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Developments in ECommerce Taxation

ECommerce taxation is a hot topic for 2001. As the level of commerce conducted over the internet continues to grow, governments are realizing that current tax systems may not be capable of administering tax rules in the digital era. This edition of ECommerce News gives an overview of important tax policy developments affecting ecommerce companies.

Internet Tax Non-Discrimination Act and State Sales Tax. On February 8, 2001, Sen. Ron Wyden (D-OR) and Rep. Christopher Cox (R-CA) introduced legislation to extend the current Internet Tax Freedom Act (ITFA) moratorium on new or discriminatory taxes (set to expire on October 21, 2001) by five years. The bill would also make the current moratorium on internet access taxes permanent.

A new and controversial part of the legislation would require states to make substantial simplifications to their sales and use taxes for out-of-state sales and would provide a mechanism by which Congress may authorize a state to require remote sellers to collect sales or use taxes if the state's law meets the simplification criteria.

Among the requirements are a single sales tax rate for all purchases and a relaxation of the standards that govern when sellers will be subject to business activity taxes, such as income taxes, within a state. "You can't squeeze the new economy into policies written for smokestack industries," Sen. Wyden said at the news conference announcing the bill.

The Wyden-Cox bill was met with immediate opposition from the National Governors Association (NGA) and the National Conference of State Legislatures (NCSL). Both groups oppose the bill's requirement that Congress pre-approve each state's system for collecting taxes on remote sales. The NGA also worries that certain types of transactions that fall under the access tax ban could be bundled with otherwise taxable transactions, such as internet calling and cable services.

The NGA is supporting legislation sponsored by Sen. Byron Dorgan (D-ND), known as the Internet Simplification and Equity Act (ISEA), originally introduced in June 2000 and expected to be reintroduced. Last year's version of the ISEA would have extended the moratorium on Internet access taxes and new discriminatory taxes by four years and called for a single, blended tax rate in each state with which remote sellers could comply, as well as uniform tax definitions and rules for compliance in each state.

If any compromise is to be reached between the NGA, NCSL, and Congress, it may revolve around a recent proposal by a group of 30 state tax administrators called the Streamlined Sales Tax Project (SSTP). On January 24, 2001, SSTP officials adopted a model bill for state legislatures. The bill offers retailers who enter the streamlined system increased ease of administration and audit protection in exchange for an agreement to collect tax on out-of-state sales. The bill also focuses on uniform definitions of categories of goods and tax rates, as well as a single vendor registration system.

While the NGA came out in support of the SSTP on February 14, 2001, the NCSL only tepidly approved a substantially modified version of the SSTP, and continues to oppose some of its key provisions. Thus, while supporters have introduced or are drafting legislation based on the SSTP in a dozen states, those proposals likely will face uphill battles in the wake of NSCL opposition.

The rift between the NGA and the NCSL has led many software executives to call for increased federal action rather than a patchwork of state initiatives. Mark Nebergall, president of the Software Finance and Tax Executives Council (SoFTEC) told *Tax Notes Magazine* on February 12, 2001, that recent squabbles among state representatives "demonstrate from a political standpoint that the state governments just are incapable of handling this problem on their own."

Whatever the end result, political handicappers are predicting that any Senate action will have to win the approval of Sen. John McCain (R-AZ), Chairman of the Senate Commerce Committee, where the Dorgan bill failed to win approval on procedural grounds last year.

New OECD Position Papers. On February 12, 2001, the OECD's Committee on Fiscal Affairs and its technical advisory groups, consisting of senior tax policy officials and business leaders from the United States and around the world, issued recommendations on a number of income tax treaty issues. Highlights:

Servers Can Create a Taxable Presence under the Model Tax Treaty - The OECD's Model Treaty plays an important role in international taxation, as it sets the framework for negotiating and interpreting hundreds of tax treaties among the world's developed countries. The primary role of the Model Treaty is to limit a state's jurisdiction to tax profits earned by non-resident corporations. Most importantly, the Model Treaty provides that a foreign corporation may only be subject to tax in those countries in which the corporation maintains a "permanent establishment" through a "fixed place of business."

Previously, the determination of whether a corporation maintained a fixed place of business depended upon the foreign corporation actually employing personnel in the taxing country in connection with such business. In its latest pronouncements, the OECD amended the commentary to the Model Treaty to provide that computer servers alone can be considered to create permanent establishment if "the business of an enterprise is wholly or partly carried on through the equipment."

While the OECD noted that certain types of activities such as advertising and relaying information through a mirror server for security purposes may not, in themselves, create a taxable presence, the text leaves open the question whether many other forms of ecommerce business models, particularly application service providers and B2B marketplaces, may be subject to tax in those countries where they maintain servers.

Importantly, however, the OECD clarified that serving a web site from a particular country will not alone subject a corporation to tax in that country.

International Sales of Digital Products Not Subject to Withholding Tax - The OECD also clarified that payments for downloaded digital products would be treated as business profits subject to tax only in the home country of the software provider. Previously, some countries argued that such payments, commonly referred to as “licenses,” should be treated as royalties, and therefore subject to withholding tax in the customer’s country. The fact that the OECD was able to reach a unanimous decision on this point is a credit to the U.S. representatives. The OECD rule now closely matches U.S. regulations on this point, which were fashioned with the help of software industry representatives.

EU Continues to Consider VAT for Digital Products. In June 2000, the European Commission proposed rules that would have forced online sellers from around the world to collect value added tax (VAT) on sales of digital products and services to European customers. Currently, European sellers are required to charge VAT on digital deliveries regardless of whether the customer is located in an EU country, whereas non-EU sellers can offer the same products and services without adding VAT.

While the European Parliament approved the proposals on December 14, 2000, the proposal still lacks the necessary unanimous approval by the EU’s finance ministers. The ministers have set a deadline of June 2001 for reaching an agreement on the final draft.

The EU proposal has been strongly denounced by the U.S. government and business community. Further, many in the EU doubt its enforceability against sellers who have no physical presence in the EU.

Many believe that the EU will be unable to come forward with a workable solution until differences among the member states’ own systems (including vastly different rates) are harmonized.

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MONTHLY UPDATE

DATA PRIVACY. Internet privacy promises to be one of the most high profile, and contentious, tech issues to face the new Congress and Administration. Rep. Anna Eshoo (D-CA) and Rep. Chris Cannon (R-UT) have introduced H.R. 237 requiring web site operators to disclose how information is gathered and for what purpose. The proposal tracks last Congress’s McCain bill (introduced by Senate Commerce, Science, and Transportation Committee Chairman John McCain (R-AZ) and cosponsored by Sen. John Kerry (D-MA), also a member of the committee).

Congressmen Asa Hutchinson (R-AR) and Jim Moran (D-VA) reintroduced legislation to create a bipartisan Privacy Protection Commission. H.R. 583, The Privacy Commission Act, establishes a seventeen-member commission to conduct a comprehensive study of privacy issues and make recommendations for action to Congress. The bill achieved a majority vote in the House of Representatives last year, but failed to reach the supermajority vote required under the legislative procedure used to send it to the Senate.

MEDICAL PRIVACY. The Department of Health and Human Services published regulations regarding medical records privacy during the final weeks of the Clinton Administration. The regulations establish standards controlling the flow of sensitive medical information and penalties for its misuse. Although the rule was published December 28, it was not sent to Congress until the week of February 12. Under the 1996 Congressional Review Act, the rules cannot be effective until Congress has had 60 days to review the regulation — so the rules' effective date has been pushed back to mid-April.

Health care industry lobbyists are urging new Health and Human Services Secretary Tommy Thompson to delay the effective date and reopen the rulemaking process, while consumer interest groups are urging the Secretary not to delay the effective date.

SPAM. Representatives Heather Wilson (R-NM) and Gene Green (D-TX) introduced H.R. 718, a bill to "protect individuals, families, and Internet service providers from unsolicited and unwanted electronic mail." The measure requires so-called "spammers" to include a valid return email address that recipients can use to demand that they not receive such email. Victims of spam would be empowered to seek damages from spammers and the Federal Trade Commission would be authorized to prosecute the offenders. Sen. Conrad Burns (R-MT), who chairs the Senate Commerce Subcommittee on Communications, is working on a similar bill in the Senate. The House overwhelmingly passed an anti-spam bill in the last Congress, but the legislation never made it out of the Senate Commerce Committee.

MERGERS. The Federal Accounting Standards Board (FASB) continues to work on its proposal to eliminate the "pooling method" of accounting for business combinations. At Congressional hearings on the matter last year, technology industry representatives testified before sympathetic Members of Congress regarding the negative consequences that the elimination of pooling would have on technology industry mergers, the ability to attract capital, and the overall health of the economy. In response, the board postponed action on the issue until it developed a better way to calculate intangibles under the board-favored "purchase method" of accounting.

FASB's new proposal announced this month allows goodwill that is acquired after a merger to retain its value and not be devaluated over time as is currently required under the purchase method of accounting. Certain "trigger events" under the plan would require that goodwill be reexamined to determine whether it retained its value.

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