

## Traits of the E-Commerce Business Model and the Tax and Fiscal Issues They Raise

The chart below summarizes some of the tax issues facing businesses, as well as tax and fiscal issues for state and local governments posed by the e-commerce business model.

<b>E-Commerce Traits</b>	<b>Tax &amp; Fiscal Considerations for Businesses</b>	<b>Tax &amp; Fiscal Considerations for Government</b>	<b>Examples</b>
<p>Location:</p> <ul style="list-style-type: none"> <li>▪ Ability to interact with customers is not dependent on location.</li> <li>▪ Can reach customers in many different states and countries without the need for many physical locations.</li> <li>▪ Some physical assets needed to conduct business (such as servers) are not necessarily tied to a single physical location, but can easily be relocated without any interruption to business.</li> <li>▪ Mobile equipment (servers through which web pages are accessed and orders processed) can easily be moved to a more favorable tax location.</li> <li>▪ More custom inventories so less storage needs.</li> <li>▪ Less vertical integration, more outsourcing.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reduced operating costs.</li> <li>▪ Fewer physical facilities needed, so companies have a physical presence in very few states and countries in which they have customers.</li> <li>▪ Sales tax issue of distinguishing between taxable goods and non-taxable services.</li> <li>▪ Improved tax-planning opportunities due to lower costs of moving servers rather than physical structures.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Land-use decisions.</li> <li>▪ Increased competition among local jurisdictions as they work to encourage e-commerce companies to locate their physical facility in their jurisdiction.</li> <li>▪ Onerous tax systems can more easily be avoided by businesses because is easy to relocate. Competition among taxing jurisdictions may increase.</li> <li>▪ Greater likelihood that residents purchase from foreign (out-of-state) vendors—use tax collection issue; dealing with a global economy.</li> <li>▪ May need to reconsider tax rules that base jurisdiction to tax on location. A server is not like a vending machine because the server's location is not tied to the ability to serve particular customers. Also, servers can be moved.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Amazon.com (8 physical locations in U.S. and at least 3 in Europe, but customers in over 150 countries)</li> <li>▪ Egghead.com (sells software only via the Internet)</li> <li>▪ Purchase of cars via the Internet</li> <li>▪ Musicmaker.com (custom CDs)</li> </ul>
<p>Transaction details:</p> <ul style="list-style-type: none"> <li>▪ Possibility of anonymous transactions where products are delivered electronically and payment is made with electronic money.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Streamlined operations that in many cases can be completed by a computer that can be located anywhere in the world.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Difficulty of verifying that a transaction occurred and where it occurred; loss of an audit trail.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Sale of software and other information electronically.</li> </ul>

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<p>Nature of products:</p> <ul style="list-style-type: none"> <li>▪ Digitized products, rather than physical products.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reduced costs of storage and delivery.</li> <li>▪ Is the digitized product subject to sales and use tax? Laws vary from state to state.</li> <li>▪ Shift from selling tangible products to digitized ones may cause shifts in state income tax liability and increased filing obligations because of different sourcing rules for tangible versus intangible sales and the fact that P.L. 86-272 does not apply to sale of intangible items.</li> <li>▪ In many states, digitized products, as well as services, are not subject to sales and use tax. Thus, the tax base is shrinking. To maintain a more neutral tax system, consideration should be given to broadening the tax base and lowering the tax rate.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Less tangible personal property - thus, smaller sales tax base.</li> <li>▪ Fewer physical business locations are needed, so businesses are more likely to have customers in the state, but no physical presence (nexus). At the international level, countries will find that businesses have a permanent establishment (taxing presence for income taxes) in fewer countries.</li> <li>▪ Should P.L. 86-272 be updated to also address nexus for state income tax purposes for sales of intangible items and services?</li> <li>▪ Should sourcing of revenues be standardized among the states to avoid multiple taxation of income and to simplify multistate taxation rules? Today, for income tax purposes, most states source sales of tangible products to the destination state (in most states, if the seller is not subject to tax in that state, the sale is “thrown back” to the state of origin). Sales of intangibles are typically sourced to the state where the greatest income-producing activity occurs. However, a few states, such as Minnesota, source revenue from services and intangibles to the state where service is received or the intangible is used by the purchaser.</li> <li>▪ Should sales and use taxes bases be broadened beyond tangible personal property?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Music, books, videos, and software</li> </ul>

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<p>Nature of transactions:</p> <ul style="list-style-type: none"> <li>▪ Increased use of bartering (such as for advertising on web pages).</li> <li>▪ Improved ability to reach a larger customer base by advertising on the Internet.</li> <li>▪ Improved ability to match willing buyers and sellers.</li> <li>▪ Improved use of technology to set prices.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Valuation of the transaction for financial and tax reporting purposes.</li> <li>▪ Ability to reach a broad market across many states and countries without the need for a physical presence, thus reducing multistate and international tax obligations.</li> <li>▪ Reduced costs.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Fewer intermediaries who may have previously served as a tax collection point.</li> <li>▪ Valuation and reporting issues (bartering transactions are generally required to be reported to the government and the other party for tax purposes).</li> </ul>	<ul style="list-style-type: none"> <li>▪ <a href="http://www.bannerexchange.com">http://www.bannerexchange.com</a></li> <li>▪ E-Bay and other auction sites</li> <li>▪ <a href="http://www.usbid.com/">http://www.usbid.com/</a></li> <li>▪ <a href="http://www.tradeout.com">http://www.tradeout.com</a></li> <li>▪ <a href="http://bartertrust.com/">http://bartertrust.com/</a></li> <li>▪ <a href="http://www.priceline.com/">http://www.priceline.com/</a></li> <li>▪ Sept. 2000 report that Amazon.com was tracking data about customer buying habits and using variable pricing to retain customers. This is certainly easier to do on-line than in person at a store.<sup>1</sup></li> </ul>
<p>Distribution methods:</p> <ul style="list-style-type: none"> <li>▪ Reduced (or sometimes changed) need for intermediaries (disintermediation).</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reduced costs to customers.</li> <li>▪ Possible quicker service and closer tie to customers.</li> <li>▪ New types of intermediaries created, such as ISPs, virtual malls, repair services and various portals.</li> <li>▪ May change reduce number of places where vendor has nexus. For example, in some states, a vendor that has arrangements with a company to provide warranty services may be found to have nexus in the state where the repair company is located. An alternative today is to just sell (resell) customers a service contract between the customer and warranty repair company. For example, see WarrantyNow.com.</li> <li>▪ May not be obvious whether intermediary needs to account for inventory under the tax rules.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Fewer tax collection points.</li> <li>▪ May need to attempt to collect tax (such as some excise taxes) from consumers or use new intermediaries.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Sales of clothes from manufacturer to final consumer.</li> <li>▪ Purchase of airline tickets directly form airline's web site.</li> <li>▪ Consumer purchase of fishing equipment from outside of the U.S. where no excise tax is collected.</li> <li>▪ Vendors arranging for sale of services directly between customer and third parties who will provide services (rather than the vendor being directly involved with the third party which may create nexus for the vendor).</li> </ul>

<sup>1</sup> David Coursey, "Behind Amazon's preferential pricing," Yahoo! News, 9/11/00.

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<p>New Types of Assets:</p> <ul style="list-style-type: none"> <li>▪ Domain names</li> <li>▪ Web sites</li> </ul>	<ul style="list-style-type: none"> <li>▪ For federal and state income tax purposes, what is the nature of these assets? The answer is important to buyers so they can determine if the asset's basis can be amortized and to seller's to know the character of the gain or loss from disposition (capital or ordinary).</li> <li>▪ Would the transfer be subject to sales/use tax?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Do existing rules adequately address these types of new assets or is additional guidance needed?</li> </ul>	<ul style="list-style-type: none"> <li>▪ In 2000, the name "loans.com" sold at auction for a reported \$3 million and in 1999, the name "business.com" sold for \$7.5 million.<sup>2</sup></li> </ul>
<p>Greater Outsourcing:</p> <ul style="list-style-type: none"> <li>▪ Use of companies to create web sites and to store sites on servers</li> <li>▪ Use of service companies to assist with technology deployment</li> </ul>	<ul style="list-style-type: none"> <li>▪ Does the relationship with the third party (outsourcing company) create nexus for the business in the locations where the third party is located?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Existing rules on nexus may not be sufficient to address new transactions, such as web hosting.</li> </ul>	<p>Companies providing outsourcing services:</p> <ul style="list-style-type: none"> <li>▪ Exodus Communications, Inc.</li> <li>▪ Digital Island, Inc.</li> </ul>
<p>Global Marketplace:</p> <ul style="list-style-type: none"> <li>▪ The Internet makes it easier and cheaper for even small businesses to sell goods and services in the global marketplace.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Some small businesses may get involved in complex international and multistate tax issues.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Tax agencies may find increased non-compliance due to lack of global tax expertise within small businesses.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Various companies exist that provide assistance to small businesses engaging in e-commerce. For example: <a href="http://smallbusiness.yahoo.com/">http://smallbusiness.yahoo.com/</a> <a href="http://Bigstep.com/">http://Bigstep.com/</a></li> </ul>
<p>Workforce:</p> <ul style="list-style-type: none"> <li>▪ Remote workforce that may be scattered throughout a state or country, rather than working in a single work location together.<sup>3</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Issues as to whether the presence of employees in the state creates tax obligations for sales, income and other tax purposes.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reduced infrastructure costs as more people work closer to their homes.</li> <li>▪ Business license taxes applied to home workers.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Customer support provided via the Internet with workers working out of their homes, rather than the company's physical location.</li> </ul>

<sup>2</sup> The Associated Press, "Loans.com Domain Name Sells for \$3 Million," *New York Times*, Technology Section, January 31, 2000.

<sup>3</sup> The GartnerGroup predicts that by 2003, one-third of the U.S. workforce will be working remotely at least one day per week. Jack Lessinger, author of *Penturbia*, predicts that more of the workforce will move from urban and suburban settings to telecommute from remote areas including resort areas and farms. "For Better or Worse, IT's Influence Over Our Daily Lives Will Only Grow," *Executive Edge*, June/July 1999, page 15.

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<p>Technology:</p> <ul style="list-style-type: none"> <li>▪ Businesses using technology to track customer buying habits, adjust prices, track orders, etc.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Improved customer service at lower costs.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Can the software/data tracking be broadened to assist in tax determinations and collections?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Amazon.com keeps track of all orders a customer has made (customer can access), makes book recommendation based on prior orders.</li> </ul>
<p>More Power to Customers:</p> <ul style="list-style-type: none"> <li>▪ More information on products and prices is easily available to consumers from the Internet.</li> <li>▪ It is easy to shop for the “best deal” without leaving your computer.</li> <li>▪ Supplier exchanges can be formed to reduce inventory, improve availability of information and to speed up orders.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Increased price competition and need to get information to consumers in a timely manner.</li> <li>▪ Need to identify new ways to serve customers and suppliers.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Increased competition may reduce number of companies and reduce profits.</li> <li>▪ Opportunity to benefit from new ways of purchasing goods and services.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Business-to-business supplier exchange formed in February 2000 by General Motors, Ford, and Daimler-Chrysler.</li> <li>▪ Web sites that help consumers find the best deal on a particular product on the Internet.</li> </ul>
<p>Making Optimal Use of the Internet May Challenge Old Rules:</p> <ul style="list-style-type: none"> <li>▪ New guidance may be needed for tax-exempt organizations using the Internet.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Does a donor web link on a tax-exempt organization’s web site considered an acknowledgement or advertising (which may create unrelated business taxable income (UBTI))?</li> <li>▪ Does a donor receipt generated on the web satisfy the documentation requirement for deductibility of donations of \$250 or more?<sup>4</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Do state tax rules need to be updated?</li> </ul>	<ul style="list-style-type: none"> <li>▪ <a href="http://www.cob.sjsu.edu/assoc/bap/sponsors.htm">http://www.cob.sjsu.edu/assoc/bap/sponsors.htm</a></li> </ul>

<sup>4</sup> 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.