

Why Internet Companies Generate Tax Issues

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January 2001

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

- 1. Location**—Existing tax systems tend to determine tax consequences based on where the taxpayer is physically located. The e-commerce model enables businesses to operate with very few physical locations. Location factors primarily raise tax issues at the international and state and local levels, rather than at the federal level. For example, the U.S. Supreme Court has ruled that a state may only require a vendor to collect sales and use tax if the vendor has a physical presence in the state.¹
- 2. Nature of Products**—E-commerce allows for some types of products, such as newspapers and music CDs, to be delivered in digitized (intangible) form, rather than in tangible form. Digitized products raise issues at the state level as to whether sales tax applies and in which state income is generated for state income tax purposes. It can also raise income tax issues regarding the type of revenue generated and how it is to be reported, as well as whether digitized products are subject to traditional inventory accounting rules.
- 3. New Marketing Techniques**—The Internet has allowed for new ways of selling and buying goods and services. For example, individuals can offer their unwanted items to a worldwide group of potential buyers via auction sites, such as E-Bay. The Internet can also be used to easily link business buyers and sellers through exchange web sites where buyers post what they have to sell and sellers match up with them, or vice versa. Such sites can almost operate without human intervention for the matching function. In addition, the Internet has increased the use of bartering, most notably with respect to exchange of web banners that serve as advertisements. These new techniques raise various tax issues at all levels. For income tax purposes, issues include whether an exchange intermediary or broker should be accounting for inventory, and what amount of information reporting should be required for low-value bartering transactions. At the international level, the source of the income generated (which country) might be uncertain.
- 4. New Types of Assets**—Some of the new assets created by commercial use of the Internet are domain names (URLs) and web sites. For income tax purposes, issues exist as to how to treat the costs of creating or acquiring such assets, as well as the characterization of any gain or loss generated upon disposition of the asset. Sellers of such assets may face uncertainty in the law as to how to characterize the gain or loss generated from the disposition (capital or ordinary).
- 5. Making Optimal Use of the Internet May Challenge Old Rules**—One area where use of the Internet has potentially raised some tax issues involve how some tax-exempt organizations are using the Internet. For example, a tax-exempt organization might allow donors to be listed on the organization's Web site. This may cause the entity to face issues as to whether the listing is merely

¹ *Quill*, 504 U.S. 298 (1992).

an acknowledgement or whether it is advertising that may result in unrelated business taxable income (UBTI) for the organization. Another issue may exist where an organization that primarily operates on the web, such as a non-profit information exchange, meets the tax definition of a tax-exempt organization. Also, the Internet may allow for more efficient interactions between a tax-exempt organization and its donors, yet existing rules were not written with such interactions in mind. For example, a receipt is required for certain donations in order for the donor to be entitled to a deduction. Will a receipt generated by and printable from a Web site constitute an appropriate acknowledgement for tax purposes? In October 2000, the Service issued Announcement 2000-84, 2000-42 I.R.B. 385, which lists various issues that tax-exempt organizations may face related to the Internet. The Service is seeking input from interested parties as to whether additional guidance is needed for tax-exempt organizations.

6. Nature of Transactions—The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concerns for the Internal Revenue Service as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed. In a speech entitled, “Tax Administration in a Global Era,” (former) Treasury Secretary Summers stated:

“The Internet provides new ways for tax administrations, such as the IRS, to improve the ease and transparency of tax collection. But new technology also raises certain problems. In a world where cyber-transactions are growing at a rapid pace, tax administrations face the challenge of adapting existing tax systems to an economy that increasingly ignores physical borders.

In such a world, it will be easier for companies to avoid tax collectors by operating worldwide through web-sites based in jurisdictions that are unwilling to share taxpayer information.”²

² From a speech to the 34th General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.