Indirect Taxation of Electronic Commerce: Options Paper

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INDIRECT TAXATION OF ELECTRONIC COMMERCE:

OPTIONS PAPER

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INTRODUCTION

The Computer Systems Policy Project (CSPP) is an affiliation of chief executive officers of eleven major U.S. companies that develop, build, market, service and support information processing systems, software and solutions. The companies involved are: Apple Computer, Inc.; Compaq Computer Corporation; Data General Corporation; Digital Equipment Corporation; Hewlett-Packard Company; IBM Corporation; NCR Corporation; Silicon Graphics, Inc.; Stratus Computer; Sun Microsystems, Inc.; and Unisys Corporation.

In 1997, the CSPP began a new project to foster global electronic commerce. The CSPP identified seven policy issues that will have a significant effect on the success of Global Electronic Commerce.

Of these seven, CSPP believes tax policy will be particularly instrumental in determining whether the vast potential of Global Electronic Commerce is realized, or alternatively, frustrated.

CSPP, therefore, is committed to ensuring that (1) tax policy in the U.S. and internationally is coordinated among appropriate governments and businesses and (2) businesses and consumers who choose to conduct transactions electronically are not penalized for doing so.

To carry out this policy view, CSPP formed a Tax Counsels Working Group to develop tax principles for discussions with domestic and international governments on establishing sound, neutral tax policy that is also based on common standards and uniform definitions. This options paper has been written pursuant to that instruction. The CSPP also actively supports enactment of the Internet Tax Freedom Act in the U.S., and the establishment of comparable moratoria in the international arena, to enable orderly development of electronic trading in its nascent stage.

I. TAX POLICY OBJECTIVES

A. Neutrality

1. Electronic commerce ("E-commerce"), whether delivery occurs on- or off-line, should *not* be taxed at a higher rate than comparable conventional commerce.
2. E-commerce, whether delivery occurs on- or off-line, should *not* be subject to special taxes that are not generally applicable to conventional commerce; i.e., no new or discriminatory taxes on electronic commerce.

B. Fiscal Balance.

1. The CSPP recognizes the legitimate need for governments to collect revenue, and does *not* insist that E-commerce be tax free, provided that any taxes are imposed in a neutral, nondiscriminatory manner.

C. Simplicity

1. The rules for taxing E-commerce should be clear.
2. Uniform classification of on-line E-commerce transactions should be adopted.
3. Taxes on E-commerce should be imposed in a manner that minimizes compliance costs.
4. Tax authorities should take advantage of new technology to reduce the costs of complying with tax rules.

D. Technological Efficiency.

1. Taxes should *not* interfere with the development of superior E-commerce technologies and business models.

E. Free Trade

1. Consistent with current practice, and the treatment of intangible goods and services generally, on-line E-commerce trade should remain duty free.
2. E-commerce imports, whether delivery occurs on- or off-line, should be free from discriminatory taxation (i.e., national treatment).
3. Double indirect taxation of E-commerce trade (by the country of export and the country of import) should not occur.

II. STATE AND LOCAL SALES AND USE TAXES

A. Off-line Delivery

1. **Status quo.** Out-of-state sellers generally are not taxable with respect to local sales unless the seller has a physical presence within the state. Customers are subject to use tax; however, compliance is very low among non-business customers. It is unclear whether states can impose reporting requirements on out-of-state vendors absent nexus. Retention of the status quo would allow E-commerce to compete on a level playing field with mail/telephone order sales. While this achieves the neutrality objective, states may be deprived of a legitimate source of revenue and, consequently, may be unwilling to support federal legislation barring new, discriminatory taxes on E-commerce.

2. **Options for reform**

   a. **Tax Reporting Option 1. Mandatory reporting.** To facilitate collection of use tax, federal legislation could be enacted to require vendors to report customer information to states in which the vendor does not have tax nexus. Reporting could be required for E-commerce only or for mail order sales as well. Limiting taxmandatory reporting to E-commerce would violate the principle of neutrality and should be rejected.

      TaxMandatory *reporting* should be evaluated in comparison with a tax mandatory *collection* option (discussed below). It is not clear that reporting imposes any less of a burden on vendors than actual collection of tax; however, taxmandatory reporting would impose a much greater burden on customers and on state and local governments.

   b. **Tax Collection Option 2. Mandatory collection.** Federal legislation could be enacted permitting states to require out-of-state vendors to collect use tax with respect to local sales where the vendor has more than a threshold amount of sales within the state. This is analogous to the "distance selling" rules under the European VAT. TaxMandatory collection could be restricted to E-commerce, or could apply more broadly to mail/telephone order sales. Restrictingg mandatory collection to E-commerce, however, would violate the principles of neutrality and should be rejected. *The CSPP notes that the recently announced negotiations between representatives of the U.S. Congress, U.S industry, and the National Governors Association may be an appropriate vehicle to effect reform. The CSPP strongly favors the mandatory collection option over the mandatory reporting option.*

c. **Sales tax reforms.** In conjunction with either option 1 or 2, states should make certain reforms, including:
   1. Support enactment of moratorium legislation;
   2. Require major simplification of the existing local option sales and use tax regimes, such as the single state tax rate proposal recently made by the National Governors' Association;
   3. Exempt all purchases by business customers to avoid tax cascading and to reduce the number of taxable transactions (business customers would continue to be subject to use tax where purchases are for personal use, rather than business purposes);
   4. Require nationally uniform rules for tax classification (but not necessarily uniform rates);
   5. Additional protections, as appropriate, for vendors who act in good faith; and
   6. In the case of the mandatory collection optionó
      a. Agree that collection responsibility for use tax creates no inference regarding nexus for any purpose, including sales/use tax or income tax;
      b. Agree that a website or a server alone is *not* sufficient to create tax nexus;
      c. Provide reasonable allowances to cover vendor collection costs;
      d. Adopt rules for protecting vendors from multiple taxation;
      e. Adopt nationally uniform registration, return, remittance, and exemption procedures; and
      f. Allow a single national sales tax registration and payment system through a national clearinghouse maintained by the states. (This would shift a portion of the burden of mandatory collection onto the states, creating a strong incentive for harmonization and simplification of state sales taxes.)

B. On-line Delivery

1. **Status quo.** Under present law, there is considerable uncertainty about application of the retail sales tax to on-line delivery:
   a. The vendor may not be able to determine the purchaserís address;
   b. b) The sales tax characterization of on-line transactions may be unclear (e.g., supply of service, sale of good, rental of good, sale of copyrighted article, license of copyrighted article, etc.); and
   c. On-line delivery of consumer software currently is exempt from sales and use tax in some but not all states; and,
   d. Uniform tax treatment of services does not currently exist.

As a result, state and local governments have found it difficult to collect sales and use tax with respect to on-line transactions. However, these transactions do not necessarily result in a revenue loss to the states, for three reasons:

1. The scope of most sales and use taxes generally is limited to *tangible* property;
2. E-commerce cannot cause a loss in sales and use tax unless it displaces transactions that would have resulted in tax. No such displacement occurs where the alternative form of business is mail order, or where the transaction would not have occurred at all but for E-commerce; and
3. To the extent that E-commerce stimulates new business activity, states collect additional income, payroll, and property taxes.

While the revenue erosion fears of state tax administrators probably are overstated, options

for allowing effective collection of tax merit consideration. However, care should be taken to avoid adopting taxing mechanisms that interfere with the evolution of technology and business models.

2. **Options for reform**
   a. **Tax Reporting Option 1. Mandatory reporting**. To facilitate collection of use tax, federal legislation could be enacted to require vendors to report customer information to states in which the vendor does not have tax nexus. Reporting could be required for E-commerce only or for mail order sales as well. Limiting taxmandatory reporting to E-commerce would violate the principle of neutrality and should be rejected.

      TaxMandatory reporting should be evaluated in comparison with a taxmandatory collection option (discussed below). It is not clear that reporting imposes any less of a burden on vendors than actual collection of tax; however, taxmandatory reporting would impose a much greater burden on customers and on states and local governments.
   b. **Tax Collection Option 2. Mandatory collection**. Federal legislation could be enacted permitting states to require out-of-state vendors to collect use tax with respect to local sales where the vendor has more than a threshold amount of sales within the state. TaxMandatory collection could be restricted to E-commerce, or could apply more broadly to mail/telephone order sales. Restricting mandatory collection to E-commerce, however, would violate the principles of neutrality and should be rejected. *The CSPP notes that the recently announced negotiations between representatives of the U.S. Congress, U.S. industry, and the National Governors Association may be an appropriate vehicle to effect reform. The CSPP strongly favors the mandatory collection option over the mandatory reporting option. The CSPP favors parallel reform of the taxation of on-line and off-line commerce but recognizes that simultaneous implementation will be dependent on timely resolution of the technical issues involved with on-line commerce (see section II.B.1., Status quo).*
   c. **Sales tax reform.** For on-line commerce, imposition of either optiona mandatory collection or reporting system

      would require the vendor to determine: (1) the relevant tax jurisdiction of the purchaser; and (2) the appropriate tax classification of the good or

      service supplied. As there are thousands of taxing jurisdictions, uniform rules for determining jurisdiction and classification would be essential to achieving an administrable tax system.

      CSPP endorses that sales taxes not be applied to on-line services. Congress could limit themandatory collection or reporting responsibilities to sales taxes imposed by states that enter into a *multi-state compact* or otherwise adopt uniform rulesand dispute resolution mechanisms, including rules for: (1) determining the tax classification of on-line sales; and (2) imposing tax on customers who refuse to provide requisite tax information.

   d. **Role of technology**. The market rather than tax rules should guide the development of on-line commerce technology and business models. For example, if E-commerce moves toward a cable model (e.g., due to bandwidth considerations), sales tax collection could be relatively simple. As another example, technology might be developed to allow credit card companies to transmit electronically to vendors the

customer's zip code (for credit card billing) along with credit approval information.

III. FOREIGN INDIRECT TAXES

A. Off-line Delivery

1. **Status quo.** VAT-registered vendors are liable for tax on the sale of *goods* when (1) the goods are delivered; (2) the invoice is rendered; or (3) payment is received, whichever comes first. Exports of goods generally are taxed at a zero rate. Tax on the importation of goods is imposed on the importer, generally at the same time and manner as customs duties.

   Due to the elimination of internal border controls, special rules apply to sales of goods between European Union ("EU") countries. Where the importer is registered for tax, the VAT on import of goods is self assessed by the importer (under the so-called "reverse charge" method). Where the purchaser is not registered for tax, the vendor is required to register for VAT in the territory of the customer if the monetary value of sales exceeds a specified annual threshold (typically ECU 35,000 to 100,000). These "distance selling" rules essentially impose economic nexus on EU vendors.

   The status quo generally appears consistent with the CSPP's objectives.

B. On-Line Delivery

1. **Status quo**. Separate rules apply to goods and services under VAT. On-line E-commerce transactions generally fall within the services classification. Services are taxable in the territory where the place of supply is deemed to occur. Services supplied outside of the EU generally are taxed at a zero rate. Within the EU, if services are supplied outside the country where the vendor is established, zero rating applies only if the customer provides a valid VAT registration number. Where the customer does not provide a valid VAT registration number, depending on the type of service involved, the vendor will be obligated to register and pay VAT in the territory where the service is performed or where the vendor is established. In general, a requirement to register for VAT creates no inference regarding whether a permanent establishment exists for income tax purposes. *The CSPP believes that this is appropriate as a matter of tax policy.*

   Where a nonEU vendor supplies services in the EU to a VAT-registered customer, the customer self-assesses VAT under the reverse-charge method. Unregistered customers are not taxable as there is no "use" tax concept under the EU VAT. Depending on the type of service involved, the vendor may be obligated to register and pay VAT in the territory where the service is performed; in other cases, the vendor may be liable for VAT (if any) in the territory where the vendor is established.

   In the case of telecommunications, nonEU suppliers to unregistered EU customers are now obligated to register and pay VAT in the countries where their customers are located. It will be difficult, however, to enforce these rules.

   In the case of VAT-registered customers, the EU VAT system appears to be consistent with the CSPP's indirect tax objectives. In the case of unregistered customers, however, the EU VAT system may not be fully consistent with the principles of free trade. The issue arises where the place of supply is deemed to be where the customer belongs or the consumption occurs, as is the case with telecommunications services within the EU.

   For example, a US telecommunications operator, who is not established within the EU, will be obligated to register for VAT in the countries where its unregistered customers are located. By contrast, an EU vendor is not required to register for VAT in the EU countries where its customers are located, but instead pays VAT in its country of residence. Thus a US

operator, who is not established within the EU, could be required to register in each of the 15 EU countries if it has customers in all of these jurisdictions. Unlike the distance selling rules applicable to off-line delivery, there is no monetary threshold for telecommunications services.

US vendors can avoid 15 EU VAT registrations by creating a permanent establishment (PE) in one of the EU-member countries; however, this exposes the US vendor to income tax liability and forces the vendor to bear the costs of potentially redundant operations.

2. **Options for reform**
    a. **Single EU VAT registration**. To eliminate the need for 15 EU VAT registrations, the EU could provide a mechanism whereby nonEU vendors register for VAT within a single EU jurisdiction without creating a permanent establishment. Alternatively, an EU-wide registration mechanism could be created, and tax payments could be made to an EU authority that would be responsible for allocating revenues among the member countries. This would eliminate the need for multiple registrations and would put nonEU vendors on a par with EU-based vendors (consistent with the principle of national treatment)
    b. **De minimis rule**. Under the EU VAT, a de minimis rule applies with respect to the taxation of mail order sales of *goods*. By contrast, in the case of services, there is no monetary threshold. To achieve neutrality, a de minimis rule could be adopted for services.
    c. **Place of supply rules**. Under the EU VAT, the place of supply of services is, by default, the place where the supplier is established. For certain specified services, however, the place of supply is determined by reference to (1) where the customer is established; or (2) where the service is performed. EU member countries are legitimately concerned about unfair competition and loss of revenue attributable to services supplied to unregistered EU customers by off-shore vendors. This can occur for services that are deemed to be supplied where the supplier is located, if the supplier is located outside of the EU. In the case of telecommunications services, the EU approved a derogation, effective July 1, 1997, that permits EU member countries to treat telecommunications services as being supplied where the customer is established or the services are used.

        The CSPP does not, in principle, oppose use of a destination basis, rather than an origin basis, for determining the place of supply of services. Within the EU, however, the CSPP recommends the adoption of a single-country registration system and a de minimis rule (as described above). The CSPP views use of a destination system for services as transitional within the EU; when the EU ultimately adopts an origin system, both goods and services should be taxed under the same rules (see discussion of the origin system below).
    d. **Uniform classification.** Most VAT systems around the world, including the EU VAT, have not kept pace with technological developments. As a result, it is frequently difficult for taxpayers to determine the applicable rate of tax on E-commerce transactions; the application of tax to bundled transactions (e.g., Internet access combined with content); and the jurisdiction to which tax is due (i.e., place of supply). Moreover, difference in interpretation among VAT countries raise the possibility of double taxation.

        The CSPP recommends that the OECD work with the EU to develop guidelines for a more uniform system of VAT classification for on-line E-commerce that takes into account, among other things, bundling of transactions.

C. Proposed Origin-based system in EU

The EU has delayed the effective date for a "definitive" origin-based VAT system until January 1, 2002, and it is commonly believed that this date will slip further. Under the origin-based system, vendors generally would be taxable on sales of goods within the EU, at local VAT rates, regardless of the destination of the goods. An EU clearinghouse mechanism would be established to redistribute revenues (from exporting to importing countries) to achieve roughly the same distribution of revenue as the current destination-based system. Services also would be taxable on an origin basis, consistent with the taxation of goods. To avoid excessive tax competition among EU member states, EU member countries would need to harmonize VAT rates. *The CSPP believes that an origin-based system, along the lines proposed by the European Commission, would achieve substantial simplification of the EU VAT.*

IV. INTERNATIONAL TRADE

A. Off-line delivery.

1. **Status quo**. Under present law, international trade in tangible property generally is taxed on a destination basis, consistent with free trade principles.

   The status quo generally is consistent with the CSPPís indirect tax policy objectives.

B. On-line delivery.

1. **Status quo**. Under present law, transactions involving a U.S. vendor and a foreign customer in theory could be subject to both state sales tax and foreign VAT.
2. **Options for reform**
   a. **Model tax treaty**. To avoid double taxation, consideration should be given to adding a clause to the US and OECD model tax treaties relating to double indirect taxation.
   b. **Sales tax/VAT conformity**. If the OECD and EU are able to develop uniform classification and place of supply rules for purposes of VAT, the states should incorporate these rules within their sales and use tax systems for purposes of international trade.