

# INTERNATIONAL TAX CONSEQUENCES OF ELECTRONIC COMMERCE

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## **Abstract**

{1}The ascendancy of the Global Information Infrastructure is causing unprecedented social, economic, and technological change. Boundaries between geographically distant countries are rendered virtually irrelevant due to the rise of rapid communication systems. Economics is at the heart of this communications revolution and drives individuals and corporations to develop relationships in foreign countries. These relationships result in international business transactions which form the basis of electronic commerce. Generally, electronic commerce is any economic transaction which employs a digital intermediary such as the Internet or electronic data interchange as its primary vehicle. Thus, a music recording no longer needs to be sold on a CD but can be sold online and downloaded to a hard drive.

{2}Many questions and issues arise when attempting to classify online transactions as a sale, service, license, or lease. The classification of a transaction is significant because it determines the source of the income. The source then determines the jurisdiction which receives the tax revenue. In response to these issues, the Internal Revenue Service authored Proposed Treasury Regulations § 1.861-18 to provide a method for classifying the transfer of computer programs. Each transaction is evaluated according to the transfer of its underlying rights. The Proposed

Regulations are limited, as they omit many forms of existing electronic commerce. However, they can act as a paradigm for classifying the transfer of all forms of copyrighted and digitized information. Nevertheless, certain forms of digitized information may have characteristics of multiple classification regimes. The result of this scenario is that multiple taxing jurisdictions may claim taxing authority and the taxpayer may be faced with double taxation or protracted litigation to correct the situation. This paper will investigate and offer recommendations to resolve the problem of taxation conflicts in the arena of global electronic commerce.

## **I. Introduction**

{3}The emergence and rapid rise of electronic commerce blurs the distinctions between income classifications. Transactions previously regarded as identifiable among the international tax community are now being debated, discussed, and evaluated in every country with links to the global digital economy. International tax practitioners are often confused as to what advice to offer their clients given the uncertainty of the ultimate taxing jurisdiction. Due to the novelty, fear, and lack of comprehension of the underlying technologies among many worldwide taxing authorities, classification conflicts will surely lead to multiple jurisdictions claiming taxing authority, thereby exacerbating the dilemma of double taxation.

{4}In an attempt to rectify and prevent tax conflicts, IRS Proposed Regulations ß1.861-18 ("Proposed Regulations") classify the transfer of computer programs as

either a sale, service, license, lease, or provision of know-how. Although the Proposed Regulations are limited in scope, they can act as a framework for the classification of many forms of electronic commerce. For example, the transfer of an online newspaper to a foreign customer or the retrieval of a digital photograph from an online database has characteristics of a sale or lease, the performance of a service, and the generation of royalties. In fact, Treasury recognizes that the Proposed Regulations affect only a slice of a much larger pie, that of the transfer of all digitized information. <sup>[11]</sup> Currently, computer software comprises a significant amount of the multi-billion dollar digital information industry. This proportion is expected to shrink dramatically as new conduits for communications, such as satellite, wireless, cable, and fiber optic technologies, blanket the globe and create the ability for people in any and every location to link to the Global Information Infrastructure ("GII"), otherwise known as the Information Superhighway. <sup>[12]</sup>

{5} Because electronic commerce will encounter enormous growth and unforeseen advances, a taxation model that classifies income according to a transaction's underlying economic value should be adopted. This model should amend the Proposed Regulations and incorporate the unique features of various electronic transactions. First, it must apply to both copyrighted and non-copyrighted digitized information including content and services. Second, transactions should be analogized to their functional equivalents. Third, transactions should be subject to an economic value test in order to determine where the value of the transaction lies and which party

holds its value. <sup>[3]</sup> Taken together, these amendments shall allow for both proper income classification and sourcing.

## **II. Explanation of Proposed Regulations §1.861-18**

{6} Prior to explaining how the Proposed Regulations are a paradigm for other forms of digitized information, it is crucial to understand their genesis and purpose. The software industry is growing at an enormous rate. Companies such as Microsoft and Netscape are no longer regional companies but global players. Their software is sold and distributed throughout the world. In time, the software, which was traditionally installed by loading copies of a program stored on a disk onto a hard drive, will be downloaded and installed by remote transmission through various forms of electronic transfer.

{7} The Internal Revenue Service authored Proposed Regulations §1.861-18 in order to classify transfers of computer programs. Proper classification will permit countries with links to the GII to facilitate tax policy, avoid double taxation conflicts, and ensure that taxes are not an impediment to economic growth. Under the Proposed Regulations, a transaction is evaluated in relation to the transfer, or lack thereof, of the underlying copyright. The copyright of a computer program, as with a music composition or a book, is its primary protection. In turn, the rights associated with the ownership and use of the computer program form its principal source of value. <sup>[4]</sup> Therefore, the value to the owner of the copyright to a computer program is

held in the title to the copyright; the value to the buyer of a copy of the program is the right to use or sell that copy. <sup>[5]</sup> The IRS recognizes two principal rights associated with the transfer which determine the income classification. The first is the right to copy the program and then sell, license, lease, or lend it; the second is the right to modify the program based upon the original copyrighted computer code. <sup>[6]</sup> In sum, the classification of the transaction depends upon the amount and types of rights transferred from the owner to the purchaser. Where a transaction has more than one dominant characteristic, it may be separated into multiple transactions and classified accordingly. <sup>[7]</sup>

#### ***A. Characterization as a Copyright Right or Copyrighted Article***

{8} Once the transfer of rights has been determined, the transaction is either classified as a transfer of a copyright right or a copyrighted article. This key distinction relates to the rights allocated to the purchaser. If the entire set of substantial rights has been transferred, a sale of a copyright right has transpired. <sup>[8]</sup> For example, if a U.S. software manufacturer produced a graphics program and sold the right to reproduce, market, and sell the program as well as modify and create derivative programs based on the initial code, this would be classified as the sale of a copyright right. Alternatively, a license would be generated if the original creator retained any of the substantial rights and thus royalty income would arise. <sup>[9]</sup> For instance, if the same U.S. corporation instead granted a foreign corporation the non-

exclusive right to both reproduce and distribute the graphics program for six months (less than the actual remaining life of the program), a license would result and all payments would be royalties. <sup>[10]</sup>

{9} The transfer of a copyrighted article, on the other hand, occurs when the transferee does not receive any of the rights associated with the computer program's copyright. The purchaser is prohibited from modifying and/or distributing the program. This transaction typically, but not necessarily, occurs when a consumer purchases a mass-marketed computer program either in a retail store or online. <sup>[11]</sup> It is functionally equivalent to purchasing the graphics program in the example above, accompanied by either a site license (a license to use at one location) or a shrink wrap license (a transfer in perpetuity for use in return for a one time payment). Copyrighted article income will either be classified as a sale or a lease generating rental income depending upon the allocation of the burdens and benefits. <sup>[12]</sup>

{10} The provision of services and the provision of know-how are additional forms of income classification as defined in the Proposed Regulations. The classification of services with respect to a computer program is determined by the facts and circumstances in the agreement, generally for the development or modification of a program. <sup>[13]</sup> The provision of know-how refers to the computer programming expertise that cannot be copyrighted and is subject to trade secret protection. <sup>[14]</sup>

### ***B. A Formulary Approach to Classification***

{ 11 } The IRS employs a formula to determine the income classification of a transaction. The formula disregards the vehicle of exchange and instead focuses on the substance of the transfer. First, electronic transactions involving computer programs are analogized and treated functionally equivalent to their traditional counterparts. <sup>[15]</sup> Second, if no functional counterpart exists, the Proposed Regulations consider the unique nature and special features of computer programs in determining the income classification. <sup>[16]</sup> The reasoning behind this formula is that technological advancements are only incremental improvements of existing technologies. The transaction is almost certain to have a traditional counterpart and therefore, reliance upon the traditional functional counterpart eliminates the need to develop alternative tax rules. <sup>[17]</sup> For example, e-mail solicitations are a substitute for bulk postage mailers. The message of the IRS is that the Internet, chat lines, multi-player games, online databases and most other forms of digitized information are all either extensions of or substitutes for current technologies.

### ***C. The Economic Value Test***

{ 12 } The Proposed Regulations classify the transfer of computer programs based on an analysis of the underlying rights. <sup>[18]</sup> Since the primary source of value for a computer program is its copyright, this approach not only applies to computer programs but also to all forms of copyrighted and digitized information. It is feasible

and logical to substitute the term of any copyrighted property, such as "music recording" or "digital book," for "computer program" in the Proposed Regulations. However, as classification delineations become increasingly blurred, other forms of digitized information do not as easily fall into the specific formula of the Proposed Regulations. For instance, the classification of an online almanac as a service or a sale would likely generate tax revenue for different jurisdictions. The multiple tax treatment for sales, services, licenses, and leases, coupled with the ease of remote computing and reduced maintenance and managerial demands, could lead proprietors of electronic commerce to relocate to offshore tax havens. <sup>[19]</sup>

{ 13 } In response, all forms of income from digitized information should be classified under an economic value test. This test is consistent with the Supreme Court's decision in *Frank Lyon Co. v. United States*. <sup>[20]</sup> The Court opined that the tax consequences of a transaction should be determined by its "substance and economic realities." <sup>[21]</sup> Furthermore, Treasury's analysis of a computer program's underlying rights is essentially an economic value test. The test determines who holds the primary source of value, that of the copyright. This framework is applicable to all future Treasury regulations regarding digitized information. First, all transactions involving copyrighted digitized information should be subject to the identical test of the Proposed Regulations. Second, transactions comprised of non-copyrighted digitized material should be analogized to their functional equivalents. If none exist, the

transactions should be subject to a broad economic value test in relation to the facts and circumstances.

{ 14 }The economic value test will answer key questions such as:

- Where is each party located?
- What type of property is transferred?
- Who manages and markets the property?
- Where are the online "negotiations" held?
- What type of payment is made?
- How is the risk allocated?
- Do limits on alienation and future interest exist?
- Who holds any future burdens and benefits?

### **III. The Nature of Electronic Commerce**

{ 15 }Electronic commerce is simply engaging in business online. It includes any type of computerized buying and selling, both by individuals and from company to company. <sup>[22]</sup> It employs online services, the Internet, and electronic data interchange ("EDI"), in which one company's computer queries and transmits purchase orders to another company's computer without human intervention. Internet transactions, only a slice of the electronic commerce pie, accounted for 1% of GDP in 1996 and is expected to grow by billions by the year 2000. <sup>[23]</sup>

{16}Electronic commerce spans all sectors of a production and distribution chain. Products are now developed, marketed, sold, and used digitally. This means that the product has no tangible form. Everything on a computer is read in digital, binary code such that the relationships between 1's and 0's form the property. For example, a word processing application and a music recording are essentially the same product. Each is comprised of different variations and distributions of 1's and 0's, thereby furnishing the product with its unique attributes. The Proposed Regulations reject the distinction between tangible and intangible goods. Moreover, the method of delivery, whether by diskette, CD-ROM, or electronic transmission, does not affect its income classification.

{17}Digitized information assumes a variety of forms and roles. Under current tax regulations, these various forms, functions, and roles create distinct income classifications and thus create tax sourcing conflicts. Digitized information appears in the form of music, publications, motion pictures, games, informational databases, photographs, and services. In time, the primary conduit for digital information is electronic transmission through the GII. The GII is essentially a worldwide network of computers who share the ability to communicate. The Internet's star child, the World Wide Web ("Web"), is the GII's most publicized and commercially popular mode of communication. It is easy of use, has a graphical interface, often includes e-mail capabilities, and can be navigated internationally.

{18}The Web is hardly the exclusive vehicle of the GII. Security concerns have forced companies to build intranets with online protectors known as firewalls to prevent hacking and entrance by intruders. These intranets often span countries and are used for electronic commerce. Recently, the trend in the corporate world has been towards building extranets. These "intranets with a door" grant security clearance to privileged and qualified outsiders. Conceptually, a corporate intranet can be analogized to a castle with a moat. An extranet would be the same castle with a drawbridge used to permit and prohibit entrance and exit to visitors. America Online ("AOL") could be viewed as an intranet whose subscribers have access to the universal Internet but whose non-subscribers cannot use the proprietary services nor access the content exclusive to AOL. Given the similarities between the transfer of computer programs and the transfer of other forms of digitized information, the Proposed Regulations can act as a paradigm for future tax policy involving the classification of digitized information.

#### **IV. Critique of Income Sourcing Rules**

{19}Traditional income sourcing concepts and rules in relation to the transfer of digitized information will cause confusion among taxing jurisdictions and taxable enterprises. Generally, a foreign corporation or individual will only be taxed in a country in which it has a sufficient nexus. The nexus threshold varies from country to country.

### *A. Traditional Approach to Source-Based Taxation*

{20} Individuals and foreign corporations are taxed according to their residence and the income's source. The residence of an individual is based upon citizenship and the physical location of the individual's activities. The United States taxes citizens on their worldwide income and defines residents by a "bright-line" test. <sup>[24]</sup> If an individual is physically located in the United States for 31 days during the current year and at least 183 days during the past three years, the individual may qualify as a resident under the "substantial presence test." <sup>[25]</sup> Previously, a foreigner may have visited the United States to perform consulting services that would have qualified her to be a resident. Current technological advances would likely erode this base, as services can be performed online from her home country with the same result. Corporations face a much simpler residency test. If a corporation is incorporated in the United States, it is taxed on its worldwide income. <sup>[26]</sup>

{21} Non-residents and foreign corporations engaging in electronic commerce pose large problems for global tax authorities. Non-residents and foreign corporations are generally only taxed on the net amount of active U.S. source income that is effectively connected to a U.S. trade or business. <sup>[27]</sup> Passive income not effectively connected to a U.S. trade or business, such as dividends, royalties, interest, and rents, are subject to a 30% gross tax. <sup>[28]</sup>

{22} A low threshold exists for levying taxes on non-residents and foreign corporations that engage in a U.S. trade or business. <sup>[29]</sup> Taxation only results from the

income that is effectively connected to the activities of the U.S. trade or business.<sup>[30]</sup> The residual is foreign source income not taxable in the United States. The sale of inventory,<sup>[31]</sup> the solicitation of orders,<sup>[32]</sup> or the use of an agent<sup>[33]</sup> can result in U.S. taxation. However, the level of these activities all demand some form of physical presence. The Internet allows for non-resident individuals and foreign corporations to conduct the same level of activity without having a physical presence in the United States. An obvious problem exists when a foreign enterprise selling digitized music contracts with a U.S. Internet service provider ("ISP") to house its Web site. Here, the electronic transfer of the music is completed by a customer downloading the program. Regardless of income classification, sourcing issues arise. If the U.S. ISP is characterized as an independent rather than dependent agent, it is unlikely that the foreign entity will be taxed. However, it may be concluded that storage of the digital information on a U.S. server is storage of "inventory" in the United States. This may, according to traditional sourcing concepts, impute U.S. taxing jurisdiction on the effectively connected income. The dilemma does not end here. The foreign entity can easily transfer its "inventory" to a foreign mirror site in a matter of seconds, thereby no longer engaging in a U.S. trade or business. Moreover, the "inventory" cannot be confiscated or feasibly subject to import tariffs due to its intangible nature. As a result, legal, administrative, and regulatory problems arise.

## ***B. The Impact of Tax Treaties***

{23} Tax treaties often relieve the problem of jurisdictional conflicts and double taxation. The United States is currently a partner to 48 tax treaties. The functional result of a treaty is to grant taxing authority to residence countries while limiting or eliminating source-based taxation. <sup>[34]</sup> Nevertheless, the source country maintains taxing jurisdiction under a treaty when the foreign person or corporation earns business profits attributable to a permanent establishment.

{24} The threshold for levying taxes on non-residents and foreign corporations is increased under the permanent establishment standard. Simply engaging in a U.S. trade or business is not a sufficient nexus to create a U.S. tax liability. Both the OECD Model Tax Treaty and the U.S. Model Tax Treaty provide that a foreign enterprise from one contracting state is exempt from source-based taxation unless the business profits are attributable to a permanent establishment located in the other contracting state. <sup>[35]</sup> A permanent establishment, such as an office, workshop, quarry, or factory, is a fixed place of business, through which the business of an enterprise is wholly or partially carried on. <sup>[36]</sup> A Web site appears to avoid many of the traditional standards in ascertaining whether or not a permanent establishment exists.

{25} The treaty framework for establishing source-based taxation erects a large hurdle for justifying the taxation of a foreign enterprise. Given the nature of electronic commerce, countries will either have to redefine their permanent establishment thresholds for levying taxes or shift towards a more realistic, residence-based taxing

regime. Tax authorities will find it difficult, if not impossible, to administer and police the flow of global electronic commerce.

1. *Ambiguous Sources Necessitate the dependence upon Residence-Based Taxation*

{26}Nexus arguments simply cannot withstand the mobility and flexibility of electronic commerce. Due to its nature, the location of a Web site is unlikely to create effectively connected income or become a fixed place of business.<sup>[37]</sup> First, it is economically inefficient to expand the definition of a fixed place of business, effectively lowering the nexus threshold. Once a rule is established in one jurisdiction that impedes commerce with excess taxation, the site will be shifted to another location with little or no transaction costs, thereby avoiding the tax burden. Second, vendors in the digital world often do not know where their Web site is housed. The location of the Web site is inconsequential while issues such as security, price, and space limitations are the determinants in choosing an ISP. Providers of goods or services contract with ISPs who place the Web sites on servers located anywhere in the world. In fact, Web sites are often located on multiple or mirror servers to ensure safety and to protect against unexpected interoperability. This could create the disastrous scenario of an enterprise generating effectively connected income in two, three, or four countries.<sup>[38]</sup> Third, due to the force of disintermediation, tax compliance will become more complicated.<sup>[39]</sup> Financial institutions currently act as

financial intermediaries and record monetary transfers between parties. Electronic commerce eliminates the need for these intermediaries. Payments travel directly from one enterprise to another, often anonymously and without a trail. <sup>[40]</sup> Finally, and most importantly, the placement of a Web site has little or nothing to do with the income earned in the country where the server is located. Traditional source arguments rely upon the reasoning that the country where the economic activity occurs provides the economic climate for the generation of income. Thus, taxes should flow into the source country for the development and preservation of this climate. However, the economic value that underlies most transactions is modified in the digital community. So long as data can be transferred (with globalization and the success of cable, fiber optics, and satellite communications, ubiquitous connectivity is only a matter of time), the ability to shift and hide "nexuses" makes it inefficient and dated to tax along this standard. <sup>[41]</sup>

{27} Taken together, these factors form a vital portion of the argument which advocates residence-based taxation. Technology organizations and Treasury foresee a shift towards residence-based taxation. <sup>[42]</sup> Due to new forms of communication and the explosion of electronic commerce, residence-based taxation is likely to gain importance and rationale. Treasury, in its white paper titled *Selected Tax Policy Implications of Global Electronic Commerce*, states, "[i]n the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source-based taxation

could lose its rationale and be rendered obsolete by electronic commerce." <sup>[43]</sup> Treasury explains that all people reside "somewhere." <sup>[44]</sup> If there is to be a shift towards residence-based taxation, Treasury acknowledges that traditional definitions of residency may need to be reviewed.

## **V. Evaluation of Income Classification Regimes**

{28} The nature of electronic commerce does not lend itself favorably to developing clear and concise income classifications for the transfer of goods and services. The rise of intangible products confounds the traditional classification regime. Due to the newness of electronic commerce and the Internet, Treasury does not commit to one type of classification standard for emerging forms of digitized information. In fact, Treasury rejected imposing new taxes on electronic commerce. Nonetheless, it is important to understand the current forces shaping electronic commerce for future classification and sourcing rules. This issue is best exposed through the following continuous scenario:

{29} The online newspaper, along with its archival database, is the ideal example to illustrate how sales, service, and royalty classifications are muddled by electronic commerce. The online publication has many features which are not covered by the definition of "computer program" in the Proposed Regulations. In time, the Proposed Regulations should act as the framework for classifying these other forms of copyrighted content and digitized information. <sup>[45]</sup> Let us assume that the consumer

resides in foreign Country X and purchases the fictional online newspaper, The Online Times, published by a U.S. corporation. In order to subscribe, a consumer must fill out a form online. The form requires the consumer to input general information such as her name, address, and billing preferences. Often, the form will not be processed without completely filling it out. <sup>[46]</sup> The consumer must then agree to a subscriber agreement. This is a boilerplate subscriber agreement which claims that the information is copyrighted and the consumer has limited rights to usage, copying, reproduction, and distribution. <sup>[47]</sup>

{30} Once the consumer has paid the fee by inputting the credit card number, the new subscriber is permitted access to the online newspaper. The content is retrieved through the company's World Wide Web site. This enables the newspaper to resemble a print paper with graphics, interactive crosswords, and even added features such as streamed sound and video. In order to read the paper, the subscriber must enter her login name and password. Additionally, the subscriber often has access to archived articles that can be accessed through a keyword, date, and topic query.

{31} This scenario raises two questions:

- How should the income be classified?
- Given its classification, where should the income be sourced?

### *A. Classification as a Sale*

{32} If the income is classified as sales income, then this transaction, traditionally, is analogous to a person receiving the daily U.S. print edition in a foreign country. If the foreign consumer subscribes to a U.S. newspaper and picks it up each day at either the door or the local newsstand in Country X, the income will be characterized as the purchase and sale of inventory property if Country X employs a similar taxing regime to that of the United States'.<sup>[48]</sup> Taxing jurisdiction stems from the rationale that the income is sourced where the sale takes place, otherwise known as the "passage-of-title" test.<sup>[49]</sup> The Online Times would be responsible for foreign taxes and, in turn, would receive a tax credit for foreign taxes paid. On the other hand, if the inventory was manufactured in the U.S., taxation would be apportioned between the U.S. and Country X depending on an independent factory or production price from sales to independent distributors, if such a price exists.<sup>[50]</sup> Although the term "manufacturing" does not neatly apply to digitized information, the work product of writing the articles and organizing the online paper may qualify.

{33} The classification strategy distilled from the Proposed Regulations would treat the transfer as functionally equivalent to the purchase of a print newspaper. Printing the online newspaper confers the same rights as the traditional printed one. The economic value of the paper lies in the same country (Country X) whether it was bought or delivered electronically. Thus, the regime of the Proposed Regulations would treat this transaction as a transfer of a copyrighted article, and the taxing

jurisdiction would lie where the title passed. None of the substantial rights have been transferred and the subscriber in Country X would hold the "benefits and burdens" of the newspaper. <sup>[51]</sup> The source of this transaction would be where the customer is located. The Treasury white paper appears to support this view. It states, "Depending on the facts and circumstances, some of these transactions may be viewed as the equivalent of the purchase of a physical copy...which would probably not subject the seller to U.S. taxation..." <sup>[52]</sup>

## **1. Criticism of a Sales Classification**

{34} Various criticisms lie in treating this transaction as a sale sourced in Country X. First, the transfer is procedurally different. The subscriber actively fetches the paper from the publisher's Web site. Would a functional difference be created if the newspaper was delivered each morning as an e-mail to the electronic mailbox located on a server in Country X? It should not, but it does create a stronger analogy to the traditional delivery process. Second, the subscriber may have to obtain the newspaper from a site housed anywhere in the world, thereby weakening, if not completely dissolving, the connection between the income producing activity and Country X. The Online Times would lack a physical presence and nexus in Country X. This brings into question where the passage-of-title has actually taken place, possibly undermining the taxing authority of Country X.

{35} If the passage-of-title is not deemed to have occurred in Country X, a significant amount of tax revenue will be lost. Sales of other forms of digitized information such as music or videos, would no longer be taxed in Country X. Under traditional channels of distribution of tangible goods, Country X receives tax revenue from sales of such products. Countries which consume U.S. developed and created goods will unlikely give up that tax base simply due to a different conduit of transfer. If the end product is the same, and the customer is located in Country X, it is inconceivable that Country X would give up that tax base.

### ***B. Classification as a service***

{36} Initially, it appears that this transaction would generate sales income. However, features of The Online Times indicate that the activity could generate service income. By reclassifying this transaction as a service, taxes could be sourced either in Country X or the United States, depending on where the performance is deemed to occur.

#### **1. Current Rules Governing Service Income**

{37} Income from labor and personal services rendered either by an individual or on behalf of a corporation is sourced where the services are physically performed. <sup>[53]</sup> This "place of performance" rule is based on the theory that the location of the performance is the situs of the economic activity giving rise to the

income. This principle is held by both the U.S. and most international tax authorities.<sup>[54]</sup> When a non-resident alien performs services in the United States, he is often considered to be engaged in a U.S. trade or business. The compensation, in turn, is treated as effectively connected income and is taxed in the United States.<sup>[55]</sup> This is a logical extension of the rationale behind the current sourcing rules. The performer provides something of value, i.e. services, which are "consumed" in the United States. This rule functions similarly for U.S. persons performing services abroad. For instance, if a U.S. house painter works in Country X, he would pay taxes on the resulting compensation earned in Country X. Later, he would receive a foreign tax credit on his U.S. taxes since U.S. citizens are taxed on their worldwide income. Consistent with this sourcing rationale, foreign base company service income is exempt from Subpart F constraints for compensation received for services performed in the foreign country where the controlled foreign corporation is incorporated.<sup>[56]</sup>

## **2. The Ascendancy of Service Income in Electronic Commerce**

{38}Service income is expected to grow immensely. While total U.S. employment is expected to grow at a rate of 20% over the next decade, service-sector employment will grow at a rate closer to 30%.<sup>[57]</sup> This is attributed primarily to the growth of the telecommunications and information technology infrastructure. Most service income from electronic commerce will result from consulting and information retrieval transactions. Consulting will span various industries such as engineering,

managerial, design, accounting, architectural, and law. However, the classification of services under the current code sections will cause conflicts and disunity among international taxing jurisdictions.

{39}The supply of information is often classified as the provision of services. Online information databases, the warehouses of data, are no longer used exclusively for newsfeeds. The Online Times may provide daily and even up to the minute newsfeeds, but this activity constitutes only a portion of its features. While many people subscribe to tangible newspapers for the daily news, online publications provide many more features that appear to be functional equivalents to traditional services. Specifically, a proponent for classifying The Online Times as a service would focus on its archival feature and its potential for personalized news.

{40}The Online Times' first service-like feature is its organized database of past articles. The trend online is to offer the subscriber a comprehensive set of features in order to prevent publication shopping. No user wants to go online to get the daily news from one source, biographies of sports figures from another, and historical financial data from a third. The shift to consolidate these features must be swift in order to procure a user and secure his loyalty and subscription. The Online Times would employ a query function to retrieve archived articles housed in high-capacity servers. It would act as a one-stop solution for users to research topics. Even if The Online Times did not own the actual content, a hyperlink to an outside source on the Web would be supplied. Why would a user who primarily employs The Online

Times for its research capabilities subscribe to The Online Times instead of using one of the free online search engines? Quite possibly, The Online Times uses more sophisticated search, retrieval, and filtering technology that saves the user valuable time sifting through much of the irrelevant information currently located online. It may also provide exclusive articles not found on the free online services such as Yahoo! and Excite. If more applicable and focused information is offered to the user, it would be financially prudent to subscribe to The Online Times.

{41} The Online Times' second service-like feature is its ability to personalize the daily news tailored to each subscriber's interests. With tangible newspapers, users must burrow through each section in order to find articles of interest. However, The Online Times can adapt each virtual paper to deliver articles related only to the topics its subscribers specify. All other information is filtered out. If a user is only interested in news relating to his financial portfolio, he could personalize The Online Times to retrieve only those articles each day. In fact, many search engines, online publications, and push technologies already employ this feature.

{42} The first step in classifying this type of income is to functionally equate its service-like features with traditional services. There are obviously many sales-like features but it is important to disregard them in this initial comparison. In the final analysis of the economic value, the transaction must be broken down by each distinct feature. Either the predominant feature will determine its income classification (given a de minimis secondary feature) or the transaction will be separated into distinct

transactions with different classifications and sourcing. The two features explained above suggest that The Online Times may be a service. Treasury, in the section of its white paper titled *Definition of service income*, suggests that the income generated from querying an online encyclopedia "may result in services income..." <sup>[58]</sup> Moreover, tax authorities consider the income from online archival databases with research capabilities as service income. In a discussion with a Treasury official, Lexis-Nexis, Westlaw, and Value Line are each currently classified as services. <sup>[59]</sup>

{43} The personalized features of The Online Times additionally qualify the activity to be classified as a service. If a U.S. corporation hired a research company located in Country X to scour newspapers and cut out only the articles that dealt with basketball, China, and movie reviews, the compensation would be deemed service income and sourced in Country X. Similarly, a search of The Online Times database would retrieve identical, and probably even more articles. This personalized feature is functionally equivalent to a U.S. architect designing a house tailored to the specifications of her foreign client. This activity generates service income. The architect's blueprint is analogous to the basket of articles; each is exactly constructed according to the needs and wishes of the client and user.

{44} Under scrutiny of the economic value test, The Online Times could be classified as a service. The Online Times contracted with various authors, writers, and providers of content. Some of the material may be proprietary to The Online Times

while other material may not. It does not matter in determining the transaction's classification. The economic value of The Online Times is essentially a database of articles and its associated query retrieval feature. The subscriber can gain access to the database in order to retrieve answers to his questions just as a business pays a consulting firm to research a topic. The firm's value is its ability to search through newspapers, periodicals, and books and then return with a portfolio of articles. Here, The Online Times retrieves the articles tailored to the subscribers request and returns with a similar portfolio.

### **3. Criticism of a Service Classification**

{45}Classifying The Online Times or any archival database as a service elicits much criticism. Is this transaction functionally equivalent to the services of the house painter or to the sale of a CD-ROM with a query function? The answer initially seems obvious. The economic value of the CD-ROM is not in its tangible essence, but rather in the information that is stored on it. Similarly, The Online Times' economic value is the information that can be transmitted online. The CD-ROM and the online service provide identical end products. Only the means of transfer differ. If The Online Times also sold a CD-ROM which contained all prior articles and a query function, it would be classified as a sale. Therefore, a crucial aspect of this conflict lies in whether the right to use the CD-ROM in perpetuity for a single payment is sufficient to warrant different income classification. <sup>[60]</sup>

{46}Evaluating this argument under the framework of the Proposed Regulations, the CD-ROM appears to be merely a basket of copyrighted articles. Likewise, the subscriber to The Online Times owns a right to retrieve copyrighted articles. The online service and the CD-ROM are each distributors of copyrighted works. Would it be prudent or consistent to treat these activities differently? Treasury explains that customers may be indifferent to the purchase of a CD-ROM or to the use of an online database given a fast online connection. Treasury suggests that a delineation between classifying the activity as either a sale or a service may be based on the frequency at which each product is updated and whether payment is made on a periodic basis or a one time fee. <sup>[61]</sup> Quite often, CD-ROM software is updated frequently so that a user does not need to subscribe to an online service. <sup>[62]</sup> Therefore, it would be difficult to determine how regularly the online service needs to be updated so to treat the activity as a service rather than a sale. <sup>[63]</sup> The updates would depend on the need for timely material and the costs associated with updates. But issues such as customers' preference for one method over another given identical end products should not be a determining factor in the income classification. Furthermore, additional features suggest that this transaction is more similar to a sale of a copyrighted article than to a service. First, neither the subscriber to The Online Times nor the purchaser of the CD-ROM can modify the product. Second, the customer is permitted to use each product at only one time. The online service limits use to one

subscriber by restricting access to a single login name and the shrink wrap license prohibits the use by multiple users. <sup>[64]</sup>

{47} Although a shift in the classification of online databases from service to sales income is plausible, there will still be a large and growing base of online service income. This growth will stem primarily from consulting services. Whatever the outcome, online services will generate many issues regarding the sourcing of income.

***a. Potential Conflicts over "Place of Performance" Rule***

{48} Conflicts will affect two underlying principles of sourcing service income where the service is performed. First, online services do not require the performer to be physically present in the country where the product of the service lies. A U.S. doctor overseeing an operation in Country X need not be present in the foreign country, yet can navigate a team of surgeons to successfully perform the operation. Prior to the rise of high-speed communications, the doctor would have had to travel to Country X and, in turn, pay taxes in Country X. What is the functional difference between these activities? None, except where the doctor is located. The doctor's function is identical to actually standing in the operating room in Country X. With sophisticated remote control and advances in telemedicine, the doctor will soon be able to actually perform certain procedures of the operation.

{49} Second, online services do not require anyone to actually perform the services. <sup>[65]</sup> If the sourcing rationale of services implies imposing a tax in the country

of performance, can a tax be levied on non-performance? For example, accessing The Online Times located on a server in the United States may generate income from services rendered in the United States. If the database, which only requires minimal servicing and updates, is instead incorporated in a tax haven, income would flow to the haven. What incentive would there be to locate a sophisticated database which performs many traditional maintenance functions itself in the United States? Does the economic value of this service stem from the location of the end product, as with the painted house, or in organizing the information, as with an online database?

#### **4. Solutions to Sourcing Digital Service Income**

{50} Consistent with the model of The Online Times as a distributor of a daily newspaper with personal service features, five potential sourcing solutions exist. In actuality, the sourcing conflict asks the question, "Where did the service take place?" Given the increasing ability to perform services in which they are consumed in a location other than the place of performance, are taxing jurisdictions willing to give up a large tax base due to the flexibility and mobility of electronic commerce?

{51} The first solution would tax the service where the technical "performance" takes place. The "service" would need to be defined as the complex retrieval and distribution features of The Online Times server located in the United States. Although the request for information is typed in Country X, the information is

processed and all "negotiation" occurs in the United States. Thus, the U.S. would have taxing authority.

{52}The second solution would source the product where the services are consumed. This requires a redefinition of "place of performance" to consider whether the actions of the subscriber in accessing The Online Times is an integral part of the performance. Here, the subscriber connects to the database through the Internet, most likely through the Web. Often, the subscriber will install software that permits interaction with The Online Times. Country X may claim that this produces a sufficient nexus to tax. The Online Times could be engaged in a trade or business since access is through a local connection, or the local dial-up connection could impute a dependent agency relationship, particularly if the local ISP is advertising The Online Times to its own subscriber base. Most likely, Country X would claim that an actual performance by the subscriber occurred. The negotiation could be considered cross-bordered and even dependent upon the input by the subscriber in Country X.

{53}The third solution would source the income where the human capital was employed. <sup>[66]</sup> Database researchers located in the U.S. collect data, information, and articles on the topic which the subscriber in Country X performs a search. Consistent with the economic value test, the value of that search does not lie in Country X. The economic value of the database resides in its collection and organization, i.e. the human capital employed to create the archive. Therefore, if the economic value resides in its completed form, the United States would have taxing authority over The

Online Times as the "performance" is where the database is assembled, where management oversees its execution, and where the minimal servicing occurs.

{54}The fourth solution would split the income. This could be achieved in two ways. First, it could be apportioned between both countries. Second, part of the income could be deemed sales income and part could be deemed service income.<sup>[67]</sup> The concept of "place of performance" could either be discarded altogether in exchange for a multiple economic value test or performance could be considered to occur at multiple locations. This reevaluation of sourcing rationale would retain a portion of the tax revenue in Country X. Traditional similarities would be in the treatment of international shipping and communications services.<sup>[68]</sup> Currently, these transactions are taxed half in the United States and the other half in the foreign jurisdiction if either the beginning or the end occurs in the United States. Although such a rigid formula need not apply, the concept of apportionment may satisfy all taxing parties given the changing nature of service income.

{55}Finally, in light of Treasury's analysis, taxing jurisdiction for service income may be usurped by the taxpayer's residence.<sup>[69]</sup> In its white paper under the section titled *Source of Services Income*, Treasury states that "residence-based taxation should necessarily play a larger role."<sup>[70]</sup>

### *C. Classification as a License*

{56} A third method for classifying income generated from The Online Times is to treat it as royalty income. The ease of transferring digitized information could create the appearance that this transaction is a license. Classification as a license, rather than a sale, could shift the tax base.

#### **1. Current Rules Governing Royalty Income**

{57} Traditionally, royalties are payments generated by the licensing of intangible property such as copyrights, trademarks, scientific works, patents, and secret formulae. <sup>[71]</sup> The Proposed Regulations disregard the nature of the product and classify the income according to its substance. The intangibility of the product does not factor into its ultimate classification. Additionally, the Proposed Regulations classify income as a license generating royalty income if the licensor limits the transfer by retaining some of the copyright rights. <sup>[72]</sup>

{58} Royalties are currently sourced where they are used. <sup>[73]</sup> The existence of a tax treaty limits source-based taxation and royalties are taxed where the owner of the property resides. <sup>[74]</sup> If royalties are instead attributable to a permanent establishment or to the performance of services from a fixed base in the country where the royalties are used, income may be deemed to be business profits and taxed in the source country. <sup>[75]</sup>

## 2. The Ambiguity of Royalty Income and Sales Income

{59} The Online Times will generally be characterized as either sales or service income, or a mixture of both. Nevertheless, royalty income could arise if an entity in Country X purchases a subscription to The Online Times and pays a premium for the use of the publication by more than one person. This could occur if the entity is a corporation in which multiple employees need access to the online publication. For example, if one print edition of the paper was purchased and then circulated at a research department for review, one sale would have transpired. On the other hand, if one password was issued and multiple persons used it, the standard usage agreement for online publications would be violated. Access is limited to personal, non-commercial use only. <sup>[76]</sup> If The Online Times sold one subscription accompanied by distribution or lending rights in order for employees to access the publication, royalty income may arise. Is this not a substitute for multiple sales with an fee premium for lending rights? Or is the transaction partially royalty income since the use of a copyright was transferred? If the corporation had limited distribution rights, a literal reading of the Proposed Regulations would likely recognize this transaction, at least in part, as a license generating royalty income.

{60} Without a tax treaty between the United States and Country X, the taxable income from The Online Times would be paid as either sales or royalty income to Country X. <sup>[77]</sup> If Country X was governed by similar tax rules, the royalty income would be subject to a 30% withholding tax on passive income, or be treated as

business profits if the income was related to a trade or business in Country X. <sup>[78]</sup> Since part of the income is from the sale of the subscription, the liberal nexus standard of "trade or business" would likely impute business profits income and avoid the withholding tax.

{61} If the transaction was deemed to be partially a license and if the United States and Country X were partners to a tax treaty, the royalty income from the use of The Online Times' copyright would flow to the resident state of the licensor unless a permanent establishment existed. Here, the lack of a physical presence for engaging in electronic commerce would circumvent the permanent establishment requirement and the tax revenue would flow to the United States. Country X could lose a substantial amount of revenue as this would apply not only to electronic newspapers but also to information databases, music distributors, book publishers, and movie studios. In response, Country X would either reclassify this transaction as a sale according to the economic value test or re-negotiate the treaty and impose greater source-based taxation for royalty income. This would, in effect, maintain its tax base.

### **3. Criticism of a License Classification**

{62} This transaction is functionally equivalent to purchasing multiple subscriptions, thereby generating sales income. The economic value test determines that the intent of the subscriber is to own many newspapers which incidentally are accompanied by distribution and lending rights. Looking through these unsubstantive

rights, the sale of The Online Times is identical to the sale of many physical newspapers. Here, the unique characteristics of digitized information allow for The Online Times to possess features that appear to characterize the income differently than its traditional functional equivalent. The accompanying copyright rights are tangential to the subscriber's intent and are not bargained for. They simply facilitate the distribution process. The significance of classifying the income generated by The Online Times as either sales or royalty income affects the sourcing while shifting the jurisdiction receiving the tax revenue. <sup>[79]</sup>

## **VI. Conclusion**

{63} Electronic commerce will continue to grow and mature until it constitutes a significant portion of the world's GDP. The recent explosion of online commerce and the excitement surrounding the creation of a global economy certifies this postulation. With this expansion and shift in commerce, the tax implications increase in consequence. In order for countries to maintain their tax bases and to avoid double taxation conflicts, the new forms of commerce must be analogized to their functional equivalents in the traditional tax code. Transactions can no longer be distinguished according to their superficial appearance but must be clarified to expose their substance. Consistent with the framework of Proposed Treasury Regulations §1.861-18, the economic value test unveils and discloses the underlying rights of the transaction in accordance with its facts and circumstances. This will permit for proper

income classification and, in turn, proper income sourcing. This analysis is intended to further understanding of potential sources of conflict concerning electronic commerce. Although it does not allege to be the definitive legislative solution, it should assist policy makers in developing laws governing and practitioners in planning strategies for the rise of electronic commerce

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## Footnotes

[<sup>1</sup>] Department of the Treasury Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce, 7.3.3 Proposed regulations on computer program transactions*, 96 TNT 228-10 (1996) [hereinafter Treasury White Paper on Electronic Commerce].

[<sup>2</sup>] The President's Information Infrastructure Task Force, *A Framework for Global Electronic Commerce* (visited February 8, 1997)

<[http://www.iitf.nist.gov/electronic\\_commerce.htm](http://www.iitf.nist.gov/electronic_commerce.htm)>. This is the Clinton administration strategy paper for global electronic commerce.

[<sup>3</sup>] Treasury White Paper on Electronic Commerce, *7.1.5 The ascendancy of residence-based taxation*. The Treasury white paper suggests that a Congressional reversal of sourcing rules for non-inventory property in the Tax Reform Act of 1986 to a residence-based system is partially due to the attribution of income to the location of economic activity. Electronic commerce is often not sourced in any one jurisdiction. Using the same intent, it is important to focus on where the principal economic value

lies. This often will not apply to the actual online transaction but rather to issues such as preparation of the transaction, country of incorporation, location of management facilities, etc.

<sup>[4]</sup> Prop. Treas. Reg. § 1.861-18, Supplementary Information, paragraph 7, 61 Fed. Reg. 58, 152 (Nov. 13, 1996).

<sup>[5]</sup> *Id.*

<sup>[6]</sup> Prop. Treas. Reg. § 1.861-18(c)(2)(i)-(ii). These two rights are a synthesis of three of the primary rights of the Copyright Act of 1976 (17 U.S.C. (103), (106)(1), (106)(2), and (106)(3)). Additionally, two other rights are listed as copyright rights that affect the classification of the income. They are: (iii) the right to make a public performance of the computer program, and (iv) the right to publicly display the computer program. These rights are not as frequently associated with the transfer of computer programs and do not materially impact any of the models described in the Proposed Regulations or this paper.

<sup>[7]</sup> Prop. Treas. Reg. § 1.861-18(b)(2).

<sup>[8]</sup> Prop. Treas. Reg. § 1.861-18(f)(1).

<sup>[9]</sup> Prop. Treas. Reg. § 1.861-18(f)(1), Supplementary Information, paragraph 14. The IRS states that there is no transfer of a copyright right unless it is accompanied by the right to distribute the copies to the public. This section is confusing in light of § 1.861-18(f)(1) which states that a transfer of a copyright right is accomplished by the transfer of "substantial rights." Since there are only two primary rights in §1.861-

18(c)(2) (the right to reproduce and distribute and the right to modify the original code), the IRS should clarify -18(f)(1) to explain what "substantial rights" means and whether both or one of those rights have to be transferred to produce a transfer of a copyright right.

<sup>[10]</sup> See Prop. Treas. Reg. § 1.861-18, Example 6.

<sup>[11]</sup> *Attorneys Recommend Changes to Computer Program Regs.*, 97 TNT 39-25, Letter from Ronald A. Perlman and Paul J. Berman, Attorneys, Covington and Burling, to Internal Revenue Service (February 11, 1997). Perlman and Berman, on behalf of IBM, state that there is a significant market for "high-end" computer programs which are often overlooked since they are not mass-marketed and found on the shelves of retail stores. The rights associated with these programs may impute classification as a copyrighted article. Nevertheless, IBM claims that a classification of these programs as a lease rather than a license is a misapplication and misunderstanding of the nature of these "high-end" programs as well as traditionally inaccurate. See *infra* note 79.

<sup>[12]</sup> Prop. Treas. Reg. § 1.861-18(f)(2).

<sup>[13]</sup> See Prop. Treas. Reg. § 1.861-18(d), Example 15.

<sup>[14]</sup> See Prop. Treas. Reg. § 1.861-18(e), Example 16.

<sup>[15]</sup> Prop. Treas. Reg. § 1.861-18, Supplementary Information, paragraph 8.

<sup>[16]</sup> *Id.* at paragraph 9.

[17] Treasury White Paper on Electronic Commerce, 7.4.2 *Role of existing concepts*. Treasury suggests that a video conference could act as a substitute for a conference call.

[18] Treasury White Paper on Electronic Commerce, 7.3.3 *Proposed regulations on computer program transactions*.

[19] An Anguillan Internet Service Provider hosts Web sites for businesses wishing to incorporate offshore. The site bills itself with the following: "Anguilla is a pure tax haven. There are no income taxes, no corporate taxes, no sales taxes, no value added taxes, etc. As the Internet grows, and more business is done over the Internet, the physical location of a business matters less and less. When looking for the best jurisdiction to locate your company in, don't just compare California and Washington, consider Anguilla. A zero-tax jurisdiction is hard to beat. Without a 50% tax burden, your company's after tax earnings would be double, and the value of a growing company would be more than double." The prices are competitive and the transactions are as secure as any U.S. ISP could offer. There is little, if any, incentive to locate a company delivering digital media and data in the U.S. The potential for fraud is obviously enormous as well. *Anguilla &endash; Offshore and Online!* (visited February 6, 1997) <<http://www.offshore.com.ai/taxhaven>>.

[20] 435 U.S. 561 (1978).

[21] *Id.* at 582.

[22] ECnet &endash; The Electronic Commerce Information Resource, *What is Electronic Commerce? -- Definitions* (visited April 14, 1997) <<http://www.year-x.co.uk/ec/yxwidef.htm>>.

[23] Government Technology, *Electronic Commerce* (visited April 14, 1997) <[http://www.govtech.net/1997/gt/apr/april1997-ecgrid/Question\\_1.shtm](http://www.govtech.net/1997/gt/apr/april1997-ecgrid/Question_1.shtm)>.

[24] I.R.C. § 1 and § 7701(b).

[25] I.R.C. § 7701(b)(3). The 183 days is calculated by a weighted formula giving more weight to recent years.

[26] I.R.C. § 11 and § 7701(a)(3) and (4).

[27] I.R.C. § 871(b) and § 882(a).

[28] I.R.C. § 871(a) and § 881(a). This is known as "fixed or determinable annual or periodic income" or FDAP income.

[29] I.R.C. § 864(b).

[30] I.R.C. § 864(c).

[31] *See Handfield v. Commissioner*, 23 T.C. 633, 638 (1955).

[32] *See United States v. Balanovski*, 236 F.2d 298, 303 (1956).

[33] *See Lewenhaupt v. Commissioner*, 20 T.C. 151, 163 (1953).

[34] Treasury White Paper on Electronic Commerce, 7.1.4 *Role of tax treaties*.

[35] OECD Model Tax Convention on Income and Capital (1992), Article 7, paragraph 1 [hereinafter OECD Model Tax Treaty]; United States. Model Income Tax Convention of September 20, 1996, Article 7, paragraph 1 [hereinafter U.S. Model

Tax Treaty]. *Compare with* United Nations Model Double Taxation Convention Between Developed and Developing Countries, Article 7 [hereinafter UN Model Tax Treaty]. The UN Model Treaty is more liberal in its definition of permanent establishment and often favors the interests of developing countries. The U.S. and OECD Model Treaties favor capital exporters while the UN Model Treaty favors capital importers. Thus, under the UN Model Treaty, the source state has greater taxing authority. Given the trend toward software development and services originating in the United States, it is foreseeable that new treaty partners will use the UN Model Treaty as their framework in order to maintain part of their foreign tax base.

<sup>[36]</sup> OECD Model Tax Treaty, Article 5, paragraph 2; U.S. Model Tax Treaty Article 5, paragraph 2.

<sup>[37]</sup> Many of these arguments raise similar domestic tax issues. Congress has yet to resolve how states are permitted to tax electronic commerce. Bills and joint resolutions have recently been introduced to Congress concerning this issue. They generally call for a moratorium on additional Internet taxes for both domestic and international transactions. *See* Internet Tax Freedom Act, S. 442, 105th Cong. (1997). The decision of *Quill* (*Quill v. North Dakota* 510 U.S. 899 (1993)) should act as the functional equivalent to guide Congress on creating legislation to tax domestic Internet transactions. *Quill* re-instituted the "physical presence" requirement for out-of-state mail order companies to collect a use tax. Thus, mail order does not impute a

"substantial nexus" and states cannot impose a tax on out-of-state vendors selling to in-state customers. This framework can further be applied to the international tax principle of "effectively connected income" in order to limit source-based taxation.

[38] See Mike Tarsala, *Net Commerce: Double Taxation is Just the Start*, Investor's Daily, January 14, 1997, at A1, A6. Nilesh Shah, partner at KPMG, international services division, says that current rules permit taxation of business conducted over the Internet in any location where the data makes a "pit stop."

[39] Treasury White Paper on Electronic Commerce, 6.3.2 *Disintermediation*. See also Garrison, Bruce, *Treasury Discussion Paper Opens Debate on Taxing the Internet*, The Metropolitan Corporate Counsel, January 1997, at 6. Garrison explains that tax withholding and information reporting will decrease as cross-border investment and licensing transactions proliferate without the use of a financial intermediary.

[40] From an economic vantage point, this would create lower prices as cost savings could be passed to the consumer.

[41] This argument does not apply to ISPs. The primary business of an ISP is to provide connectivity to use the Internet or any electronic communications device as a vehicle for the transfer of digitized information. ISPs "set up shop" as enterprises functionally equivalent to telecom providers. They own the physical property &ndash; the server &ndash; which could be compared to renting an office and they maintain or pay for maintenance of the infrastructure, similar to the payment for civil

services such as sanitation. The ISP would likely qualify as a fixed place of business, even through remote management.

[42] *See also* Information Technology Association of America, *Straight Talk: Internet, Tax & Interstate Commerce*, Q.4, (visited April 3, 1997)

<<http://www.ita.org/p7.htm>>. The Information Technology Association of America (ITAA) is a trade association which represents the computer software and services industries. It does not openly advocate residence-based taxation; however, many of the arguments suggested by Treasury for the shift toward residence-based taxation are reiterated in the ITAA paper. Primarily, both organizations believe that the administrative difficulties for policing nexus rules as well as the ease of shifting and hiding money internationally prevents the Internet from fitting into the current tax code's framework for sourcing income.

[43] Treasury White Paper on Electronic Commerce, 7.1.5 *The Ascendancy of residence-based taxation*. The shift towards residence-based taxation may cause uneasiness among certain tax consultants. Carol Dunahoo, principal in the National Tax Services Group of Price Waterhouse and former Treasury tax advisor, states that "there remains a lot of uncertainty about how existing rules apply." Howard Gleckman, Marsha Johnston, Catherine Lee, *The Tax Man Cometh to Cyberspace*, Business Week, December 9, 1996, at 132. In turn, this may lead to increased tax evasion. In fact, Treasury speculates as to the effects electronic commerce may have on controlled foreign corporations (CFCs) and the associated

Subpart F income. Treasury wonders "[i]f CFCs can engage in extensive commerce in information and services through Web sites or computer networks located in a tax haven, it may become increasingly difficult to enforce Subpart F. Some persons engaged in electronic commerce may already be locating their businesses offshore... It may be necessary to revise Subpart F or the regulations thereunder to take these new types of transactions into account." *Id.*, 7.3.5 *Effect on controlled foreign corporation rules*. Furthermore, residence-based taxation is endorsed by international organizations. The OECD Model Tax Treaty and the U.S. Model Tax Treaty favor residence-based taxation.

[44] *Id.*

[45] The current definition of a computer program is one that uses functional instructions to bring about an intended result. Prop. Treas. Reg. § 1.861-18(a)(3). A database may be part of a computer program but must be incidental to the program's primary function. *Id.* The nature of electronic commerce suggests that copyrighted content and multimedia, and digitized services could be classified under the framework of the Proposed Regulations. *See supra* pages 7-10.

[46] *See* The Wall Street Journal Interactive Edition, *Wall Street Journal Subscriber Agreement*, (visited March 28, 1997)

<<http://wsj.com/admin-cgi-bin/preRegUser.cgi>>.

[47] *Id.* "The information available through WSJIE is the property of Dow Jones or its licensors and is protected by copyright and other intellectual property laws.

Information received through WSJIE may be displayed, reformatted and printed for your personal, non-commercial use only." *See also* Britannica Online, *Britannica Usage Agreement*. (visited March 28, 1997)

<<http://www.eb.com:193/subscribe/usage.htm>>. The Encyclopedia Britannica Usage Agreement states, "Britannica Online contains copyrighted material, trademarks, and other proprietary information. No copying, automated browsing or downloading, redistribution, publication, or commercial exploitation of material available on Britannica Online is permitted, except as otherwise expressly permitted under applicable U.S. copyright law. In addition, such material may be used for noncommercial purposes in connection with the preparation of papers, reports, presentations, or scholarly uses..." Although Encyclopedia Britannica claims to provide copyrighted information, the Treasury white paper classifies the online encyclopedia first as a service and then as "a means of distributing copies of copyrighted works." Treasury White Paper on Electronic Commerce, 7.3.4 *Definition of services income*.

[48] I.R.C. § 861(a)(6); I.R.C. § 865(b); I.R.C. § 862(a)(6).

[49] *Id.*

[50] I.R.C. § 863(b)(2); Treas. Reg. § 1.863-3.

[51] Prop. Treas. Reg. § 1.861(f)(2).

[52] Treasury White Paper on Electronic Commerce, 7.3.1 *Transactions in digitized information*. The Treasury compares the potential classification of the transfer of a photograph as either a sale or a license, depending upon the use of the purchaser.

[53] I.R.C. § 861(a)(3) and I.R.C. § 862(a)(3).

[54] *See* U.S. Model Tax Treaty, Article 14, paragraph 1 and Article 7, paragraph 1; *See* OECD Model Tax Treaty, Article 7, paragraph 1 and Article 14, paragraph 1.

[55] I.R.C. § 871(b).

[56] I.R.C. § 954(e)(1)(B).

[57] National Academy Press, *Information Technology in the Service Society: A Twenty-First Century Lever* (1994). The projections do not differentiate between employment in online industries and traditional industries. Nevertheless, the focus of the report is on the use of, reliance upon, and growth of information technology.

[58] Treasury White Paper on Electronic Commerce, 7.3.4 *Definition of services income*.

[59] Interview with Treasury Official, in Washington D.C. (March 28, 1997).

[60] Treasury White Paper on Electronic Commerce, 7.3.4 *Definition of services income*.

[61] *Id.*

[62] Telephone interview with Constance Spheeris, Corporate Counsel of *Tax Analysts* (May 16, 1997). *Tax Analysts* provides legal research resources for tax attorneys. Two of its core products are TAXBASE and THE ONE DISC. TAXBASE

provides a daily online newsfeed, a daily printed letter delivered by post mail or e-mail, and allows subscribers to access most official tax documents. It costs \$247.50 a year. THE ONE DISC is a CD-ROM and is billed as a "complete basic tax library." It is updated monthly and costs \$249 a year. Tax Analysts' goal is to integrate ONE DISC into TAXBASE. If each product offers similar features and information, would it be logical to classify them differently? The major difference is that the CD-ROM is upgraded monthly and the online service is updated daily. Additionally, the CD-ROM owner can keep the product after the subscription ends. Nevertheless, the CD-ROMs may be worthless without timely monthly updates. This would suggest a closer similarity to a service than a sale.

<sup>[63]</sup> *Cf.* Treas. Prop. Reg. § 1.861-18, Example 13. (A foreign corporation pays a monthly fee for the use of a computer program. In return, the foreign corporation has the right to receive upgrades once they become available. When the contract is terminated, the foreign corporation may keep the latest version of the program. This transaction is treated as a sale of a copyrighted article. The determinant may be that the customer has right to use in perpetuity one version of the program.).

<sup>[64]</sup> *See generally*, Treas. Prop. Reg. § 1.861-18, Example 1 (transferee receives the right to use one copy of a computer program located on multiple machines at only one time).

<sup>[65]</sup> *See* W. Brian Arthur, *Increasing Returns and the New World of Business*, Harvard Business Review, July-August 1996, at 100, 108. Arthur states, "...operations that

were once handled by people &ndash; designing fancy financial instruments or automobiles or fashion goods, processing insurance claims, supplying and inventorying in retail, conducting paralegal searches for case precedents &ndash; are increasingly handled by software."

[66] *See e.g.* Cook v. United States, 599 F.2d 400 (1979) (sculptor was taxed where the sculpture was made, not where it was sold). *See also* Rev. Rul. 72-423, 1972-2 CB 446 (management services were deemed foreign source income for services conducted from abroad by mail and telephone).

[67] Prop. Treas. Reg. § 1.861-18(b)(2).

[68] I.R.C. § 863(c)(2)(A) and I.R.C. § 863(e)(1)(A).

[69] *Cf.* U.S. Model Tax Treaty, Article 14, paragraph 1. (The taxing jurisdiction for personal services excluding business profits is granted to the resident state of the provider of the services unless the income is attributable to a fixed place of business in the other contracting state. Since "fixed place" does not require the same degree of permanence as does a permanent establishment, it is plausible to envision a database providing services and housed in a contracting state being subject to taxation in that contracting state.)

[70] Treasury White Paper on Electronic Commerce, 7.4.2 *Role of existing concepts*.

[71] I.R.C. § 861(a)(4) and I.R.C. § 862(a)(4).

[72] Prop. Treas. Reg. § 1.861-18(f)(1).

[73] I.R.C. § 861(a)(4) and I.R.C. § 862(a)(4).

[74] U.S. Model Tax Treaty, Article 12, at paragraph 1; OECD Model Tax Treaty, Article 12, paragraph 1. The UN Model Treaty allows for limited source-based taxation; *see also supra* note 35.

[75] U.S. Model Tax Treaty, Article 12, paragraph 3; OECD Model Tax Treaty, Article 12, paragraph 3.

[76] Telephone interview with Linda Arnold, Reprints Division at *Wall Street Journal* (visited May 14, 1997); The Wall Street Journal Interactive Edition, *Wall Street Journal Subscriber Agreement*, (visited March 28, 1997)

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[77] I.R.C. § 861(a)(4) and I.R.C. § 862(a)(4).

[78] Treas. Reg. 1.871-7(b).

[79] *Attorneys Recommend Changes to Computer Program Regs.*, 97 TNT 39-25, Letter from Ronald A. Perlman and Paul J. Berman, Attorneys, Covington and Burling, to Internal Revenue Service (February 11, 1997). International Business Machines Corporation ("IBM") is leading an assault on the classification principles of the Proposed Regulations with regards to the license/lease distinction. This issue does not directly relate to the issues associated with a subscription to The Online Times and is therefore not included in the body of this paper; its impact, however, is potentially

significant and deserving of mention. IBM claims that their "high-end" programs (*see supra* note 11) have been traditionally characterized as licenses. Although the transfer of the rights associated with the programs are similar to those of a copyrighted article, IBM asserts that by reclassifying the transaction as a lease, substantial confusion surrounding international tax policies and double taxation would result. Specifically, this recharacterization could remove tax revenue from the source country by eliminating the withholding tax on royalties. In turn, source countries may levy a withholding tax on rental income from leases thereby confounding and enlarging the problem without altering the tax effect. Furthermore, IBM claims that a lease classification is inconsistent with commercial practices and copyright law. IBM states that the right to use a computer program and to copy it to a computer's memory is exclusive of the right to have a tangible copy of the program. The license agreement accompanied by all computer programs grants the right to use as the transferee of the program is prohibited from using it without the license. This argument does not take into account the nature of the computer's abilities since most computer programs require reproducing it into the memory. It would be interesting to hear IBM's arguments for programs that run solely on CD-ROM (no copying required) and ones that are used by the network computer (those computers without hard drives that temporarily borrow applications via an online connection).

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