E-Commerce and International Taxation

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I. PROBLEMS IN TAXING E-COMMERCE

E-commerce facilitates mobile, long-distance, or anonymous transactions when the seller may be outside the territorial power of the taxing government or when the destination of goods and services can be masked.1 Thus, buyers may not have to pay sales tax on goods purchased from a seller in a different tax jurisdiction, putting non-e-commerce merchants at a disadvantage and reducing overall tax revenues.2 Income generated by such activity may also be difficult to tax fairly. Governments rely on reporting and collection by sellers for the administration of sales taxes, including the European Value-Added Tax (VAT). For income taxes, most international tax mechanisms give priority to the source state. In e-commerce, technology can make it difficult or confusing to identify sources.3 Even when sellers and the source of e-commerce income can be ascertained, states are generally unable to enforce tax burdens extraterritorially.

Special e-commerce problems arise with electronically-conveyed services and digitized products. These include whether a particular transaction involving an intangible should be classified as a service, as a “license” of rights, or as a “sale” of goods.4 Such transactions range from the provision of customized software to access to data, programs or games held in a server but displayed on the screen of the user in a different jurisdiction. As Napster has taught us, digitized entertainment is particularly troubling in potential volume, as music and video publishers contemplate electronic delivery of the digital information that a consumer might save on...
a hard drive or a CD, such as a music album or game program.\(^5\) Those issues not only raise sales tax problems but also create uncertainty when income generated in those transactions could be classified as "business profits" or possibly as "royalties" paid for rights in intangible property. Domestic statutes taxing international income and bilateral tax treaty provisions usually prescribe separate tax rates and other treatment for "business profits" as compared to "royalties."\(^6\)

Taxes levied at international borders on tangible goods are increasingly used to equalize sales or consumption taxation between imported goods and domestically-produced competitive products. However, these taxes are not applied to electronically-conveyed services and products. Threshold issues including the pinpointing of a nexus supporting tax jurisdiction are raised when electronic messages or devices may conceptually touch the territory of a state, such as the mere location of a Web server, or the transmission by physical wires or by wireless waves over a state. Within the United States, the place of delivery of services has been raised as an issue, for example New York asserts income tax jurisdiction over telecommuters.\(^7\)


\(^7\) U.S. Gen. Accounting Office, Telecommuting: Overview of Challenges Facing Federal Agencies, Pub. No. GAO-01-1116T, 5-6 (2001) ("increased state tax liability for employers and employees involved in interstate telecommuting arrangements may have the greatest potential to undermine further growth."). The author also discusses the implications of a case, in which a person telecommuting to a New York company from Tennessee was subject to New York income taxation, a ruling that could result in double taxation by the resident state and New York on the same income. See id. citing In the Matter of Thomas Huckaby, N.Y. Division of Tax Appeals, DTA No. 817284, (Feb 8, 2001.) See also U.S. Gen. Accounting Office, Telecommuting: Overview of Potential Barriers Facing Employers 10, Pub. No. GAO-01-926, (2001) and Fla. Stat Ann. 212.02 (19) (1998) (Florida tangible personal property tax statute aimed at tax images appearing on a computer screen under its tax on tangible personal property, which applied to "personal property which may be seen, weighed, measured, or touched or is in any manner perceptible to the senses). In this context it is of note that a Florida court ruled that computer images are neither tangible nor personal property. See Florida v. Quotron Systems, Inc., 615 So. 2d 774 (1993).

There is also concern about locating the "place of effective management" to establish the resident state of a corporation. Destination becomes a difficult concept when the particular product or service being sold or licensed will be "used" in multiple jurisdictions by the buyer.

Even when conceptual issues are clarified, by agreement or statute, problems of practical administration exist in the complexity of reporting, registry, and record-keeping that must be maintained. They also attract attention to privacy issues involved, and the compliance burden placed on taxpayers and businesses charged not only with collection and payment of the taxes, but also with ascertaining the appropriate tax rates to be applied when those rates vary depending on the location of the user.

II. CROSS-BORDER TAX SYSTEMS

When transactions generating income, or resulting in sales, have cross-border connections, international tax mechanisms have been developed to rationalize concurrent claims to taxing jurisdiction over the income, or the sale. An extensive network of bilateral income tax treaties link most of the developed nations and many of the developing nations. Within the European Union (EU), extensive steps have been taken by each of its member states to coordinate each nation’s separate taxes on goods, services, and corporation profits.\(^8\)
Most countries assert some degree of tax jurisdiction on income and transactions with foreign aspects under their own domestic tax laws that may tax income received by residents from foreign sources, or income remitted abroad from domestic sources. Cross-border sales are often subject to customs duties or registration fees in the state where goods are used. Within the United States, in the absence of border taxes, many state laws impose a use tax on residents who have purchased goods from sellers who did not collect sales tax on them. The technologies that generate e-commerce have challenged those existing mechanisms with transactions that cannot readily be identified under existing definitions in the treaty networks, nor in the domestic statutory provisions for sales and income taxation.

III. POLICY OBJECTIVES WEIGHED IN E-COMMERCE TAXATION

Two related concerns have focused the international response: (1) that a transaction with a cross-border aspect may be taxed more lightly than a similar purely domestic transaction, stimulating tax evasion and tax competition between governments; (2) and, that reallocation of resources in response to tax conditions rather than market conditions will create economic distortions that diminish productivity.9

Tax neutrality is one policy-rationale applicable to tax provisions burdening each of the broad areas of economic activity.10 In that context, tax neutrality means that each parallel activity is equally taxed, so that market decisions among goods, services, and licensing options are made on merits rather than because of tax considerations. If e-commerce is not taxed consistently with other forms of commerce, market distortion and consequent inefficient allocation of resources would arise.

It has proved technically and administratively difficult to impose a consistent pattern of taxation covering ecommerce. In the absence of consistency or enforceability, a wait-and-see approach is attractive, at least so long as the volume of e-commerce and electronically-delivered products is not significant in percentage terms.

Alternative policy considerations have also been introduced, to favor the establishment of e-commerce as an infant industry with great promise in ultimately creating a more productive and flexible economy. Favoring e-commerce over other commerce thus may lead to short-term market distortion and inefficiency, but that has been perceived as a rational price to achieve longer-term objectives. Lawmakers have also been concerned with imposing a sales tax obligation on e-commerce sellers, creating an inequity in compliance burdens as compared to domestic merchants who do not have to check on the buyer's ultimate place of use and determine the appropriate tax rate for that location.

The issue arises both internationally and within domestic tax systems. Domestically, opposition has stressed fairness issues—merchants are not competing on an equal playing field.11 Internationally, and between states within the United States with different sales and income tax systems, a more complex issue is raised as well: the reallocation of economic activity to tax havens because of conditions irrelevant to market performance. A state that provides more favorable tax treatment—a lower rate, or an exemption—will be a more attractive location for both sales and production. A state where technical expertise and an established technology base has created an early lead in ecommerce may be able to hold or expand its share of a market even when more efficient competitors enter the field if it had a head start under an infant industry tax break.

In international trade, e-commerce provides a major opportunity for enhancing overall productivity. The rapid expansion of trade treaty networks, especially the World Trade Organization (WTO) agreements, have already enhanced world productivity because goods and capital have increasingly been able to cross international boundaries according to market allocations without constraints imposed by customs duties and other political barriers to trade. The more efficient producers thus have access to worldwide markets. However, labor other than that embodied in goods has not been mobile across international boundaries. E-commerce provides a

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9 See id.
mechanism to permit a larger share of the labor element in transactions to be delivered at any location with access to international electronic communication. That labor component could be in the form of sales contacts, customer service on delivered goods, or in the form of electronically-delivered services such as Website design, maintenance and other programming.

Just as with liberalized trade in goods, there have been displacement and transitional issues as workers are compelled to reorient themselves to different economic roles under market forces exerted by comparative economic advantage. That has slowed the process because of political concerns, but overall the process continues. However, e-commerce offers efficiency gains without the more destabilizing prospect of physical migration and its attendant increases in family attenuation and cultural tensions.

Theoretical efficiency gains may be lost if tax neutrality is not ensured. Ruinous tax competition between states may also reduce revenues available to a state from its traditional tax bases as e-commerce expands. International efforts to develop legal, technical, and administrative tax systems dealing with e-commerce are therefore critical. Those efforts have primarily been the promotion of uniform tax rules among the various taxing jurisdictions involved in e-commerce.

IV. UNIFORM TAX RULES

E-commerce has made cross-border transactions more frequent thus has attracted the attention of tax officials worldwide. One notable impact in the increase of international trade has been coordination and remarkable convergence of the various tax systems in trading countries. For decades, significant efforts to harmonize tax systems have been made within the EU, where sales taxation under VAT predominates and transnational commerce in all forms has been highly developed.  

More recently within the United States, a national effort is being made to redesign the existing patchwork of sales and use taxes in the various states to create a uniform system, the Streamlined Sales Tax (SST), that would be neutral in interstate commerce, would cover electronic commerce and would facilitate tax compliance and collections from sellers.

In the meantime, the United States Congress passed the Internet Tax Freedom Act (ITFA) in 1998, temporarily freezing some taxation of e-commerce under state sales tax regimes. Supporters of the moratorium emphasize the potential of e-commerce for productivity growth and are concerned about the burdens that might be imposed in complying with a multiplicity of varying rules and rates. In 1998, the WTO agreed on a temporary moratorium barring customs duties on electronic transactions, and the World Customs Organization began working on improved transparency. With such efforts in place uniformity may be achieved eventually limiting such burdens.

The Organization for Economic Cooperation and Development (OECD), a group to which the industrialized countries belong and that develops economic policy information and studies, has been active in studying the impact of e-commerce on international taxation of income and consumption. The OECD has led many tax coordination efforts, including its Model Income Tax Treaty that has been the pattern for most of the

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15 See id. (“The Internet Tax Freedom Act of 1998 (ITFA) was enacted to help address some of the emerging challenges associated with electronic commerce. The ITFA had four major components: 1) a moratorium on new Federal Internet or Internet-access taxes; 2) a declaration that the Internet should be free of international tariffs and other trade barriers; 3) a 3-year prohibition on new taxes imposed on Internet access and on multiple or discriminatory taxes on Internet commerce; and 4) the establishment of a nineteen-member Advisory Commission on Electronic Commerce (ACEC) to study and submit a report to Congress on international, Federal, State, and local tax issues pertaining to the Internet.”).
16 See generally Report to accompany H.R. 1552, by the Committee on the Judiciary, H.R. Rep. No. 107-240 (debate in House included many proponents of the SST who sought its inclusion in the House version).
world’s tax treaties and its efforts to make statistical comparisons among countries more meaningful by encouraging more nearly comparable practices in reporting economic information.

In 1998 finance ministers from the OECD countries met in Ottawa, Canada, to discuss tax rules appropriate to the mechanisms of electronic commerce. Two significant measures were adopted in principle: that taxation under the VAT be centered on the place of consumption, rather than on the places of supply along the production chain, and that digital products should be classified as services. The VAT regimes generally are analyzed as consumption taxes, like United States sales taxes on goods, but usually are imposed at higher rates on a wider base that includes many services, such as lawyers’ fees as well as laundry.

In 1999 the OECD proposed rules that would establish income tax jurisdiction on business profits from transactions where only a Web server, not actual company sales personnel or other physical contacts, are present in a country. Income tax jurisdiction would be limited to situations where the country with the Web server has an income tax treaty with the country where the seller is physically located. Even those limited proposals have not been adopted, and other issues arise when either the Web server or the seller are located in a tax haven country. Thus the bilateral income tax treaty network that links most industrialized countries has provided a starting point for an agreement on neutral and equitable apportionment of tax revenues raised on the income from e-commerce, and has stimulated pressure on tax haven countries to release information on persons and activities within their territories. However, similar problems raised by sales taxation are perhaps even more pressing and formidable.

In 2000 the European Commission proposed rules for the EU that would compel online sellers to collect VAT on their sales of electronically-delivered products and services to customers located in Europe— wherever the seller might be located. Products that are subject to physical delivery are subject to VAT upon entry into any European state, under the common external tariff structure of the EU.

The extension of tax jurisdiction to digitally-delivered products was widely opposed, even within Europe. It was intended to protect European sellers who already must collect the tax from unfair competition with sellers in the United States and other foreign sellers who do not have to collect such taxes. Although a United States seller would in many cases not have assets at risk for collection by the European tax agencies, many United States suppliers would hesitate to build up huge tax liabilities within Europe that might someday be subject to collection, perhaps after business expansion, merger, or change in tax rules.

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19 OECD Office of Economic and Community Development, Taxation Framework 5 (1998) (“Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place... the supply of digitized services should not be treated as a supply of goods.”).
21 However, technology may quickly render the web server itself as a physical presence obsolete. See generally Interactive Services Ass’n Task Force, White Paper: Logging On to Cyberspace Tax Policy, 12 St. Tax Notes 209, 217 (Jan. 20, 1997) (“state reliance on POPS [the physical presence of network hardware] for taxing jurisdiction may be comparable to constructing a tax system on quicksand in that the increasing use of satellite or other wireless technologies may eliminate any need for POPS.”).
25 Id. at 3. See also Bolkstein, supra note 7 and accompanying text.
26 See Taxing Digital Downloads, 3 E-COMMERCE L. REV. 29 (2001) (“the EU is proposing that the company will be required to file a monthly report in the chosen country, but pay taxes based upon the country of each customer’s purchases. The VAT would then be redistributed to the relevant country.”).
Although technology to monitor transactions, calculate tax liabilities, and facilitate enforcement could be envisioned, it was not yet in place in 2000. The European Commission withdrew the proposals in 2001, and subsequently changed them.

Under the revised proposal, a seller could register in any EU member state, as before, but was to remit VAT at a rate applicable in the member country of destination (which varies from fifteen to twenty-five percent). Registered sellers would be given access to the VAT database, and would be entitled to rely on the information thus received in setting the appropriate tax rate.

The revised proposal failed again in summer 2001 primarily because of the opposition by the United Kingdom in a process where unanimous approval is needed. The U.S. Congress examined e-commerce taxation issues—primarily in the context of United States interstate commerce—during 2001 as the Internet Tax Freedom Act was set to expire in October of that year. Divisions in Congress were substantially along party lines, with the Republican-controlled House passing an extension of the limited moratorium on new Internet taxation in mid-October, while the Democratically led Senate, refused to act on the extension as such.

The leading Senate bill to extend the act contained extensive material on the SST, as well as the ITFA extension provisions. Although the ITFA

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27 See Commission Proposal, supra note 24. (giving online traders access to the VIES (VAT Information Exchange System), database of VAT data created for official information exchange between member states and state tax authorities and would discharge the supplier from tax liabilities if he can establish that he acted in good faith and verified the status of his customer).


30 See H.R. 1552, 107th Cong. (1st Sess. 2001) (“An act to extend the moratorium enacted by the Internet Tax Freedom Act through November 1, 2003, and for other purposes.”).

31 See NTU: House Takes Action Against Internet Tax Hike, Senate ‘Leaves Window Wide Open,’ U.S. NEWSWIRE, Oct. 19, 2001 (“Rather than simply assent to the House’s two-year Moratorium extension, the Senate adjourned after becoming embroiled in partisan debate.”).


34 See The European Commission, Taxation Policy of the European Union (2000) at http://europa.eu.int/comm/taxation_customs/publications/taxation/tax_brochure.htm (last modified Feb. 26, 2002) (“Tax policy is a symbol of national sovereignty and part of a country’s overall economic policy, helping finance public spending and redistribute income. In the European Union, responsibility for tax policy mainly lies with the Member States, that may delegate some of it from central to regional or local level, depending on the constitutional or administrative structure of government.”).
trading partners, who rely more heavily on sales taxes than on income taxes, as well as recent decisions of the WTO that favor rebates of sales and VAT taxes on exports, while banning income-tax reductions on export sales profits as an illegal subsidy to exports. Therefore, the rhetoric of necessity for reliance on sales taxes under more uniform tax rules is likely to become intense, with the SST dominating in the United States, and both the WTO and the EU continuing to take significant steps as well. E-commerce taxation supplies some genuine policy concerns that would be addressed by uniform tax rules, but may be used as a popular vehicle to promote rules with far wider implications.