

Taxation and Today's Digital Economy

By Annette Nellen

Annette Nellen examines the digital economy, with an emphasis on recent activities of the OECD, and addresses three aspects of today's digital economy: (1) transacting business with virtual currencies, such as Bitcoin; (2) providing digital goods and services; and (3) transacting business enhanced by the Internet.



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Introduction

The continual and rapid pace of the emergence of new technologies and business models entering the marketplace challenges tax rules that lawmakers and tax agencies cannot update or clarify quickly enough. Tax practitioners continually face challenges in both understanding the technology and how tax rules apply. And change, of course, continues.

Emerging in the 1990s with the rapid growth of Internet activities, particularly e-commerce, the “digital economy” continues to evolve with new applications and business models. For example, rather than buying goods online with a credit card, today you might buy them with a virtual currency. Today, your client might be engaged in a service business where she has never seen the hundreds of customers she serves, with everything handled online, possibly through a third-party broker using a sophisticated website.

This article begins with a brief overview of the digital economy, with an emphasis on recent activities of the OECD, an international organization working to address cross-border tax issues presented by today's digital business models. This article then addresses three aspects of today's digital economy with a brief background on the composition and operation of each, tax considerations and suggestions for dealing with open tax issues. The focus is on federal tax concerns, but some

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state and international tax issues are also chronicled. In addition, new opportunities for tax compliance and administration are noted.

Exhibit A summarizes various digital business transactions, applicable tax rules and open issues. In addition, a due diligence checklist is provided in Exhibit B to assist in identifying and understanding possible digital activities of

your clients and the tax relevance. This article focuses on the transaction and tax basics; many of these topics and subtopics could be addressed in more detail. Some topics could be addressed in a short article, while for others, a treatise would be needed to fully address the details of the technology and the international, federal, state and local tax rules that apply, as well as the open tax issues and how to address them.

EXHIBIT A. DIGITAL ECONOMY TAX RULES AND CONSIDERATIONS*		
Digital Economy Activity	Tax Rules and Considerations	Open Tax Issues
Transacting Business with Virtual Currencies		
Mining virtual currency	<ul style="list-style-type: none"> Income upon receipt (Notice 2014-21). If in a trade or business, self-employment taxes owed. Local business license tax may apply. 	<p>What exchange information should be used to measure the value and when during the day or week it should be measured? Should an average of daily rates be used?</p> <p>Should any expenses be capitalized?</p>
Using virtual currency	<ul style="list-style-type: none"> The virtual currency is treated as property (Notice 2014-21). Thus, need to calculate gain or loss and its character every time it is used. Recordkeeping is needed; software programs exist to help the user. If gifted, did recipient obtain information on giver's basis? If donated to charity, follow rules for documentation and appraisal (if required). If contractors or employees paid using a virtual currency, normal information reporting rules apply. If merchant accepts virtual currency, normal sales tax rules likely apply. If handle exchange of virtual currency into a sovereign currency, Form 1099-K (Code Sec. 6050W) may be required. 	<p>Exchange rate to use (see comment above).</p> <p>It may not be possible to know which lot of virtual currency was used making use of the required specific identification method impossible. Guidance needed from the IRS on whether another approach, such as FIFO, may be used.</p> <p>Character of the asset may not be clear where a business holds and regularly uses a virtual currency for revenue and expense purposes.</p> <p>Verify how state treats virtual currency used by merchants.</p> <p>For use outside of the United States, review VAT and sourcing rules.</p>
Holding virtual currency	<ul style="list-style-type: none"> Security is important as loss of the code due to a crashed hard drive or theft is unlikely to qualify as a personal theft loss. Needs to be noted and considered in estate and gift tax planning. 	<p>IRS needs to provide guidance for when the asset must be reported on an FBAR or Form 8938. In the meantime, if any connection to a foreign entity, it may need to be reported.</p>
Providing Digital Goods and Services		
Sale of software via electronic means or any digital item Provider of cloud computing resources	<ul style="list-style-type: none"> Verify if a sale or license (Code Sec. 7701(e), Rev. Rul. 55-540 and case law, such as Grodt & McKay Realty, 77 TC 1221, Dec. 38,472 (1981)). Determine if cash method of accounting permissible (Code Secs. 448, 471, Reg. §1.446-1(c)(2)(i), Rev. Proc. 2001-10, Rev. Proc. 2002-28). Determine if Code Sec. 199 applies (for example, special rule for software at Reg. § 1.199-3(i)(6)). Determine if any expenses constitute research or experimental expenditures under Code Sec. 174 and if taxpayer qualifies for Code Sec. 41 research credit. Determine where seller has sales tax and income tax nexus and how taxed under laws of those states. For sales outside of the United States, may need to collect VAT. 	<p>State nexus and income sourcing rules may not be complete or clear regarding cloud computing transactions and digital assets.</p>
Owning digital asset and using cloud services	<ul style="list-style-type: none"> Determine proper tax treatment of owned digital assets (Code Secs. 167, 197, 263). Review technology and its use to ensure that confidential data is not at risk; implement identify theft precautions. 	<p>Statutory change to Code Sec.197 or IRS guidance needed regarding treatment of an acquired domain name (URL).</p>

EXHIBIT A. DIGITAL ECONOMY TAX RULES AND CONSIDERATIONS*

Digital Economy Activity	Tax Rules and Considerations	Open Tax Issues
Transacting Business Enhanced by the Internet		
Selling goods online (e-commerce)	<ul style="list-style-type: none"> Determine if seller is in a trade or business or if activity is a hobby (Code Secs. 162 and 183 and regulations). Be familiar with IRS Audit Technique Guide for the Retail Industry, Chapter 3 on online sales, particularly part about potential tax issues. Determine where seller has nexus. Note that if seller uses fulfillment services of another vendor, seller likely has inventory (physical presence) in the states where its inventory is located; client needs a system to track this and comply with sales tax laws. If selling via drop shipment, review state sales tax law to determine which party is required to collect sales tax. If engaged in affiliate marketing (ads on websites of others), may have nexus in states where affiliates are located. If sales tax obligations in multiple states, consider finding a software tool to simplify compliance. 	State nexus rules may not be clear or complete. Congress may expand sales tax nexus through Marketplace Fairness legislation (such as S. 698 (114th Cong)).
Rent out real estate property via a website	<ul style="list-style-type: none"> Determine what rules govern treatment of income and expenses (Code Sec. 280A(e), 469 or 162). For short-term rental, determine if exclusion of Code Sec. 280A(g) applies. Determine if income is investment income under Code Sec. 1411 (if landlord has income about the threshold amount). Determine if transient occupancy tax, business license and other possible local taxes are owed. 	Clarification needed under Code Sec. 6041 as to when a landlord is required to issue Form 1099 to service providers.
Providing services to clients found via a website	<ul style="list-style-type: none"> Determine if service provider has been properly classified by payor (based on whether W-2 or Form 1099-MISC or Form 1099-K received). If payor treats as contractor, determine if service provider is in a trade or business or hobby. If client is improperly classified as a contractor, consider filing Form SS-8 with the IRS and Form 8919 with the 1040. For shared driving activity, be familiar with IRS Audit Technique Guide for the cash intensive businesses, Chapter 17 on taxicabs. 	Worker classification guidance is needed for workers who do not fit neatly within the employee or contractor categories or where it is not clear who the employer is (the web host or the service-recipient).
Crowdfunding	<ul style="list-style-type: none"> Need to determine the reason funds were solicited. General rule is that the funds are income unless an exclusion applies or the funds are an equity investment. Determine if sales or use tax applies such as because contributors were promised goods that are taxable. 	

* This exhibit lists some common “digital economy” transactions along with some of the applicable tax rules, compliance considerations and open issues for which guidance is needed.

The three aspects of the digital economy addressed are from the perspective of how clients engage in the digital economy. They are:

1. transacting business with virtual currencies, such as Bitcoin;
2. providing digital goods and services; and
3. transacting business enhanced by the Internet, such as finding customers, including working in the “sharing economy.”

The above categorization can involve some overlap. For example, virtual currencies are a digital good or service. However, a download of a game or music serves a different purpose or need than does obtaining virtual currency. Also, e-commerce can be the sale of digital goods or services.

It can also be the sale of tangible goods online that can more easily reach a worldwide market with fewer costs than required in the bricks-and-mortar model.

The Digital Economy

The digital economy has existed for as long as we have had computer hardware and software. The growth of the Internet, starting in the 1990s, though, greatly expanded the elements and capabilities for a pervasive digital economy. Accelerating the historical picture to recent times, a review of the work of the Organisation for Economic Co-operation and Development (OECD) is helpful. The OECD, comprised of 34 countries, including the United States, works to identify and

EXHIBIT B. DUE DILIGENCE IN THE DIGITAL ECONOMY

Below are questions to consider asking clients in order to determine if they engage in digital economy transactions and if yes, the nature of the activity. Comments are included for each question to highlight additional due diligence and compliance considerations.

1. Did you make purchases from online stores or auction websites?
 - Use tax may be owed.
 2. Did you sell anything online (new or used goods, intangibles, information or services) using an auction website or your own website?
 - Trade or business, or hobby?
 - Sale of personal items may have generated taxable gains.
 - Sales tax compliance in state of residence and possibly also where customers are located. Nexus considerations include location of merchandise (particularly if fulfillment centers of another vendor are used), nature and location of any sales assistance including via affiliate marketing.
 3. Did you generate income from online games, gambling, raffles or cashing out virtual money or tokens for real money?
 - Identify tax consequences.
 - Online gaming may require FBAR if funds held by foreign entity (see FBAR instructions and *J.C. Hom*, DC-CA, 2014-1 ustrc ¶150,307).
 4. Did you generate income from links on your website?
 - A personal blog, for example, might have ads that generate revenues for the owner.
 5. Did you engage in any crowdfunding activity?
 - Need to determine the purpose and the nature of the receipts.
 6. Did you loan or borrow money through an online website that matches borrowers and lenders?
 - Determine if valid loan or instead a gift or other type of income.
 7. Do you generate funds from renting out your property?
 - Need to determine if client is properly tracking revenues and expenses.
 - Determine proper reporting under Code Secs. 280A, 469 and 162.
 8. Do you provide services to clients you find via a website (web host)?
 - Find out what websites are used, the nature of the work, how paid and if a Form 1099 or W-2 was received.
 - Help client identify expenses, such as use of car, computer, home office, and how to track, document and report.
 - Determine if client is an employee or contractor. If misclassified, discuss with client. Possible remedies include client discussion with payor, or filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, with the IRS, and possibly Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, with Form 1040.
 9. Did you have any other Internet transactions that generated income or a deduction?
 - To determine if the above questions did not capture everything.
 10. Did you receive a Form 1099-K, *Payment Card and Third Party Network Transactions*, for any Internet-related activity?
 - While Form 1099-K is not directly reported on any tax form, the IRS may use it to review reported revenues. The Form 1099-K is likely to report gross transactions without any reduction for commissions that may have been kept by a web host, returns or other transaction adjustments.
 11. Do you own or use virtual currency?
 - Follow Notice 2014-21 to determine tax consequences.
 - Determine if any gift or donation was made using virtual currency.
 - Help client with recordkeeping to track value every time used or obtained.
 - If client exchanges virtual currency for sovereign currency with customers, ask if he or she has reviewed applicable federal and state registration rules. This question can help you gauge your client's awareness of legalities associated with this activity, which may also affect determination of business versus hobby status.
 12. Do you have digital assets, such as a blog, photos or documents stored online, valuable virtual world creations, an online gaming account, etc.
 - See if client knows the value and if the assets are noted in estate and trust documents.
 - May be a good opportunity for discussion about protecting one's identity online to prevent identity theft.
- For any of these questions and answers, also consider the following:
1. Learning more about the technology involved.
 2. Learning more about the company the client is interacting with for the Internet activity. Good sources are the business websites, SEC reports, news articles, any terms of service agreement required for using the website and any court case involving the company (usually includes a clear explanation of the business activities).
 3. Asking the client to describe how the technology works, how funds are generated, etc., to gauge how well the client understands what they have become involved with. Ask if the client has read any terms of service agreement they have signed or have agreed to sign via a click on a website, and if they have a copy.

address common problems and promote solutions.¹ A high-profile recent problem under examination by the OECD is known as “BEPS” for “base erosion, profit shifting,” a problem exacerbated by the digital economy. As part of its study, in March 2014, the OECD released a discussion draft for public comment on tax challenges of the digital economy.²

In this report, the OECD observes: “The digital economy is characterized by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs.”³ The report explains

aspects of the digital economy, including e-commerce, “app stores,” online advertising, “cloud-based processes,” the “Internet of Things” (multiple devices and people connected *via* the Internet), virtual currencies, advanced robotics, 3D printing and the “sharing economy.” These and other aspects stem from constant development of “information and communication technology” (ICT). The report observes that new technologies often allow for new revenue models, such as advertising (*e.g.*, ads on social media sites), selling data collected from websites and providing services online.

Some additional considerations for understanding the digital economy and its potential and issues include the following:

- It is viewed as key to economic growth. For example, S. Res. 110 (114th Cong) calls for the United States to “develop a strategy to incentivize the development of the Internet of Things in a way that maximizes the promise connected technologies hold to empower consumers, foster future economic growth, and improve our collective social well-being.”⁴
- New business models generate new revenue sources, possibly replacing older models at some point. For example, merchants can better target advertising and obtain quick results on effectiveness through website ads. This advertising model, often referred to as affiliate marketing, generally involves the website owner placing the ad on their website. The owner is compensated when someone clicks on the ad. The compensation may be in the form of a fixed amount per click or a percentage of the sales should the “clicker” place an order.
- The digital economy generates more than tax issues. For example, the use of personal data assistants (PDAs) by employees challenges the meaning of a workweek under the Fair Labor Standards Act (FLSA), as the devices operate 24/7.⁵ Litigation over whether people earning money from “shared economy” activities, such as providing rides in their personal cars, are employees or contractors for labor law purposes, note that these workers don’t neatly fit either category. A March 2015 order of the U.S. District Court of Northern California directs the issue to a jury trial. The judge described the task of the jury as fitting a “square peg” into one of “two round holes.”⁶
- Software programs that allow for decentralized transactions, verification and recordkeeping, such as is used for Bitcoin (discussed later), challenge tax administration where no responsible party is in charge. Such systems may also provide opportunities for improved tax compliance and administration.

- Time and location are not always relevant in transacting business in that mobile devices and the Internet enable activities to be done anywhere, anytime. For tax purposes, this can affect sourcing of income, nexus or permanent establishment, compensation arrangements and even worker classification.⁷

Transacting Business with Virtual Currencies

What Is Virtual Currency?

A virtual currency is one that is intangible (digital); it has no physical location or representation. It operates as a medium of exchange, usually throughout the world, yet is not backed by any government or entity. It is convertible into sovereign currency or goods (usually in the real world, but for some currencies, it might only be useable in a virtual world). It can also be described as a “peer-to-peer” system due to the role of a network for connecting users and verifying transactions. This currency relies on cryptography to verify transactions. Bitcoin, probably the most popular virtual currency, also uses the “Blockchain” as a perpetual, public ledger of all transactions, indicating dates and amounts (but not user names as they are not necessary for verification). The Blockchain serves to verify that the sender and recipient of Bitcoin are using a true bitcoin (digital code).

Bitcoin entered the economy in 2009. It was created by anonymous parties who developed the software and “Blockchain.” There is a finite amount of bitcoin to be released over the next 100+ years by “miners” using software and a good deal of computing power to solve equations. The process gets increasingly difficult over time. Thus, one way to obtain bitcoin is to mine it. It may also be obtained through a money exchanger or by selling goods or services to someone who pays you with bitcoin. Users typically hold the coin (the cryptography codes) in a “wallet.”

Other types of virtual or digital or crypto currencies include Litecoin, Primecoin and Dogecoin.⁸

Why Use Virtual Currency?

Reasons for using a virtual currency include the following:

- It has lower transaction costs than credit cards.
- Vendors can avoid chargebacks where a credit card user tells the credit card company he or she did not receive the goods ordered. The credit card company then reverses the charge unless the vendor can prove delivery. Being a decentralized system, there is no

- third party to resolve vendor and customer disputes.
- Less personal information needs to be transferred in comparison to use of checks or credit cards. This can afford anonymity (assuming goods are not physically delivered to the customer) and reduce the risk of identity theft or credit-card fraud.
- It is easier to use in the global marketplace, as it is a global currency. There is no need to convert one sovereign currency into that of another country's currency.
- It can be used for micropayments.
- Some countries have unreliable banking systems or inflationary conditions.

Reasons for not using a digital currency include the risk of fluctuation in value, additional recordkeeping and uncertainty as to tax treatment (for some transactions).

Federal Tax Guidance

In March 2014, the IRS released Notice 2014-21⁹ on the tax treatment of virtual currency. This guidance applies to such currency that is convertible to sovereign currency and acts as a medium of exchange. The notice provides 16 Q&As and seeks public input on other areas in need of guidance with respect to the tax treatment of virtual currency.

The key point made in Notice 2014-21 is in Q&A 1. The IRS states that virtual currency is treated as property (rather than foreign currency). This statement really answers most questions about virtual currency in that there is already a significant body of tax law on the treatment of property. Per the IRS: "General tax principles applicable to property transactions apply to transactions using virtual currency." Additional Q&As deal with valuation, mining, use and information reporting.

Per Notice 2014-21, miners generate taxable income upon successfully mining a virtual currency. Gross income equals the fair market value of the currency at the date of receipt. This means that a miner is really providing a service, rather than producing property. Thus, the expenses of mining appear to be treated as current expenditures. If the miner is a dealer of virtual currencies though, the rules of Code Sec. 263A should be considered (additional guidance from the IRS would be helpful). If the miner's activity rises to the level of being a trade or business, self-employment tax is owed (Q&A 9).

When virtual currency is exchanged for goods or services, a barter transaction occurs. This is the tax relevance of the IRS treating the currency as property.

Example. Amy purchased one X coin, a virtual currency, from an exchanger in 2012 for \$90. In March

2015, she used the X coin to purchase goods valued at \$140. Amy has a gain of \$50 from this transaction. Assuming Amy held the X coin for investment (likely given the time period she held it), she has a long-term capital gain to report.

To determine the dollar value of a virtual currency transaction, an exchange rate determined per market supply and demand is used. The conversion tool should be used "in a reasonable manner that is consistently applied" (Q&A 5). There are several exchanges that can be found *via* a web search. Unless the IRS provides more guidance, it appears that the taxpayer can determine which one to use (provided it is based on supply and demand) and whether to use a daily average or a rate published at a certain time of the day (or other reasonable method).

A user of a virtual currency applies existing property tax rules to determine the character of any gain or loss, whether a loss is usable (that is, the virtual currency is not a personal use asset), and whether virtual currency held for business or investment purposes is like-kind to another virtual currency.

One significant topic omitted from Notice 2014-21 is whether virtual currency is considered a foreign asset for purposes of the Report of Foreign Bank and Financial Accounts (FBAR) and reporting foreign financial assets.¹⁰ In the meantime, existing tax rules should be considered.¹¹

State Tax Guidance

Several states have issued guidance on virtual currency for income and/or sales tax purposes. For example, New York will follow Notice 2014-21 for income tax purposes. For sales tax purposes, because virtual currency is intangible, it is not subject to sales tax in New York. Thus, in a barter exchange, the party that receives virtual currency is not subject to sales tax.¹²

Providing Digital Goods and Services

Nature of the Transactions

Digital goods and services encompass a broad and growing list of items. Digital goods include software, games, books and other written documents, music and ringtones.

Digital services include telecommunications, online gaming, virtual worlds and website hosting. The European Union directive on application of VAT to electronically supplied services, defines these digital services as including

website supply and web hosting; provision of software, information and databases; supply of music, film, games and event broadcasts; and distance teaching.¹³

Cloud computing is the provision of digital services and perhaps digital goods as well. The National Institute of Standards and Technology (NIST), part of the U.S. Department of Commerce, defines cloud computing as “model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction. This cloud model is composed of five essential characteristics, three service models, and four deployment models.” The essential characteristics are: on-demand self-service, broad network access, pooled resources, rapid elasticity and measured service. Basically, cloud computing allows 24/7 access to data and electronic services, such as storage and access to software, that is not dependent on location. That is, the location of the computer servers does not affect the access. The providers might use servers in multiple locations with usage changing throughout the day based on demand, maintenance schedules and utility costs.

NIST describes the service models with the following acronyms that have become well-known (although not necessarily well understood outside of the computing field):

- Software as a Service (SaaS)—allows access to software without the need to transfer it to the user’s computer.
- Platform as a Service (PaaS)—allows access to tools and information for creating software.
- Infrastructure as a Service (IaaS)—allows access to hardware and software to help support data transfer and storage and other functions. IaaS has been described as similar to “outsourcing of IT functions.”¹⁴

The deployment models noted by NIST refer to those which have access to a particular “cloud” or network of servers and software. These models are private, community, public and hybrid.¹⁵

Federal Tax Considerations

Digital goods and services can raise some issues that predate the digital era. These include whether revenue generated is for services, sale of inventory or lease income. It also includes whether a Code Sec. 199 deduction is allowable to the cloud operator. For certain international transactions, Reg. §1.861-18 on classification of software transactions, along with federal tax rulings, may help provide some support and assistance for classifying cloud computing transactions¹⁶ and transfers of software and other digital assets for federal tax purposes. Reg. §1.861-18

provides guidance to classify software transactions as one of the following:

- Transfer of a copyright right
- Transfer of a copyrighted article
- Provision of services
- Provision of know-how

Development of software, including a website, game or virtual world, involves rules for R&D including Code Sec. 174 expensing and the special software development treatment provided in Rev. Proc. 2000-50, as well as whether the development costs qualify for the research credit.¹⁷

Inventory accounting issues can arise for a seller of software online. For example, if a copy of the software is made for each customer purchase and download, is that the sale of inventory or provision of a service? Accounting method rules under Code Secs. 446 and 471 come into play. Provision of software in the SaaS model should be the provision of a service as nothing is transferred to customers.

Some new issues arise with digital activity. For example, the law is not clear whether acquisition of a domain name (URL) is an acquired intangible asset under Code Sec. 197. This asset, nonexistent when Code Sec. 197 was enacted in 1993, does not fit within any category of Code Sec. 197, but does fall within the intent of this provision.

Also, estate planning and tax rules can come into play in new ways with digital assets. For example, what happens to one’s digital assets at death? These assets can include blogs, social media accounts, cloud storage of photos and other documents, e-book and digital music libraries and more.¹⁸

State Tax Considerations

Most states do not impose sales tax on services and digital goods, or only tax certain digital goods, such as off-the-shelf software. In several states, sales tax applies to “tangible personal property” defined as “personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses.”¹⁹ Some states have added off-the-shelf software to the definition of tangible personal property, whether obtained via tangible media or digital download.²⁰

As more goods move to digital form though, more states look to broaden their sales tax base to address its erosion. For example, Wisconsin changed its sales tax law effective October 1, 2009, to apply to the sale, use and storage of certain digital goods. FAQs from the Wisconsin Department of Revenue note that not all digital transfers are subject to sales tax. For example, purchase of blank legal forms in digital format is not subject to sales tax, but purchase of a digital book is.²¹

Most states have issued guidance on some aspect of sales tax and cloud computing. Generally, if a state does not tax services or intangibles, cloud computing transactions are not subject to sales tax because there is no transfer and no tangible property. Yet, some states tax information or data processing services or software no matter how acquired. The rules of each state must be reviewed to know whether sales tax applies to any cloud computing transaction.

Generally, digital assets, being intangible, will not create sales tax nexus in a state. In the *Quill* decision the U.S. Supreme Court held that a physical presence is required for sales tax nexus.²² However, a state might view licensed software as tangible property that is still owned by the licensor causing that party to have nexus in the state.²³

For state income tax purposes, the tax treatment of digital goods and services involves nexus, sourcing and apportionment rules. For nexus purposes, more states are moving towards some type of economic nexus standard when a taxpayer does more than sell tangible personal property (where P.L. 86-272 would provide guidance).²⁴

Generally, states have sourced sales of other than tangible property using costs of performance. However, states have been moving to market sourcing for services and intangibles. The rules of each state must be reviewed with careful attention paid to how market sourcing rules are described as they are not always consistent from state to state.

Proposals have been introduced in Congress, since at least 2010,²⁵ to prohibit state and local governments from imposing multiple or discriminatory taxes on digital goods and services. As stated in H.R. 1643 and S. 851 (114th Cong), the purpose is to “promote neutrality, simplicity, and fairness in the taxation of digital goods and digital services.”

International Tax Considerations

At the international level, digital goods and services raise issues of permanent establishment, sourcing and application of value-added tax (VAT). Recent attention to this topic exists in the OECD BEPS project (noted earlier) and a change to the application of VAT to digital goods and services in the European Union, effective January 1, 2015.²⁶

Transacting Business Enhanced by the Internet

Beyond activity described in the prior section that can only take place via the Internet, the Internet also allows for improvements to many “old economy” business models. Most notable is e-commerce, which enables not only the sale of digital goods and services, but also tangible goods.

It enables a provider of goods or services to easily cross borders to reach a wider customer base. It also enables service providers to serve customers without the need for an in-person meeting.

The Internet and web-based activity also makes it easy to start a business activity. This might involve a web-based storefront (perhaps even without ever having any bricks-and-mortar storefront) or it might involve an exchange service to find and connect providers of goods and services with interested customers. Examples include sellers using eBay and other auction sites. Web-based providers also offer tools for connecting tutors with pupils, house cleaners with home owners, among other possibilities. Examples also include “sharing economy” activities such as renting out your real property *via* Airbnb, HomeAway or similar company, or providing car rides using Lyft, Uber or similar provider to find passengers and arrange payment.

Web-based models also allow ease of connecting borrowers and lenders, start-ups and providers of capital (crowdfunding), and more.

The ease of using websites for finding customers or tenants, connecting parties interested in tutoring, housecleaning, rides and other services, increases the level of activity over what was feasible in the pre-Internet era when it was more costly and geographically restricted to engage in these activities. Thus, practitioners are likely to find that more clients, even those with full-time jobs, are engaged in e-commerce or some aspect of the sharing economy.

In further discussion of these activities, the party that creates the website for connecting parties who will engage in the desired transaction, such as rental of a room, is referred to as the web host.

Federal Tax Considerations

Often, the federal tax treatment of these Internet-enhanced business models is well-established, as these are not necessarily new transactions. For example, just because one finds a tenant for their vacation home *via* a web-based company doesn't change the tax treatment. The property owner must determine whether the rental rules of Code Sec. 280A or 469 (or neither) apply. An individual transporting passengers must determine if he or she is in a trade or business in order to determine how (and whether) any expenses are deductible. If in a business, self-employment tax is owed.

Some “sharing economy” activities raise worker classification and information reporting questions. A variety of terms are used to describe service providers of the sharing economy. These include freelancers, gig workers, dependent contractors,²⁷ crowd-sourced labor,²⁸ and on-demand

workers and micro-entrepreneurs.²⁹ All highlight lack of clarity as to the tax classification.

Typically, the web host requires an agreement (terms of service) signed by both third parties to specify various terms and understandings about the arrangement. This usually includes a statement that the party the web host makes payments to is not an employee. The web host may also describe the system as offering business opportunities for individuals to be their own boss or to be an entrepreneur. The gist of the agreement is that the web host is just the matchmaker that connects a service provider with someone seeking particular services (the “third parties”).

For example, Amazon’s Mechanical Turk operation is a web-based service that matches people and organizations in need of personal services that can be done remotely, with people interested and able to provide the services. The tasks might be completing a survey, writing a review of a website, or answering questions about a website or picture. The contract that both parties must agree to specifies that Amazon is not involved in the transactions between the third-party service providers and service seekers. It also notes that Amazon provides no screening and makes no recommendations; the third parties use the site at their own risk.³⁰

In contrast, some web hosts perform some initial screening of either party and may provide some instruction to the service providers, such as hours of work, attire and minimum work expectations. The web host may provide insurance coverage for any mishap. For some activities, a more detailed screening may be required of the provider, such as a background check if the service involves entering someone’s home or interacting with a child (tutoring or child care, for example). Despite any background check, the contract terms are still likely to indicate that the parties enter the arrangements and work at their risk and that there is no employer-employee relationship between the web host and the service provider (or recipient).³¹

The operations where a web host matches service providers and service recipients raise new worker classification and reporting issues. Is the worker an employee of the web host? If the worker is an independent contractor, is the employer the service-recipient third party or the web host?³²

In a standard independent contractor situation, a service recipient hires the contractor (service provider), obtains his tax identification number and issues a Form 1099-MISC, *Miscellaneous Income*, if payments for the year total \$600 or more.³³ However, in the web host arrangement, typically the host collects the fee and transfers funds to the service provider (less the web host’s fee). Thus, it would seem that the web host should issue the information report.

Code Sec. 6041 requires that an information return be issued by persons engaged in a trade or business who in the

course of that business make payments of \$600 or more to another person for “rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income” (other than per certain specified rules). While the web host makes the payment, it might not be viewed as the one who obtained the service. That is, is the web host the service recipient (does it hire someone to provide services to clientele) or is it just a payment handler and matchmaker?

Some web hosts issue Form 1099-K, *Payment Card and Third Party Network Transactions*, rather than Form 1099-MISC for payments for which the web host served as matchmaker. This approach takes the position that under Code Sec. 6050W, the host is a “third-party settlement organization.”³⁴ Such an organization issues Form 1099-K to a payee only if the payments for the year exceed \$20,000 and the number of transactions exceed 200.³⁵

Due to the dollar threshold for Form 1099-K for a third-party settlement entity (over \$20,000 of payments and over 200 transactions) and limited use of Form 1099-MISC by some web hosts, a good number of service providers (and the IRS) do not obtain an information report. This poses record-keeping problems for some providers and will contribute to the tax gap (for both income and self-employment taxes).

As the sharing economy and its service providers grow in number, these significant classification and reporting issues will need to be resolved by Congress and the IRS. Also, as software and web platforms become more sophisticated, it may be possible to make these arrangements *via* a decentralized system, such as exists for Bitcoin (*i.e.*, there is no web host).

State and Local Tax Considerations

Broadened business opportunities created by the Internet and web-based platforms and tools also generate several tax issues at the state and local levels. At the local level, some cities have made efforts to be sure any transient occupancy tax (TOT) is paid on short-term rentals on guest rooms (all defined per local law). Some cities, such as San Francisco, have made arrangements with the web host to remit any TOT.³⁶ Landlords need to review the laws in their jurisdiction to determine if there is a TOT or any other tax or fee required by owners of short-term rentals.

Renters and freelancers must also determine if they are subject to any local business license tax or special fee.

Individuals generating revenues from rentals, provision of services, advertising or other sources must determine what state tax obligations exist. Generally, for services provided only from their state, the provider will be subject to state income tax only where they live.

Any funds generated from crowdfunding must also be evaluated to understand what the amounts are for. Documentation is needed to indicate whether the funds constitute equity contributions or revenues or both. Also, if contributors were promised a product, sales tax may apply. The Washington Department of Revenue has issued a set of FAQs on crowdfunding and tax consequences. It addresses tax registration requirements, when sales tax may be owed and more. The tax agency recommends that the “project creator” who obtains the funds from the “backers,” note on the website that pledged amounts include sales tax (if applicable). It also reminds the project creator that sales tax is owed on the gross amount without reduction for the fee that the “host” (operator of the website where backers submit the funds) charges.³⁷

Due Diligence and Client Assistance

New Internet and web-based activities and the growing number of individuals involved in them for revenue generation, requires tax practitioners to review the standard questions they ask of clients for tax preparation and planning purposes. Once it is known that clients are involved in new types of transactions, it is important to gain an understanding of the technical aspects, business model (how revenue is generated, what parties are involved, *etc.*) and the tax rules.

Clients, particularly those new to being self-employed or operating a rental property, may need assistance with recordkeeping. Clients may also need financial assistance in understanding how to establish appropriate pricing of their products or services. Clients will also need to understand what types of taxes they are subject to and where. Those new to making estimated tax payments will also need guidance on how to make them, track them and budget for them.

Where tax rules are incomplete or unclear, whether at the federal or state level, consideration should be made of obtaining a ruling from the appropriate tax agency.

See Exhibit B for a list of questions to ask clients to learn or and obtain information about their online activities that may have tax consequences.³⁸

Tax Compliance and Administration Opportunities

The digital economy presents new business models and opportunities for many individuals and businesses. It also presents ideas and opportunities through advanced technology to improve tax compliance and administration. Arguably, tax compliance could be made as simple as ordering something online, paying bills online, and sending online greeting cards and invitations.

The Bitcoin Blockchain and software are one example of a sophisticated system that operates in a decentralized manner. There are already efforts underway to do more with this type of technology. For example, efforts are underway to use this type of technology for sovereign currencies. The system would allow for money transfers without the need for a bank or other third party.³⁹

The Blockchain public-ledger approach might also serve as a secure repository for tax records. One example provided in a congressional hearing on virtual currency, noted that if all real estate ownership records were stored in such a repository, a title search would cost only a few cents and could be done quickly.⁴⁰

Improved use of technology could also reduce identity theft. For example, just as is used for credit card and banking transactions, secure websites and personal identification numbers (PINs) could be used to access tax data.

The United States can work with states to develop more sophisticated tax administration and compliance systems that build on digital tools already in use for business activities. This technology also presents opportunities for economic growth. In launching a “FinTech—Innovate Finance” initiative in the United Kingdom in 2014, George Osborne, Chancellor of the Exchequer, stated: “Mobile banking apps, peer to peer lending, virtual currencies—technologies such as these are going to transform our lives, and create huge economic opportunities.”⁴¹

Looking Forward

The digital economy is really just another way to describe today's everyday economy. While we have some business models that are purely digital, we also have digital elements in all business models today. It is not possible to avoid electronic communication, data storage, funds transfers, advertising and more.

The continuing rapid pace of advancement of technology and its business use presents exciting opportunities for entrepreneurs and their tax advisers. Keeping up to date with not only tax rules, but also technology, is crucial. Making use of the technology as appropriate in both your personal and professional life will help and perhaps create new savings in time and costs and present new business opportunities.

The digital economy will also continue to challenge tax rules that were mostly written for an economy where physical goods and location were key tax determinants. We will likely see lawmakers and tax agencies at all levels of government, issue new guidance. Such guidance needs to address reporting and use of virtual currencies, sourcing, nexus and worker classification. Hopefully this needed guidance can come close to keeping up with the rapid deployment of new technologies and business models.

ENDNOTES

- ¹ See the OECD website available online at www.oecd.gov.
- ² OECD, Public Discussion Draft, BEPS Action 1: Address The Tax Challenges of the Digital Economy, 2014. Subsequent reports have also been released.
- ³ *Id.*, at 5.
- ⁴ S. Res. 110 passed in the Senate on Mar. 24, 2015.
- ⁵ See Congressional Research Service, The Fair Labor Standards Act, Overtime Compensation, and Personal Data Assistants, Sept. 12, 2011. Also see testimony of a July 14, 2011 hearing of the House Education & The Workforce Committee on "The Fair Labor Standards Act: Is It Meeting the Needs of the Twenty-First Century Workplace?"
- ⁶ *Cotter, et al. v. Lyft, Inc.*, DC-CA, Case No. 13-cv-04065-VC (Mar. 11, 2015).
- ⁷ For more on this aspect, see Cisco's white paper, *Transitioning to Workforce 2020*, 2011.
- ⁸ For additional background on how virtual currencies work, guidance from tax agencies and Treasury's FinCEN and other governments, see the author's website at www.21stcenturytaxation.com/Virtual_Currency_Tax.html.
- ⁹ Notice 2014-21, IRB 2014-16, 938.
- ¹⁰ Form 8938 and Code Sec. 6038D.
- ¹¹ For example, if an individual holds a Bitcoin wallet through a foreign entity, it may be reportable on an FBAR and Form 8938 based on *Hom*, DC-CA, 2014-1 ustr ¶150,307, where taxpayer's account held by a foreign casino was found to be reportable on an FBAR. IRS guidance would be helpful.
- ¹² New York State Dept. of Taxation & Finance, Technical Memorandum TSB-M-14(5)C, (7)I, (17)S (Dec. 5, 2014). For guidance issued by other states (and countries), see links at www.21stcenturytaxation.com/Virtual_Currency_Tax.html.
- ¹³ See (1) "Annex L" of Council Directive 2002/38/EC (May 7, 2002), available online at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:128:0041:0044:en:PDF>.
- ¹⁴ New Jersey Division of Taxation, Technical Bulletin TB-72 (July 3, 2013), available online at www.state.nj.us/treasury/taxation/pdf/pubs/tb/tb72.pdf.
- ¹⁵ NIST, The NIST Definition of Cloud Computing, Special Pub. 800-145, Sept. 2011, available online at www.csrc.nist.gov/publications/nist-pubs/800-145/SP800-145.pdf.
- ¹⁶ For more on federal guidance for cloud computing and software, see Sprague and Reid, *A Break in the Clouds: A Proposed Framework for Analyzing Cloud Computing Transactions*, TAXES, Mar. 2014.
- ¹⁷ Code Sec. 41.
- ¹⁸ A model act exists for states to adopt or modify, called the Uniform Fiduciary Access to Digital Assets Act, that may address some of these issues. See Uniform Law Commission available online at www.uniformlaws.org/Act.aspx?title=Fiduciary%20Access%20to%20Digital%20Assets. Guidance on valuation considerations for estate and gift tax purposes would be helpful.
- ¹⁹ See for example, Calif. Rev. & Tax. § 6016.
- ²⁰ See for example, Mass. Gen. Laws § 1 and NJ Stat. § 54:32B-2(g).
- ²¹ Wisconsin Department of Revenue, Digital Goods, available online at www.revenue.wi.gov/faqs/ise/diggoods.html. Also see DOR Pub 240, available online at www.static.revenue.wi.gov/pubs/pb240.pdf. Also, the Streamlined Sales and Use Tax Agreement, adopted by several states, includes a definition of "specified digital products," which an adopting state may or may not opt to subject to sales tax.
- ²² *Quill*, S Ct, 504 US 298 (1992).
- ²³ See for example, Texas Comptroller of Public Accounts, Ruling 201409970H.
- ²⁴ For more on P.L. 86-272 and economic nexus, see author's website at www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm.
- ²⁵ See for example, H.R. 5649 (111th Cong).
- ²⁶ See specific information on VAT, sourcing and one-stop-shop from the tax agency of any EU country. Also see Nellen, E.U. "MOSS" and Sourcing: Lessons for the U.S. Sales Tax? Bloomberg BNA, WEEKLY STATE TAX REPORT, Nov. 21, 2014.
- ²⁷ Lauren Weber, *What If There Were a New Type of Worker? Dependent Contractor*, WALL ST. J., Jan. 28, 2015.
- ²⁸ Rick Cohen, *Microemployers & Microemployees: Crowdourcing in the Labor Market*, Nonprofit Quarterly, Apr. 20, 2015.
- ²⁹ Lauren Weber & Rachel Emma Silverman, *On-Demand Workers: "We Are Not Robots,"* WALL ST. J., Jan. 27, 2015.
- ³⁰ See Amazon Mechanical Turk Participation Agreement, Dec. 2, 2014, available online at www.mturk.com/mturk/conditionsfuse.
- ³¹ For example, the terms of service for TaskRabbit (the web host) states that TaskRabbit is only providing a "communications platform" to connect "clients" (those seeking services) and "Taskers" (those providing the services), available online at www.taskrabbit.com/terms.
- ³² Litigation has already started on the nature of the employment relationship, if any, with respect to labor laws. For example, see *Cotter, supra* note 6, and *O'Connor, et al. v. Uber Technologies, Inc.*, DC-CA, No. C-13-3826 EMC (Mar.11, 2015). These rulings also provide information on company operations.
- ³³ Code Sec. 6041.
- ³⁴ Also see Reg. §1.6050W-1(c).
- ³⁵ The Amazon Mechanical Turk website indicates that a Form 1099-K will be issued to those with over \$20,000 of gross payments and over 200 transactions for the year, see www.payments.amazon.com/sdui/sdui/about?nodeId=201491280. A similar statement appears on the TaskRabbit website which also notes that a summary of earnings statement will also be issued to Taskers, see www.support.taskrabbit.com/hc/en-us/articles/204409640-Tax-Information-and-FAQs.
- ³⁶ The Airbnb website notes which cities and counties it collects TOT for and notes that renters should check their local city and incorporate it into their rental rate. See www.airbnb.com/support/article/653.
- ³⁷ Washington Dept. of Revenue, Crowdfunding, available online at dor.wa.gov/Content/GetAFormOrPublication/PublicationBySubject/TaxTopics/Crowdfunding.aspx.
- ³⁸ Exhibit B is an updated version of Nellen, *Internet Era Questions for Individual Clients*, AICPA Tax Insider, Jan. 10, 2008; www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/Individual_Clients.jsp.
- ³⁹ Gertrude Chavez-Dreyfuss, *Exclusive: IBM looking at adopting bitcoin technology for major currencies*, Reuters, Mar. 12, 2015, available online at <http://www.reuters.com/article/2015/03/12/us-bitcoin-ibm-idUSKBN0M82KB20150312>. Cade Metz, *An Algorithm To Make Online Currency As Trustworthy as Cash*, Wired, Apr. 8, 2015, available online at www.wired.com/2015/04/stanford-prof-builds-algorithm-internet-money/.
- ⁴⁰ See testimony of Anthony Gallippi, CEO of Bitpay, before the Senate Banking, Housing, and Urban Affairs Committee, *The Present and Future Impact of Virtual Currency*, Nov. 19, 2013, available online at www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=955322cc-d648-4a00-a41f-c23be8ff4cad.
- ⁴¹ Govt. U.K. Press Release of Aug. 6, 2014, available online at www.gov.uk/government/speeches/chancellor-on-developing-fintech.

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