page 58; available at [http://www.irs.gov/pub/irs-utl/section\\_1.pdf](http://www.irs.gov/pub/irs-utl/section_1.pdf).

A 2004 report by the Treasury Inspector General for the Commissioner of the Small Business/Self-Employee (SB/SE) Division includes a focus on unreported income from e-commerce. The IRS first studied compliance issues with e-commerce businesses in 2000 and found an income tax gap of about \$6.2 million for 1997. That gap estimate was based on 426 commercial web sites (retailers, wholesalers, services, ISPs, and adult entertainment) that were examined. The most significant cause of the gap was understatement of income. The IRS also found that about 10% of the owners of the websites were non-filers of 1997 returns and 12% of the owners could not be identified to determine whether a return had been filed. A study by the SB/SE Division of the IRS in 2004 derived an estimate of a tax gap of \$1 billion potentially, just for small businesses doing business on the Internet.<sup>34</sup>

To address the compliance concerns it found, the SB/SE Division created e-commerce compliance units within its reporting group and another within its taxpayer education and communication functions to aid in educating taxpayers. In addition, specific initiatives were undertaken such as creating information sharing arrangements with various website owners, e-commerce trade associations and ISPs. The Division also undertook efforts to improve the filing rate of Form 1099-B (bartering proceeds) among bartering exchanges. In addition a website was created to provide information to Internet businesses.<sup>35</sup>

*Why confusion exists?* There are many reasons why compliance problems exist, particularly for small e-commerce firms. First, some of the transactions don't neatly fit into existing tax rules, but these are primarily state issues, not federal income tax ones. Some may think that the IRS can't find e-commerce sites or track sales. Some may have misinterpreted the Internet Tax Freedom Act to think that e-commerce is not subject to tax. Also, there are a variety of websites and books available on starting and growing Internet businesses that may not focus sufficiently on the tax considerations. For example, a few sites the author found on the advantages of drop shipment Internet businesses did not talk about tax issues. Also, some of the books may be misleading to some business owners due to certain language – such as “loopholes,” used in the title or narratives.

*Author observation:* The IRS and state tax agencies should consider running ads on the Internet, including pop-up ones, which serve to help educate vendors and customers of tax consequences of doing business on the Internet.

### **Occasional Sales**

Generally, a seller making only “occasional” or “isolated” sales does not have to collect sales and use taxes. For example, in California, Revenue & Taxation Code §6367 provides: “There are exempted from the taxes imposed by this part the gross receipts from occasional sales of tangible personal property and the storage, use, or other consumption in this state of tangible personal property, the transfer of which to the purchaser is an occasional sale.” R&T §6006.5(a) provides that an occasional sale includes “A sale of property not held or used by a seller in the course of activities for which he or she is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state, provided that the sale is not one of a series of sales sufficient in number, scope, and character to constitute an activity for which he or she is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state.”

California Reg. §1595 further provides: “Generally, a person who makes three or more sales for substantial amounts in a period of 12 months is required to hold a seller's permit regardless of whether the sales are at retail or are for resale. Each sale of the person during the 12 months period is included in determining whether that person is required to hold a permit, or would be required to hold a permit if the activities were conducted entirely inside this state. Thus, a sale occurring outside California, whether at retail or for resale, is included, even though it would not be subject to California sales tax. A person who makes a substantial number of sales for relatively small amounts is also required to hold a seller's permit.”

The Internet led to the creation of various auction sites where both businesses and private individuals can sell items. States will likely need to review their occasional sales rules to see if they need modification if they desire to provide a broader exemption for individuals using sites, such as Ebay. Alternatively, states that do not want to modify their existing rules will need to undertake educational efforts with individual taxpayers to be sure they know when they must register as a retailer and how to collect and remit sales and use taxes.

An example of a proposed simplification is a 2005 California proposal -SB 607.<sup>36</sup> This bill would add a dollar amount to provide certainty to the occasional sales rule. The state tax agency observes that such clarity may raise

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<sup>34</sup> Final Audit Report – The Internal Revenue Service Is Making Progress in Addressing Compliance Among Small Businesses Engaged in Electronic Commerce (Audit # 200330036), Ref. No. 2005-30-010, Nov. 2004; available at <http://www.treasury.gov/tigta/auditreports/2005reports/200530010fr.html>.

<sup>35</sup> Id. The SB/SE report does not provide the URL for the website it created for Internet businesses. One the author found that may be the one reference in the report is at <http://www.irs.gov/businesses/small/article/0,,id=108188,00.html>.

<sup>36</sup> SB 607 can be found at <http://www.leginfo.ca.gov/bilinfo.html>.

revenue by improving voluntary compliance. Referring back to the statutory language cited above, SB 607 would define “a series of sales” as meaning “three or more sales in any 12-month period where the gross receipts derived from those sales exceed \$1,200. The state tax agency would be allowed to adjust the dollar amount annually for inflation.

### **Easy to Only be a Remote Vendor**

E-commerce makes it very easy for many businesses to have a customer base without a bricks-and-mortar location. The vendor or service provider may even be a sole proprietor operating out of their home. While this is great for enabling more individuals to operate small businesses, it adds to the number of sales where sales tax is not collected by the vendor. With low levels of use tax compliance, state and local governments lose sales and use tax dollars.

Apparently, some vendors may be greatly simplifying their tax compliance requirements by making all sales in their capacity as a remote vendor. A review of vendors selling used items on Amazon.com, for example, will produce a few that indicate they ship from State X, but will not *ship to* State X.

In addition, customers can fairly easily search online for their desired product from a vendor who will not charge sales tax, thus adding to the statistics of uncollected sales and use tax.

### **Untaxed Gains**

Online auction sites that enable sellers to reach a worldwide market produce a much better marketplace than selling stuff through local classified ads or yard sales. Also, a look at some of the auction sites indicates sales of some significant items not usually found at garage sales, such as collectibles. This improved marketplace likely leads to more sales and more sales where the seller produces a gain rather than a loss.<sup>37</sup> Unlike the sales of stock, no Form 1099 is produced for these sales and it is likely that many go unreported.

The cost of auditing these transactions likely outweighs the possible tax collected. Also, any proposal to require online auction houses to issue 1099s is unlikely and many items sold likely produce an unusable personal loss. However, this is an area where greater educational efforts may improve compliance. It is likely that many individual sellers do not even think about reporting gains from the sale of personal items. Such educational efforts could be in the form of instructions on tax forms and publications and ads placed on Internet sites by the IRS and state tax agencies.

### **What is Inventory?**

Inventory rules represent another area where the rules were written for the industrial era, rather than the information era. Businesses and tax practitioners are likely to encounter businesses engaged in new ways of delivering items to customers (particularly digitized products) and new types of intermediaries assisting in matching buyers and sellers where issues will arise as to whether the intermediary is subject to the inventory and accrual accounting rules.

Example 1: Ostrich Software is a sole proprietorship that develops and transfers educational software. OS only sells to customers via the Internet—both the software and payment (by credit card) are transferred via the phone lines. The software is not customized, but is off-the-shelf type software. OS expenses its software development costs under §174 and has no §263A costs. Is OS required to use the accrual method of accounting? Is it subject to §471 on the premise that it is selling “something”? If the software is considered inventory, is it de minimis?

Under Reg. §1.471-1, a taxpayer must account for inventory if the production, purchase or sale of merchandise is an income-producing factor. In *Wilkinson-Beane Inc. v. Comm’r.*, 420 F.2d 352, 70-1 USTC ¶9173, 25 AFTR2d 418 (1st Cir), the court held that “merchandise” is something held for sale. Arguably, ABC has something held for sale and thus, has merchandise for §471 purposes. That same case interpreted “income-producing factor” as measured by cost of the merchandise purchased during the year divided by the gross receipts for the year. In *Wilkinson-Beane* the percentage was about 15% which the court found to constitute an income-producing factor. It is not clear how to do this income-producing factor ratio (which has been used in many court decisions subsequent to the *Wilkinson-Beane* decision), where there is no “cost” for the numerator. However, since the software represents ABC’s entire production of gross receipts, it is likely to be viewed as an income-producing factor under any common sense interpretation.<sup>38</sup>

This fact pattern illustrates how the tax law hasn’t kept up with transactions involving software.

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<sup>37</sup> The author can attest to a personal example where two signed Ansel Adams posters with a basis of \$25 each were sold on Ebay for over \$400 each. The resulting capital gains were reported.

<sup>38</sup> If ABC’s average annual gross receipts are \$10 million or less, it may use the cash method and ignore §471 under Rev. Proc. 2002-28.

Example 2: This example is based on one in EITF 99-19, *Recording Revenue Gross as a Principal versus Net as an Agent*.<sup>39</sup> Business X facilitates the sale of guitars by making arrangements with various wholesalers to list their guitars on X's website. The wholesalers set the prices. X does not maintain any inventories of guitars. Instead, when a visitor to X's website makes a purchase, it is directed to the appropriate wholesaler who ships the product directly to the customer. X does take title to the guitars at the time they are shipped from the wholesaler. Customers pay via credit card before a guitar is shipped and based on the recordkeeping customers believe that X is the seller. X earns income by the commission set by the wholesalers for each guitar. X remits the commissions to wholesalers monthly. The sale terms posted on the website indicate that X handles the ordering, shipping and billing, but is not handling the product. Instead, the wholesalers are the true sellers of the guitars. Thus, X has no control over the quality of the products and warranties are only available if provided by the wholesaler.

Is X required to account for inventories and use the accrual method of accounting? If a business is only receiving a commission and does not have title to the goods (even if momentary) and does not have the benefits and burdens of ownership, generally, inventory accounting is not required.<sup>40</sup>

### Issues Stemming from Changes in Technology

Changes in technology from the Internet to multiple ways to communicate can lead to confusion in the application of existing law, as well as making some rules, such as ones that tax regulated industries, obsolete. Some examples follow.

#### Website Development Costs

The proper tax treatment of web site development has become a longstanding one now. Website development may include such activities as creating content and a strategy for how the site fits into sales and advertising goals, developing software, using templates to assemble content into HTML format, testing, redesign, and updating of content. The website may be only for internal use (intranet) or also for external use. The sponsor's purpose in creating the site may be solely for advertising, or the site may constitute the company's primary business operation, for example, soliciting sales from customers.

*Web Site Development Activities and Relevant Tax Rules:* The treatment of the costs to develop a web site will depend on the nature of the activity. Common activities of web site development and their likely tax treatment are described next.

*Initial Planning:* The treatment of costs incurred in deciding upon the purpose, content and use of a web page, may vary depending on the particular circumstances for incurring the costs. If the costs are viewed as an integral part of the development costs, they likely should be treated in the same manner as such costs are treated. If the planning can be viewed as a separate activity, Reg. §1.263(a)-4 should be considered to determine if the costs incurred should be capitalized. If the primary benefit is to current year activities, the costs should be deductible under §162.<sup>41</sup>

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<sup>39</sup> EITF 99-19 addresses the accounting issue as to when a sale should be reported as gross (as if the business was the seller) or at net (as if the business only earned a commission for facilitating a sale). The SEC's concern with the varied accounting treatment it was seeing among some Internet companies was that if a company reported at gross when it should have been net, it had artificially inflated its revenues, and likely its stock price. The situations described in EITF 99-19 also raise potential tax issues as to who is liable to collect sales tax on the sale (discussed elsewhere). Another possible tax issue with whether a vendor should be reporting sales at gross or net involves provisions where the amount of gross receipts is relevant to determine if a particular rule, such as IRC §263A for a retailer applies.

EITF 99-19 provides a list of factors that are to help in determining whether a company should report revenues at gross or net. None of the indicators are to be considered presumptive or determinative. Per EITF 99-19 a company should report revenue at gross if it: (1) is the primary obligor of the arrangement, (2) has general inventory risk, (3) has latitude in setting prices, (4) changes the product or performs part of the service, (5) has discretion in selecting suppliers, (6) is involved in determining product or service specifications, (7) has physical loss inventory risk, and (8) has credit risk. A company should report revenue at net if: (1) the supplier is the primary obligor in the arrangement, (2) the amount earned by the company is fixed, and (3) the supplier has credit risk. EITF 99-19 includes 13 examples to help illustrate application of the indicators.

<sup>40</sup> *Addison Distribution Inc., et al. v. Comm'r.*, T.C. Memo 1998-289; *Epic Metals Corp & Subs v. Comm'r.*, T.C. Memo 1984-322; TAM 8510003.

<sup>41</sup> Revenue Ruling 2000-4, 2000-4 I.R.B. 331 (current deductibility of ISO certification costs); *Goodwyn Crockery Co.*, 37 TC 355 (1961), PLR 7906011, Revenue Ruling 92-80, 1992-2 C.B. 57 (advertising, even if it creates goodwill, is deductible under §162); and *RJR Nabisco Inc. v. Comm'r.*, T.C. Memo 1998-252, nonacq. 1999-40 I.R.B. 2, AOD 1999-012.

*Software Development:* Per Revenue Procedure 2000-50,<sup>42</sup> software development costs may be treated similarly to §174 expenditures thereby allowing the taxpayer to currently expense the costs or to elect to amortize them over 60 months. If instead of developing the software, a taxpayer purchases software designed by someone else, the taxpayer must capitalize the software. The definition of software used in Rev. Proc. 2000-50 ties to the definition in §197. Computer software is defined as “any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software.” The term does not include any data or information base unless it is in the public domain and is incidental to the program. The term also does not include any costs of procedures external to the computer’s operations.

Rev. Proc. 2000-50 provides that software development costs may be accounted for similarly to §174 expenditures thereby allowing the taxpayer (1) to currently expense the costs, or (2) to elect to amortize them over 60 months from the date the development is completed in accordance with rules similar to §174(b), or under the 167(f) depreciation rule (36 months) starting with the date the software is placed in service.

Rev. Proc. 2000-50 does not state that software development expenditures are per se R&E expenditures. Instead, it states that software development costs “in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of §174 as to warrant similar accounting treatment.” This is particularly important for purposes of §41 because for software development activities to constitute “qualified research,” such activities must meet the definition of R&E under §174 and Reg. §1.174-2 (a standard not required to be able to currently deduct software development costs).

*Research and Experimentation (R&E):* Section 174 allows for the current deduction of research or experimental expenditures incurred in connection with a trade or business.<sup>43</sup> The “in connection with” language differs from the §162 “carrying on” language. The U.S. Supreme Court has held that the “in connection with” language allows taxpayers to deduct R&E expenditures before they are carrying on a business.<sup>44</sup> However, the taxpayer must be engaged in a trade or business at some time—there must be some actual and honest objective of making a profit.<sup>45</sup>

Research and experimentation costs are defined as R&D costs incurred in the experimental or laboratory sense, for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.<sup>46</sup> Uncertainty exists if information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. One is to look to the nature of the activity, not to the nature of the product or improvement being developed. R&E expenditures include costs of obtaining a patent, including attorney fees in making and perfecting the application.<sup>47</sup> Quality control testing does not constitute R&E. However, the regulations clarify that “quality control testing does not include testing to determine if the design of the product is appropriate” (validation testing).<sup>48</sup>

Section 174 only applies to R&E expenditures if they are reasonable in amount under the circumstances. Generally, expenditures are reasonable in amount if the amount “would ordinarily be paid for like activities by like enterprises under like circumstances.”<sup>49</sup> Depreciable property is not a §174 expenditure, but the depreciation on equipment

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<sup>42</sup> Rev. Proc. 2000-50, 2000-52 I.R.B. 601 which replaces Rev. Proc. 69-21, 1969-2 C.B. 303.

<sup>43</sup> If a taxpayer does not want to current expense its R&E expenditures, it may elect to instead capitalize them and then begin to amortize them when it first realizes benefits from the expenditures. The amortization period under §174(b) may be no shorter than 60 months. If the R&E results in an item that is depreciable under §167, that life is used. For example, if a software developer has capitalized its R&E (software development costs), the amortizable life is under §167(f)—36 months. See Reg. §1.167(a)-14(b)(1) and §1.174-4(a)(4).

<sup>44</sup> *Snow v. Commissioner*, 416 U.S. 500 (1974).

<sup>45</sup> *Brown v. Commissioner*, 58 T.C.M. (CCH) 850 (1989).

<sup>46</sup> Reg. §1.174-2(a).

<sup>47</sup> This definition differs from that in Financial Accounting Statement No. 2, Accounting for Research and Development Costs, which specifically states that costs to obtain a patent do not constitute R&D expenditures.

<sup>48</sup> Reg. §1.174-2(a)(4).

<sup>49</sup> Reg. §1.174-2(a)(6); based on I.R.C. §174(e) added by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, §7110, 103 Stat. 2106.

used in R&E falls under §174.<sup>50</sup> A product includes “any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.”<sup>51</sup>

If the expenditures for developing a web site meet the definition of R&E under §174 and the taxpayer has adopted the §174(a) expensing method, the costs are deductible. In order to potentially claim a research tax credit under §41 for the web site development costs, such costs will have to meet the definition of R&E under §174 (in addition to other requirements under §41).<sup>52</sup>

*Purchase of Software:* If instead of developing the software, a taxpayer purchases software designed by someone else, the taxpayer must capitalize the software costs (assuming the software has a useful life exceeding one year). To determine if the software designed by a third party constitutes a §174 expenditure or should instead be treated as the acquisition of a software program, a determination must be made as to who was at risk for the development. If R&E expenditures are incurred in the creation of depreciable property by another person, they are only deductible under §174 if “made upon the taxpayer's order and at his risk.”<sup>53</sup>

*Creation of an HTML File from a Template:* Various software programs exist, such as Microsoft’s FrontPage<sup>R</sup>, which provide the template and software to enable someone to create an HTML file (web page). It is unclear whether this type of activity constitutes software development. The file created with the program does not by itself enable a computer to do something. However, the file may also include some code created by the designer that does have some functionality on its own. If the creation of an HTML file from a template is not treated as software development or creation, then the costs to create this item must be examined under §162 and §263. Generally, under Reg. §1.263-4(b), taxpayers must capitalize amounts paid to acquire or create an intangible, as well as amounts paid to create or enhance a separate and distinct intangible asset (as defined in the regulations). Otherwise, the costs should be expensed when incurred. If the costs are to be capitalized, the next issue would be to determine if the asset can be amortized under §167, §1.167-3(b) or §197. In addition to the costs of creating the file, related costs of planning what the site should look like should be included with the other costs of creating the site.<sup>54</sup>

Final regulations under §263(a) on capitalization of intangibles provide that amounts paid to develop software are not treated as amounts that create a separate and distinct intangible,<sup>55</sup> and software is not given as an example of a created intangible requiring capitalization.<sup>56</sup> On the other hand, acquired software is an example of an acquired intangible requiring capitalization.<sup>57</sup> Thus, under current guidance, once a taxpayer knows if they have developed software or acquired it, the guidance is clear. However, it is not clear as to what distinguishes purchased software from developed software particularly in situations where a taxpayer begins with a piece of software but makes significant modifications to it. The factors that distinguish acquired software from developed software are to be addressed in the future by the IRS.<sup>58</sup>

*Continual Updating:* The content of a web page will most likely be updated frequently in order to provide useful information to visitors. These recurring costs do not provide a significant benefit beyond the current year and so,

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<sup>50</sup> See §174(c) and Reg. §1.174-2(b)(1).

<sup>51</sup> Reg. §1.174-2(a)(2).

<sup>52</sup> §41(d)(1)(A) and *Norwest Corp., et al. v. Comm'r.*, 110 T.C. 454 (1998).

<sup>53</sup> See Treas. Reg. §1.174-2(b)(3) and TAM 9449003 (Aug. 25, 1994).

<sup>54</sup> The question of whether use of a software program to create an HTML document constitutes software development is one in need of guidance. Attorney Douglas W. Schwartz has written an extensive analysis calling for the Treasury Department and Service to issue a revenue procedure on the accounting treatment of web site development and modification costs. Mr. Schwartz recommends that the government accept the premise that that web site development costs are most closely analogized to software development costs. Taxpayers should be allowed a choice of two different accounting methods for such costs: 1) a pool-of-costs capitalization and 36-month capitalization or 2) a site-by-site capitalization and 36-month amortization method. These methods would operate similarly to those provided for package design costs (Rev. Proc. 97-37). See Douglas W. Schwartz, on behalf of the 2000 Washington, D.C. delegation co-sponsored by the Tax Sections of the Los Angeles County and California Bar Associations, “Tax Accounting for Costs of Developing or Modifying Internet Web Sites,” *The California Tax Lawyer*, Summer 2000.

<sup>55</sup> Reg. §1.263(a)-4(b)(3)(iv).

<sup>56</sup> Reg. §1.263(a)-4(d).

<sup>57</sup> Reg. §1.263(a)-4(c)(1)(xiv).

<sup>58</sup> The proposed regulations that preceded TD 9107 suggested that future guidance would be in line with TAM 200236028 (6/4/02) and the simplifying conventions of the final §263(a) regulations; REG-125638-01, 2003-5 IRB 373, 383.

should be deducted under §162 as incurred.<sup>59</sup> Also, if the updating process involves training of employees, such costs should be deductible under §162 (and Reg. §1.263(a)-4). In Rev. Rul. 96-62, the Service held that the *Indopco* decision does not affect the treatment of training costs (such as the "costs of trainers and routine updates of training materials") as business expenses deductible under §162, even though there may be some future benefit from the costs. Training costs only need to be capitalized in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. See, e.g., *Cleveland Electric*, 7 Cl. Ct. at 227-29 (capitalization of costs for training employees of an electric utility to operate a new nuclear power plant, which were akin to start-up costs of a new business).<sup>60</sup> Also see Reg. §1.263(a)-4.

*Creation of an Asset with a Long Useful Life:* As a general rule, no deduction is allowed for amounts paid for new buildings or permanent improvements or betterments that increase the value of any property. In addition, amounts spent to restore property or in making good the exhaustion thereof for which a depreciation allowance was taken are not currently deductible. Additional examples of capital expenditures include the cost of acquiring and constructing property, defending or perfecting title to property, commissions paid in purchasing securities, and the cost of goodwill in connection with acquiring assets of a going concern.<sup>61</sup> In 1992, the U.S. Supreme Court attempted to clarify the demarcation between ordinary and capital expenditures in the *Indopco* decision.<sup>62</sup>

Per the Court, an expenditure need not create or enhance a separate and distinct additional asset to be capitalizable; other characteristics of an expenditure may indicate that it is a capital expenditure. "Although the mere presence of an incidental future benefit - "some future aspect" - may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." Several revenue rulings were issued to help explain this ruling and final regulations were issued in 2004 at Reg. §1.263(a)-4.

If any costs incurred in developing a web site do not fall under §174 or Rev. Proc. 2000-50 and create an intangible covered by Reg. §1.263(a)-4 should be capitalized.

*Creation of a New Trade or Business:* Typically, creation of a web site by a business will not constitute the creation of a new trade or business. If a business decides to create a web site in order to serve customers, it has merely used a tool to reach customers for its existing trade or business. A website should be viewed as enabling the company "to carry on an old business in a new way."<sup>63</sup> Where a website is created as part of the creation of a new trade or business, such costs must be capitalized if they are of a nature that would have to be capitalized if incurred by an existing trade or business.<sup>64</sup> If such costs are otherwise deductible and are not §174 expenditures, they should be treated as §195 start-up expenditures.

*Advertising:* One function of many websites is to advertise the company's products and services. Generally, all advertising costs are deductible under §162. Per Rev. Rul. 92-80,<sup>65</sup> "the *Indopco* decision does not affect the treatment of advertising costs under section 162(a) of the Code. These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. ... Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized." The same result would be reached under Reg. §1.263(a)-4.

*GAAP Guidance:* While the Service has delayed issuing guidance on the treatment of website development costs, guidance has been issued for financial reporting purposes. EITF Issue 00-2, *Accounting for Web Site Development*

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<sup>59</sup> *Encyclopedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982) and TAM 9645002.

<sup>60</sup> Rev. Rul. 96-62, 1996-53 I.R.B. 6.

<sup>61</sup> IRC §263(a), and Reg. §1.263(a)-1(a) and §1.263(a)-2.

<sup>62</sup> *Indopco*, 503 U.S. 79 (1992).

<sup>63</sup> *Colorado Springs National Bank v. U.S.*, 505 F.2d 1185 (10<sup>th</sup> Cir. 1974) where the court held that establishment of a credit card system by a bank was similar to its typical lending operations. "A new method is distinguishable from a new business." Similarly, see *NCNB Corp v. U.S.*, 684 F.2d 285 (4<sup>th</sup> Cir. 1982); and *First National Bank of South Carolina v. U.S.*, 558 F.2d 721 (4<sup>th</sup> Cir. 1977). In contrast, in TAM 9331001 (April 23, 1993), the IRS ruled that the activities involved in operating a retail store were substantially different from those of a manufacturer and distributor and thus, constituted a new line of business. Similarly, in *Cleveland Electric Illuminating Co. v. U.S.*, 7 Cl. Ct. 220 (Cl. Ct. 1985), the court held that a nuclear power plant operated by a utility was a new business relative to the utility's existing fossil fuel plant.

<sup>64</sup> IRC §195(c)(1)(B).

<sup>65</sup> Rev. Rul. 92-80, 1992-2 C.B. 57.

*Costs*, issued in 2000 explains the various stages and activities involved in website development and the financial reporting treatment of each. In addition, guidance has been issued on how to account for costs of developing software for internal use (Statement of Position (SOP) 98-1).

### Transfers of Domain Names

Typically, a business or individual obtains a domain name by registering with a registrar<sup>66</sup> and paying a nominal fee (perhaps \$6 to \$8). Other times, a business may acquire a domain name that has already been registered by someone else.<sup>67</sup> Some of these purchases have been quite newsworthy due to the dollar amount involved. For example, in January 2000, the name “loans.com” sold at auction for a reported \$3 million and in November 1999, the name “business.com” sold for \$7.5 million.<sup>68</sup> These types of situations may raise the tax question for the buyer of how to treat the acquisition costs, and for the seller as to how to characterize the gain. Large amounts may also be allocated to a domain name when a taxpayer acquires another business in a taxable acquisition.

Some non-tax cases are useful to gain an appreciation of the nature of the asset involved. In *Panavision Int'l v. Toeppen*,<sup>69</sup> T, an Illinois resident, had registered the domain name panavision.com and posted a picture of Pana, Illinois at the site. When P notified T that Panavision was a registered trademark, T tried to sell the name to P. P brought action against T in California on the basis that T had violated the Federal Trademark Dilution Act of 1995 and similar California law. The District Court held for P and T appealed. The Ninth Circuit affirmed. T's argument that California had no jurisdiction over him failed.

The court noted that where the only presence is through a web site, jurisdiction would only likely be found if there was "something more to indicate that the defendant purposefully (albeit electronically) directed his activity in a substantial way to the forum state." The court found that T had directed his activity (trying to obtain money from P) to California where P is headquartered. The court also stated that while T's burden of litigating in California is significant, it was not so great such as to deprive him of due process. The district court had even stated that due to fax machines and discount travel, litigating in California was not constitutionally unreasonable. The court also found with respect to the trademark dilution issue, T did make commercial use of the mark because he was in the business of registering trademarks as domain names and then selling them to their rightful owners.

In contrast, in *K.C.P.L., Inc. v. Nash*,<sup>70</sup> the court held that New York did not have jurisdiction over an individual. While the plaintiff referred to the defendant as a cyber-pirate, the court noted that the defendant did not compare to Toeppen. Toeppen had registered over 100 domain names most of which were trademarks of others, while Nash had only registered four with just one of them a trademark, although the court noted it was not a famous one. Thus, the court could not find that Nash had transacted business in New York. The court also noted that the long-arm statute of California was not as restrictive as that of New York.<sup>71</sup>

Nature of the Asset for the Buyer: When a domain name is acquired by paying a nominal registration fee, the tax question is whether that fee can be currently expensed or must be capitalized. In *Surety Insurance Company of California*,<sup>72</sup> the taxpayer had to pay annual license fees to various states in order to operate its business. Taxpayer treated the fees as current deductions and the Service argued that they were capital expenditures. The court agreed with the Service finding that the expenditures were really for acquiring the right to conduct a surety business in a specific state. The court also noted that state law allowed the certificates to be renewed annually provided the company had complied with all rules and regulations and paid the annual fee. Thus, “the license is realistically not intended nor limited to a single year where petitioner complies with state law.”

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<sup>66</sup> A list of accredited and accreditation-qualified registrars can be found at <http://www.icann.org/registrars/accredited-list.html>.

<sup>67</sup> Domain names are also traded on the web, such as on E-Bay.

<sup>68</sup> The Associated Press, “Loans.com Domain Name Sells for \$3 Million,” *New York Times*, Technology Section, Jan. 31, 2000.

<sup>69</sup> *Panavision Int'l v. Toeppen*, 141 F.3d 1316 (9th Cir. 1998).

<sup>70</sup> *K.C.P.L., Inc. v. Nash*, 1998 U.S. Dist. LEXIS 18464 (SD NY 1998).

<sup>71</sup> The non-tax cases dealing with jurisdiction in cyberspace raise an interesting nexus/due process issue for tax purposes (which is noted here because it is illustrated by such cases as *Toeppen* and *K.C.P.L.*, it does not pertain to issues under the Internal Revenue Code). While the *Quill* case (504 U.S. 298 (1992)) has already held that efforts to sell in a state (such as by mailing catalogs to residents) satisfies the due process requirement for sales and use tax jurisdiction, this may not be enough for all types of e-commerce businesses. For example, if a web site is selling regionalized merchandise (such as something related to a college or sports team in the area), yet anyone could order a product, has the business purposefully directed its activities to residents of the state? How many sales outside of the region would be necessary for a state not located in the region to make the business comply with state tax laws? Or is setting up a web site that does not prohibit customers in any particular state constitute directing activities to Internet users in all states?

<sup>72</sup> *Surety Insurance Company of California v. Comm'r.*, TC Memo. 1980-70.

Does a nominal fee need to be amortized? Arguably not. As stated in a 1982 Tax Court memorandum decision: “While we do not attempt to establish a rule of thumb as to what constitutes a small expenditure, we hold that the \$90 at issue here may be deducted currently rather than amortized over its useful life.”<sup>73</sup>

What about domain names purchased from existing holders for more than nominal amounts or taxable business acquisitions where a significant portion of the purchase price is allocated to a domain name? Is the domain name an IRC §197 intangible for purposes of determining the amortizable life?<sup>74</sup> If not, then the §167 regulations should be reviewed to determine if the asset is amortizable. Under Regulation §1.167(a)-3(b), a safe harbor rule provides that where there is no statutory life, no possibility of estimating the life with reasonableness, no prohibition on amortization, and it is not an intangible described in §1.263(a)-4(c) acquired from another person, the intangible asset will have a 15-year life. Reg. §1.263(a)-4(c) lists a variety of intangibles including those specifically covered under §197 and ones specifically excluded from §197. The intent in reading this provision seems to be that §197 already provides a rule for particular intangible assets and new regulations did not need to do the same. However, there is broad language at the start of that subsection that provides that the listed intangibles are just examples of intangibles acquired from another party. Thus it appears that any intangible acquired from another party cannot benefit from the 15-year safe harbor even if it is not a §197 intangible. Thus, if it is determined that a domain name falls outside of §197, it can only be amortized if it is to be used for a limited period and the length of that period can be estimated with reasonable accuracy. Given that a business would usually intend to use a domain name for an indeterminable period of time, it would be a better result for a domain purchased from another party at a significant cost to be a §197 intangible with a 15 year life.

Possible categories of §197 intangibles which a purchased domain name used in a trade or business or held for investment might fall within seem to be:<sup>75</sup>

1. “customer-based intangibles” and “any similar item” [§197(d)(1)(C)(iv) and (vi)]
2. “any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof” [§197(d)(1)(D)]
3. “any franchise, trademark, or trade name” [§197(d)(1)(F)]

Each of these possibilities is discussed next.

(1) IRC §197(d)(2)(A) defined “customer-based intangible” as “composition of market, market share, and any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.” Reg. §1.197-2(b)(6) further provides that a customer-based intangible includes “customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular customer, a mortgage servicing contract, an investment management contract or other relationship with customer involving the future provision of goods or services.” Arguably, if someone owns, for example, the URL *tires.com*, there is value in it because they can establish a website with that URL and generate advertising revenues by selling space on that site to tire companies wanting to list their URL and company information. If generation of advertising dollars is what causes the acquired domain name to have value, it seems to meet the definition of a §197 intangible, assuming the URL and the revenue generating possibilities can be viewed as a single asset. If the domain name does not have value from providing goods or services to customers, other possible §197 categories should be considered.

(2) A license, permit, or other government-granted right can be a §197 intangible even if it has an indefinite term or can be renewed indefinitely. Reg. §1.197-2(b)(8) includes the following examples of assets that fall within this §197 category: liquor license, taxicab medallion, airport landing right, regulated airline route, television broadcasting license. Oversight and management of IP space on the Internet is under the direction of a non-profit organization called ICANN. According to its website: “The Internet Corporation for Assigned Names and Numbers (ICANN) is an internationally organized, non-profit corporation that has responsibility for Internet Protocol (IP) address space allocation, protocol identifier assignment, generic (gTLD) and country code (ccTLD) Top-Level Domain name system management, and root server system management functions. These services were originally performed under U.S. Government contract by the Internet Assigned Numbers Authority (IANA) and other entities. ICANN now performs the IANA function.

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<sup>73</sup> *Kohen v. Comm’r.*, TC Memo. 1982-625 dealing with a bar application fee. Similarly, see *Sharon v. Comm’r.*, 66 T. C. 515, 527 (1976), aff’d 591 F. 2d 1273 (9th Cir. 1978), cert. denied 442 U. S. 941 (1979).

<sup>74</sup> This discussion presumes that domain names are property since they are regularly bought and sold.

<sup>75</sup> In some situations like that in the *Panavision* case, perhaps the purchaser can treat the payments as currently deductible to protect a current business interest.

“As a private-public partnership, ICANN is dedicated to preserving the operational stability of the Internet; to promoting competition; to achieving broad representation of global Internet communities; and to developing policy appropriate to its mission through bottom-up, consensus-based processes.”

Is ICANN a government agency? The US Department of Commerce played a role in setting up ICANN. Does that make it a government agency? One commentator has stated that the Department of Commerce is the source of ICANN’s powers.<sup>76</sup> The matter is not clear since ICANN is a non-profit organization rather than a government agency even though it was established under government authority.

(3) Reg. §1.197-2(b)(1) defines a trademark as including “any word, name, symbol, or device, or any combination thereof, adopted and used to identify goods or services and distinguish them from those provided by others. . . . A trademark or trade name includes any trademark or trade name arising under statute or applicable common law, and any similar right granted by contract.” Is a domain name a “similar right granted by contract?” While domain names and trademarks appear to share some similarities, there are also some differences. Both domain names and trademarks serve to identify a business and may have distinctive characteristics. However, the purpose of a domain name is to represent a series of numbers to locate a web site. Domain names are only unique in terms of identifying a website; they do not have any distinctive shape, color, font, etc. Also, unlike a trademark, domain name can be issued as long as no one else has registered it,<sup>77</sup> there is no need to show that it will be used in commerce. Also, some words that can be registered as domain names, such as loans.com, cannot be trademarks because they are common words.

A 2000 article suggested that a domain name derives its value from two key sources: 1) the name’s association with a company or product (such as “Amazon.com”), and 2) inherent value that is not part of the trademark value, but the value from registration of the name (such as “drugs.com”). The author posited that the value associated with the company or product can be treated as a trademark under §197, but that the inherent value cannot be treated as such.<sup>78</sup> If the government agrees with this interpretation, might the inherent value be a customer-based intangible since the likely hope for the asset (and what give it value) is that it will generate revenue, such as from advertising?

Conclusion: Depending on the facts and circumstances of the domain name and its intended purpose (what causes it to have value such that purchase price is allocated to it), a domain name might be a §197 intangible. Given the intent of §197 to simplify identification, allocation of purchase price, and determination of an amortizable life, it seems that Congress would have wanted a domain name to be a §197 intangible. But, given the existing language that doesn’t clearly bring it in, taxpayers will need to make their case for such treatment. In the meantime, this is an area greatly in need of guidance from Congress or the IRS.

Characterization of Gain for the Seller: With respect to the seller, the domain name is not a capital asset if held by someone who is in the business of buying and selling domain names (as in the *Toeppen* case). That is, the asset likely falls within §1221(1) as property held primarily for sale to customers in the ordinary course of a trade or business. If a domain name was purchased for investment and the level of activity does not rise to the level of a trade or business,<sup>79</sup> then it must be determined if the name is a copyright, artistic composition, or similar property under §1221(3). Per §1.1221-1(c)(1), “similar property” refers to something that is eligible for copyright protection. The issue then falls under copyright law. Generally, words and phrases are not copyrightable because they do not have the minimal level of creativity.<sup>80</sup> But, if the owner’s purpose of obtaining the domain name was the creativity of the name, might it be copyrightable? Resolution of this issue will likely first come from copyright cases, rather than tax cases.

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<sup>76</sup> A. Michael Froomkin, “Wrong turn in cyberspace: using ICANN to route around the APA and the Constitution,” 50 *Duke Law Journal*, 17, 71 (Oct 2000); available at <http://www.law.duke.edu/shell/cite.pl?50+Duke+L.+J.+17>. The call for establishment of a non-profit organization to manage the domain name system is explained in a policy paper of the Department of Commerce, docket number 980212036-8146-02; available at [http://www.ntia.doc.gov/ntiahome/domainname/6\\_5\\_98dns.htm](http://www.ntia.doc.gov/ntiahome/domainname/6_5_98dns.htm).

<sup>77</sup> The Anticybersquatting Consumer Protection Act (P.L. 106-113, 11/29/99) which amends the trademark statute (15 U.S.C. § 1125(d)) may deter individuals from registering domain names intended to be similar to trademarks.

<sup>78</sup> David Hardesty, “Taxation of Internet Domain Names – Can They Be Shoehorned into the 15-Year Amortization Rules?” *Journal of Taxation*, December 2000.

<sup>79</sup> There are several dealer versus investor cases under §1221(1), such as *Drummond v. Comm’r.*, T.C. Memo 1997-71 and *Guardian Ind. v. Comm’r.*, 97 T.C. 308 (1991), aff’d. without published opinion 21 F.3d 427 (6th Cir. 1994).

<sup>80</sup> See *CMM Cable Rep., Inc. v. Ocean Coast Properties, Inc.*, 97 F.3d 1504 (1st Cir. 1996), *Salinger v. Random House, Inc.*, 811 F.2d 90 (2d Cir. 1987), and cases cited therein.

If the domain name meets the definition of a trademark, §1253(a) provides that if the transferor retains any significant power, right, or continuing interest in the trademark, the transfer is not treated as a sale or exchange of a capital asset.

### **Technology, Definitions and Taxes**

Defining various types of technology so that they can be taxed or excluded poses challenges in drafting, interpreting and dealing with continual changes in technology. Some of these issues have involved defining “Internet access” for the Internet tax moratorium (an issue that the GAO recently found is a significant one), what a local franchise fee can be applied to regarding the variety of services provided by cable companies, and in state efforts to update and reform their various telecommunications taxes and fees.

*Internet access:* The definition of Internet access services posed challenges in the extension of the moratorium as to how telecommunications should tie in without the moratorium being far broader than intended. The GAO discovered that the 2004 modification to the definition of “Internet access services” led to confusion among service providers and state governments. The GAO interprets the definition as prohibiting taxes on whatever an Internet Service Provider (ISP) reasonably bundles to consumers, including e-mail, instant messaging and digital subscriber line (DSL) services.<sup>81</sup> However, in its study of the moratorium, the GAO found that some interpreted the reference to telecommunications services to be far broader. Some service providers and governments interpreted the moratorium as also prohibiting taxation of telecom services acquired by ISPs and then used to deliver Internet access. Some states stopped collecting taxes on such services in November 2005.<sup>82</sup>

The GAO study was issued to Congress in January 2006. It remains to be seen what actions, if any, Congress and the states will take to attempt to clarify the confusion that resulted from how telecommunications services was incorporated into the definition of Internet access services.

*Examples of state telecommunications reform:* With the changes in ways to communicate with a variety of technologies, some states have worked to keep their tax revenues in place by broadening the definition of communications and reducing the number of different types of taxes (apparently due to the reality that the outcome should be the focal point rather than the specific type of technology used to communicate). Two states that have made their telecommunication tax systems more technologically neutral and simple are Florida and Virginia, discussed next (these are not the only states to have made reforms though).

In 2000, Florida repealed 11 separate taxes and fees, replacing them with a single communications services tax for both state and local governments. “Communications services” is defined broadly and futuristically as:

“the transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals, including cable services, to a point, or between or among points, by or through any electronic, radio, satellite, cable, optical, microwave, or other medium or method now in existence or hereafter devised, regardless of the protocol used for such transmission or conveyance. The term does not include:

- (a) Information services.
- (b) Installation or maintenance of wiring or equipment on a customer's premises.
- (c) The sale or rental of tangible personal property.
- (d) The sale of advertising, including, but not limited to, directory advertising.
- (e) Bad check charges.
- (f) Late payment charges.
- (g) Billing and collection services.
- (h) Internet access service, electronic mail service, electronic bulletin board service, or similar on-line computer services.” [FL § 202.11]<sup>83</sup>

In 2006, Virginia replaced several taxes with a 5% statewide communications sales tax that applies to retail communication and video services in a manner whereby the type of technology isn’t important. The tax applies to local calls, paging, cable TV, satellite TV, wireless and VoIP if the call or service is sourced to Virginia. The tax, along with a 75¢ 911 tax, will also replace the local utility tax, cable franchise fee and local E-911 fee. A call is sourced to Virginia if it originates and terminates in the state or either originates or terminates in the state and the

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<sup>81</sup> GAO, *Internet Access Tax Moratorium*, *supra*, page 3.

<sup>82</sup> *Id.*

<sup>83</sup> Additional information on the Florida communications services tax can be found at <http://taxlaw.state.fl.us/cst1.asp>.

service address is in the state. If the service is sold on a basis that is not “call-by-call,” it is sourced to the customer’s place of primary use. Similarly, mobile communications services are sourced to the user’s place of primary use. Generally, the tax is collected by the communications service provider. The new rules are effective January 1, 2007.

The new definition of “communication services” in Virginia will be:<sup>84</sup>

““Communications services” means the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals, including cable services, to a point or between or among points, by or through any electronic, radio, satellite, cable, optical, microwave, or other medium or method now in existence or hereafter devised, regardless of the protocol used for the transmission or conveyance. The term includes, but is not limited to, (i) the connection, movement, change, or termination of communications services; (ii) detailed billing of communications services; (iii) sale of directory listings in connection with a communications service; (iv) central office and custom calling features; (v) voice mail and other messaging services; and (vi) directory assistance.” [§58.1-647]

Lurking issues that still need to be addressed include:

- § Will federal limitations on what state and local governments can and can’t do be eliminated or modified to allow greater flexibility for governments to reform their tax systems to better reflect changes in technology?
- § Can definitions used in all telecom laws be modified to be technologically neutral? Can definitions, regulatory rules and tax systems be modified so as to avoid or reduce the number of controversies as to what a particular communication service is and how it is to be taxed?
- § Will more states reform their telecom taxes to make them technologically neutral and simpler? There will likely be winners and losers among local jurisdictions and among different groups of consumers based on the particular technology they use and how it is addressed under a neutral rule.

### **3% Communications Excise Tax and California Utility User Tax (UUT)**

*Does the telephone excise tax still exist?* While there were efforts in Congress to repeal this 100+ year old tax, including H.R. 3916 (106<sup>th</sup> Congress, 2000) that passed in the house 420-2, nothing was ever enacted. H.R. 1889 (109<sup>th</sup> Congress, 2005) also proposes to repeal the tax. Also, despite several rulings unfavorable to the tax, which stem from changes in technology which led to changes in business practices, the 3% excise tax still exists. An overview to the legal controversy involving certain types of phone charges and billing practices follows.

Over the past few years, there have been a series of rulings on whether the 3% federal communications tax applies where the charges are not based on *both* distance and duration. The typical fact pattern involves a company (customer) that purchases long distance telephone services through a provider such as Sprint or AT&T. The provider includes the 3% federal excise tax of §\_\_\_\_ in the bill. The company then files a refund request for the excise tax on the premise that §4252 does not apply to the type of communications services it purchased from the provider. The company notes that its provider bases its fees on the elapsed time of call and not the distance (a “cents-per-minute/anywhere” type plan). The dollar amounts of the refunds have been significant – for example, \$879,000 in *ServiceMaster Co. v. U.S.*<sup>85</sup> and \$6.3 million over 16 quarters (1999 – 2002) in *Hewlett-Packard Co. v. U.S.*<sup>86</sup>

In 2004, a District Court in Ohio held that the tax did not apply where the charge did not depend on the distance. The court held that both distance and time had to be met for the service to be subject to the 3% excise tax. This decision was affirmed by the Sixth Circuit Court. [*Office Max, Inc. v. U.S.*, 93 AFTR 2d 2004-1190, 2004-1 USTC ¶70,216, 309 F.Supp2d 984 (ND Ohio 2/13/04); aff’d 428 F.3d 583 (6<sup>th</sup> Cir. 2005). In March 2006, the 6<sup>th</sup> Circuit denied the government’s request for an en banc hearing on its decision (Order 04-4009)]

A contrary result was reached in only one case - *American Bankers Insurance Group, Inc.*, 93 AFTR2d 2004-1435, 2004-1 USTC ¶70,218, 308 F.Supp2d 1360 (SD Fl 1/29/04). In this case, the court found the statute ambiguous so it reviewed the legislative history. The court interpreted the legislative history to mean that Congress intended to tax all long distance commercial services. However, upon appeal, the 11<sup>th</sup> Circuit reversed the district court decision (408 F.3d 1328, 95 AFTR 2d 2005-2291 (11<sup>th</sup> Cir. 2005)).

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<sup>84</sup> Virginia HB 568, Chapter 780; information is at <http://leg1.state.va.us/cgi-bin/legp504.exe?061+sum+HB568>.

<sup>85</sup> *ServiceMaster Co. v. U.S.*, 97 AFTR 2d 2006-2511 (DC IL).

<sup>86</sup> *Hewlett-Packard Co. v. U.S.*, 96 AFTR 2d 2005-5953 (DC CA 2005).

In *Fortis Inc. v. U.S.*, 94 AFTR2d 2004-6005 (SD NY 9/16/04), the court ruled similar to the *Office Max* case that for §4252 to apply, the charges must be based on both time and distance. In April 2006, this decision was affirmed by the Second Circuit (97 AFTR2d ¶2006-836). *National Railroad Passenger Corp (Amtrak) v. U.S.*, 431 F.3d 374, 96 AFTR 2d 2005-7332 (DC Cir 2005) also found for the taxpayer. In the lower court decision in *National Railroad*, the judge starts the opinion with: “When a defined term in the Internal Revenue Code (“Code”), 26 U.S.C. §1 et seq., fails to keep pace with technological advances and other changes in the commercial world, may the Internal Revenue Service (“IRS”) nonetheless construe the Code to levy a tax arguably envisioned by Congress? This case concerns the proper interpretation and implementation of a federal excise tax on communications services. Finding that Congress meant what it plainly said in 1965, the Court concludes that only Congress, and not the IRS on its own, may update the statutory text. .”<sup>87</sup> In May 2006, a district court, in a decision appealable to the 7<sup>th</sup> Circuit, similarly found that the long distance call must be based on both elapsed time and distance in order for the excise tax to apply.<sup>88</sup>

*Local and State Relevance:* Some state or local jurisdictions use the IRC excise tax definitions in applying telecom taxes. For example, the utility user tax (UUT) imposed by many California cities on telephone services is based on the IRC definitions of §4251 and §4252. Thus, unless changes are made in these municipal codes, these federal decisions also mean a loss of UUT for the cities imposing the tax using the federal definitions.

*IRS Doesn't Give Up:* In August 2004, the IRS issued Notice 2004-57 indicating that despite the conflicting decisions of the District Courts, the excise tax remains payable on all taxable communication services (as identified as taxable by the IRS). The IRS and Treasury also issued temporary and proposed regulations on the service provider's obligation to collect the excise tax when the customer refuses to pay it (TD 9149 and REG 163909; 810/04). “The temporary regulations provide that the collector must report the refusal to pay the tax to the IRS by the due date of the return on which the tax would have been reported but for the refusal to pay. In addition, the temporary regulations provide that, for a person using the alternative method, the separate account cannot be adjusted to reflect a refusal to pay tax for the month unless such refusal has been reported.”

In Notice 2005-79, 2005-46 IRB 952, issued in October 2005, the IRS states that it has filed appeals in five different circuits in response to its losses in the district courts (see earlier list of cases). The IRS also states that the excise tax should continue to be collected, including in the 11<sup>th</sup> Circuit. Notice 2004-57 (above) is superceded.

The Service has lost the issue in all but one District Court decision and that decision was overturned on appeal. Thus, rulings in the 2<sup>nd</sup>, 3<sup>rd</sup>, 6<sup>th</sup>, 11, and DC circuit courts, as well as the Court of Federal Claims have held against the Service. The IRS used the following arguments before the courts to justify imposition of the 3% tax under IRC §4251 even when the charge is not based on both distance and elapsed transmission time.<sup>89</sup>

1. IRC §4252(b)(1) defining “toll telephone services” is ambiguous in its use of “and” (italicized here): “For which there is a toll charge that varies in amount with the distance *and* elapsed transmission time of each individual communication.” The IRS notes that “and” can be used in either a conjunction or disjunction (or) meaning. In fact, the 3% excise tax provision includes an example of the use of “and” in a disjunctive manner. IRC §4251 provides that the tax applies to “local telephone service, toll telephone service, and teletypewriter exchange service.” The use of “and” there is disjunctive since there is no service that meets the definition of all three listed services. The IRS posits that Congress must have meant a disjunctive use of “and” at (b)(1) because otherwise, phone companies could just change their billing practice and avoid the tax.

The courts have countered that in looking for Congressional intent, the language of the statute is the starting point. The court points out that the most common definition of a word is the starting point; for “and,” that means a conjunctive interpretation. The court also notes that “and” does make sense because it is unlikely that phone companies would bill based solely on distance where the charge would only consider the distance and not how long the call lasted. Also, Congress could have used an approach similar to what it did in defining “teletypewriter exchange services and add “or other manner” to broaden the reach of the definition.

In at least one decision, the court also looked at the legislative history finding that when the language was changed in 1965, Congress had looked at the billing practices of AT&T. At that time, long distance charges were based on transmission time multiplied by a rate based on “distance mileage bands” or for “Wide Area Telephone

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<sup>87</sup> *National Railroad Passenger Corp. v. U.S.*, 94 AFTR2d 2004-6086 (DC DC). Similarly, see *Reese Brothers, Inc. v. U.S.*, 94 AFTR 2d 2004-7229 (DC PA 2004), aff'd No. 05-2135 (3<sup>rd</sup> Cir. 2006); *AOL, Inc. v. U.S.*, 95 AFTR 2d 2005-1697, 64 Fed. Cl. 571 (Ct Fed Cl 2005); *Honeywell Int'l, Inc. v. U.S.*, 95 AFTR 2d 2005-1091, 64 Fed. Cl. 188 (Ct Fed Cl 2005); and *Hewlett-Packard Company v. U.S.*, 96 AFTR2d 2005-5251 (DC CA 2005).

<sup>88</sup> *ServiceMaster Co. v. U.S.*, 97 AFTR 2d 2006-2511, (DC IL).

<sup>89</sup> These arguments have appeared in various cases. The explanation here is based on that of the Third Circuit in *Reese Brothers* (May 2006) which makes frequent reference to the Sixth Circuit *OfficeMax* decision.

Service” (WATS), a periodic charge for unlimited access within a specified area.<sup>90</sup> Thus, “and” at §4252(b) was intended to be conjunctive.

2. Rev. Rul. 79-404, 1979-2 CB 382, which defined non-distance sensitive ship-to-shore calls as subject to the tax on “toll telephone services” should be followed. The court counters that such rulings do not need to be followed where the statute is clear without them or if they conflict with the statute. In Rev. Rul. 79-404, the IRS notes that the service does not literally meet the definition of “toll telephone service” because the charge is not based on distance. However, it notes that it is clearly a long-distance call intended to be covered by the tax.
3. Congress has reenacted IRC §4252(b)(1) subsequent to the issuance of Rev. Rul. 79-404 thereby affirming its holding under the legislative reenactment doctrine.<sup>91</sup> The courts have noted that despite the legislative reenactment doctrine, “it may not always be realistic to infer approval of a judicial or administrative interpretation from congressional silence alone.”<sup>92</sup> The courts have noted that the IRS is unable to show that Congress was aware of Rev. Rul. 79-404, although the IRS did find legislative history which seemed to indicate that Congress viewed “toll telephone services” as the same as long distance calls.
4. Distance was considered in the billing practices because charges varied based on whether the call was intrastate, interstate or international. The courts have stated that “distance” is a spatial context and the words intrastate, interstate and international are “jurisdictional classifications” used for regulatory purposes that do not have the same meaning as “distance” as used in §4252(b)(1). For example, a call between counties in different states could be a shorter distance than between counties in the same state. Or a call between the U.S. and Canada could be a shorter distance than an intrastate call.
5. The tax is owed under §4252(a) as a local telephone service because the customer must first connect locally before making the long distance call. The courts have nixed this argument on the basis that it would make the elapsed time and distance provision of §4252(b) superfluous and statutes may not be interpreted in such manner.

*The Future:* In a February 25, 2006 budget hearing by the House Ways & Means Committee, Congressman Rumstad asked Treasury Secretary Snow why the IRS was continuing to pursue collection of the tax on long-distance charges that are not based on both time and distance. Specifically, Mr. Rumstad asked: “Can you please tell me why in the world does the IRS continue collecting this tax, and can you give us an indication of how long the Government will keep litigating this issue? Mr. Secretary, why not give it up?” Secretary Snow responded: “Well, I think the courts may require us to do that very soon. You know, this is pending in the Sixth Circuit. The Department of Justice took an appeal from the District Court. We are awaiting that judgment. Should the judgment come down in alignment with the prior three Federal Circuit Courts, I think the handwriting is on the wall.”

Mr. Ramstad then asked whether that would be “the end of the temporary tax enacted in 1898 to fund the Spanish-American War” to which Mr. Snow responded: “I would think the time to bring that to an end would be upon us.”<sup>93</sup> While Mr. Snow commented that the end of the excise tax may be upon us, it would still be viable for the charges that continue to be based on both time and distance and legislative action would be needed to completely terminate the tax.

**Relief at last:** In May 2006, the IRS announced that it would no longer litigate the issue and was even authorizing three years of refunds to payers of the long distance tax. Notice 2006-50<sup>94</sup> provides that the IRS will follow the holdings of the appeals court decisions interpreting §4252(b). Taxpayers will no longer owe the 3% excise tax on “nontaxable services.” Such services are defined as bundled services and long distance services. A bundled service is “local and long distance service provided under a plan that does not separately state the charge for the local telephone service.” It might include VoIP, prepaid phone cards and plans where both the local and long distance calls are charged based on a flat monthly fee or charge that varies with the elapsed time. A long distance service is

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<sup>90</sup> American Bankers Insurance Group, Inc., 408 F.3d 1328, 95 AFTR 2d 2005-2291 (11<sup>th</sup> Cir. 2005).

<sup>91</sup> This doctrine provides that “Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change.” *Lorillard v. Pons*, 434 U.S. 575, 580 (1978).

<sup>92</sup> *U.S. v. Rutherford*, 442 U.S. 544, 554 n. 10 (1979).

<sup>93</sup> House Ways and Means Committee hearing of February 15, 2006; transcript available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=4784>. Note that while the tax originated in 1898, it was repealed in 1902, but then reinstated in 1914 as a temporary measure and then reinstated. After a few years of repeal, reinstatement and extension, the tax was made permanent by the Revenue Reconciliation Act of 1990. A brief background report, *Telephone Excise Tax*, prepared by Louis Alan Talley of the CRS (September 2000) can be found at <http://budget.senate.gov/democratic/crsbackground/teltax.pdf>. This report describes the history of the tax, pros and cons for repeal and the revenues raised.

<sup>94</sup> Notice 2006-50, 2006-25 IRB 1141. Also see Treasury press release JS-4287, 5/25/06.

defined as “telephonic quality communication with persons whose telephones are outside the local telephone system of the caller.”

A key part of the notice is the refund procedure, the highlights of which follow:

- a. Collectors (service providers) or taxpayers (customers) may request a refund of the tax paid on “nontaxable services” that were billed during the period after February 28, 2003 and before August 1, 2006. (The 2003 date was selected based on a 3-year statute of limitations to claim the refund.)
- b. Refunds or credits will only be allowed if the procedures of Notice 2006-50 are followed.
- c. The refund or credit may only be requested on a taxpayer’s 2006 federal income tax return. For fiscal year taxpayers, this means the return that includes 12/31/06. A special line will be added to the forms for the refund. A taxpayer who is not required to file an income tax form must file one in order to get the excise tax refund.
- d. The refund will only be allowed on the income tax form if the taxpayer certifies that they did not already receive a refund or credit from the collector and that they will not be seeking one.
- e. A safe harbor determination procedure will be provided for individual taxpayers (including those who also file Schedule C) to calculate the amount of the refund. Details will be provided in future guidance from the IRS. This is a simplification measure that eliminates the need to submit or maintain documentation. This procedure is only available if the individual has paid all of the taxes billed by their service provider between February 28, 2003 and August 1, 2006.
- f. Instead of the safe harbor amount, individual taxpayers may request the actual amount of refund owed. Interest paid on this refund is taxable.
- g. Non-individual taxpayers may only request the actual amount for the refund; no safe harbor determination approach will apply.
- h. Businesses that deducted the excise tax must make the appropriate adjustment to taxable income for the refund and interest income (in the year the refund is received or accrued as appropriate).
- i. Partnerships and S corporations must also make the appropriate allocations to partners and shareholders for the refunds and interest income.
- j. Collectors (service providers) may request a refund only if they establish that they repaid the tax to the person from whom it was collected or obtain written consent of such persons to the allowance of the refund.
- k. The refund cannot be treated as a credit against tax for estimated tax purposes. Also, in determining estimated payments for 2007, the income from the refund must be taken into account on the date paid or credited for cash method taxpayers and when the request is filed for accrual method taxpayers.

Notice 2006-50 states that excise tax continues to be owed on local services (§4252(a)). It does not address teletypewriter exchange service (§4252(c)), but presumably, tax on such services to the extent they still exist are still owed.

*Observations on Notice 2006-50:* Certainly, this notice is welcome relief, particularly for taxpayers with significant amounts of excise tax paid on toll telephone service not based on both time and distance as it will avoid litigation and provide a simpler method for obtaining refunds. The Notice does raise a few questions though. For example, will the safe harbor refund calculation for individuals include an interest element that will have to be tracked and picked up in 2007 income?

Also, why did the IRS take the approach of defining new terms in the Notice (“bundled service,” “local-only service,” and “long distance service”) rather than using the terms of §4252? Since the IRS states in the notice that it will be following the appeals court decisions, why not just say that the excise tax is not owed on toll telephone service where the charges are not based on both time and distance? One possible answer is that it was necessary to reflect billing practices. Where a company provides both local and long distance service and does not separately state the local service charge, per Notice 2006-50, no federal excise tax is owed. Depending on whether or not Congress repeals the entire tax, customers may want to examine their service plans more closely to determine if they might be able to avoid having taxable “local-only service.” Be sure to see Notice 2006-50 for the complete definitions. State and local statutes and notices should also be reviewed as the result may differ depending on whether the jurisdiction uses language based on IRC §4252 and whether it also adopts the approach of Notice 2006-50.

Taxpayers should hear from their providers as to whether they will seek a refund for customers or if customers should seek their own. If they will not receive a refund from their service provider, individuals will likely want to

use the safe harbor method to avoid the need to document the refund amount. However, if an individual did not pay the tax (omitted it on the bill – although the collector should have continued to bill it), the safe harbor method is not available. Business taxpayers will want to start work on determining the actual refund they are entitled to claim on their 2006 return and determine if they will need to obtain information from their service providers to calculate it.

*VoIP:* On July 2, 2004, the IRS issued an advance notice of proposed rulemaking (REG-137076-02) seeking comments and suggestions “describing the various technologies, services, and methods of transmission currently available for transmitting data and voice communications and how they should be treated under [Internal Revenue Code] section 4251.” The IRS is considering updating very old regulations to “reflect changes in technology.” Soon after the release of the advance notice, some people thought the Service was planning on taxing VoIP. The IRS subsequently stated that it was not considering applying the 3% excise tax on VoIP.

Some VoIP providers may be collecting the 3% federal excise tax on VoIP. In an 8/4/04 interview, 8X8, Inc.’s CEO noted that it collects the federal excise tax from customers even though it views its services as information services rather than telecom services.<sup>95</sup> In addition, VoiceEllipse also notes on its website that it will collect the 3% federal excise tax on the VoIP services it sells.<sup>96</sup>

TAM 200343001 provides some insights on the IRS view. This ruling involved application of the 3% excise tax to prepaid phone card service. The tax treatment of prepaid phone cards is addressed by §4251(d)(1). The taxpayer argued that its services were not taxable because it used the Internet to connect customer calls and customers buy cards using the Internet. The IRS held that the services were subject to the tax noting that “use of the internet to provide communication services is not relevant; Taxpayer is furnishing communications services to its customers using telephones, regardless of the other equipment used in the process.”

Notice 2006-50 provides that “bundled services” includes VoIP (assuming it is a local and long distance service where the charge for local service is not separately stated). “Bundled services” are now defined by the IRS as nontaxable.

*Possible Congressional Actions:* In January 2005, the staff of the Joint Committee on Taxation suggested three possible solutions to the above issues (and others) with the 3% federal telecommunications tax.<sup>97</sup>

- 1) Modify the tax to apply to local and long distance voice phone services regardless of whether the charges vary based on distance or time. The tax would apply to both landline and wireless services. No guidance would be offered as to whether VOIP is a taxable communications service or a nontaxable information service.
- 2) In addition to the changes under (1), the tax would apply to any voice communication regardless of technology (but would not tax Internet access). It would not be necessary for the service to access the public switched telephone network.
- 3) In addition to the changes under (2), the tax would apply to all data communications services to end-users including digital cellular, satellite phone services, cable and satellite TV services, broadband and dial-up Internet access services.

Despite offering possible expansions of the excise tax, the JCT also notes that there is “no compelling policy argument for imposing” the tax because it distorts consumer decisions and adds to the cost of new technologies which impedes their development and deployment. Yet, the tax raises a lot of revenue – about \$6 billion in 2003 (although with Notice 2006-50, that amount will decrease).

### **DBS versus Similar Technologies**

Changes in technology have sometimes led to different tax results for service providers or consumers even though the end product looks the same. For example, if a landline phone call is subject to tax, but not an Internet call, while both callers get the same transmission result, the costs may differ and the system perceived as unfair or inequitable. The California Commission on Tax Policy in the New Economy noted such a situation with respect to consumer services received via direct broadcast satellite (DBS) versus cable. The Commission recommended that an 8% tax be imposed on DBS to make it equivalent to the fees and taxes imposed on cable services. The purpose was to improve competition between the two transmission systems even though the costs structures were not similar. Cable

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<sup>95</sup> See <http://www.viodi.com/newsletter/040800/article2.htm>. Per 8X8 Inc.’s 10-K report for 2002, its business is to “develop and market telecommunication technology for Internet Protocol, or IP, telephony and video applications.”

<sup>96</sup> Voice Ellipse, viewed May 27, 2006, [http://www.voiceellipse.com/telcom\\_taxes.php](http://www.voiceellipse.com/telcom_taxes.php).

<sup>97</sup> JCT, *Options to Improve Tax Compliance and Reform Tax Expenditures*, 1/27/05, JCS-02-05, pages 368-378.

operators pay fees for use of public rights-of-way which satellite does not require, although satellite service providers incur costs of launching and maintaining satellites and certain fees for the right to do so. The Commission also noted that the new tax on DBS would help maintain revenue base as cable customers migrate to DBS. However, if the cable fee is primarily for services rendered, there would appear to be no reason for the DBS tax.<sup>98</sup>

### Addressing the Lurking Issues

Need to consider:

- § Technologically neutral ways of taxing.
  - Finding ways for existing law to keep up with changes in technology (for example, could §197 be written to include intangibles not yet developed – as it probably should have been in 1993 to include domain names)?
- § Avoiding compliance burden for small businesses with worldwide customers.
- § Whether changes should be part of any significant federal or state tax reform efforts (rather than a separate activity that may be disconnected from the other reform efforts).
- § Caution on incentives
  - Might be misdirected
  - Might not be needed
  - Federal may restrict state and local limiting control over their own tax bases
- § How can the technology help in tax administration and compliance?
- § How to resolve issues globally?
  - For example, providing uniform sourcing rules to avoid double taxation
  - Simplify tax bases
  - Look at work of OECD

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<sup>98</sup> California Commission on Tax Policy in the New Economy, Final Report, pages 57 – 59 (Dec. 2003); available at [http://www.library.ca.gov/CaTax/Docs/2003-12\\_FinalReport.pdf](http://www.library.ca.gov/CaTax/Docs/2003-12_FinalReport.pdf).