INTERNATIONAL TRENDS: SALES, USE AND CONSUMPTION TAXATION OF E-COMMERCE

Francisco A. Laguna, J.D.*
TransLegal, Inc.

November 11, 2001

Francisco A. Laguna holds a BA in English from the University of California, Berkeley, and a JD from the Univeristy of Arizona. He has worked in the international arena for the past 16 years, assisting clients in various aspects of transnational litigation and in-bound and out-bound transactions.

He is currently president of TransLegal, Inc. a multinational consulting firm with principal offices in Alexandria, Virginia. TransLegal specializes in government relations, international paralegal and research services and translations. www.translegalinc.com.

*

INTERNATIONAL TRENDS:
SALES, USE AND CONSUMPTION TAXATION OF E-COMMERCE

Francisco A. Laguna, J.D.
TransLegal, Inc.
November 11, 2001

The increasing impact of the Internet and electronic commerce on the global economy is compelling governments to address the necessity of taxing electronic transactions on domestic and international levels. The overwhelming consensus among both governmental officials and industry leaders is that e-commerce should be subject to equitable, non-discriminatory tax régimes that will not hinder its growth potential. This article contrasts the approaches and philosophies espoused by the United States and the European Union with regard to the imposition and collection of a sales/use or consumption tax on B2B and B2C e-transactions.

Governmental bodies, international organizations and private sector groups commonly agree that e-commerce should be taxed in accordance with the standard principles governing taxation of ordinary commerce. The Organization for Economic Co-Operation and Development ("OECD") emphasizes the following criteria.

- Neutrality: Taxation on e-commerce transactions should be neutral vis-à-vis commercial transactions conducted in a traditional manner; e-commerce should not be subject to additional discriminatory or non-equitable taxes.

- Efficiency: Business compliance and government administrative costs should be kept as low as possible.

- Certainty: Rules should be clear to allow taxpayers to determine their compliance obligations.

- Effectiveness and fairness: Collection efforts should result in the garnering of required and sufficient tax revenues, and attempts should be made to curb taxpayer fraud.

- Flexibility: Tax régimes should be flexible and evolving to provide for the technological advancements that may drive future commerce.

Applying the foregoing principles to differing degrees, the aforementioned jurisdictions and the OECD have attempted to address the issue of taxing Internet transactions and determining who shall be responsible for collecting such taxes. The legal concepts of nexus and permanent establishment are central to these discussions.

I. United States

In the United States, the states legislate sales and use taxes and enforce laws related thereto. In certain states, cities and localities may also impose sales taxes. By some accounts, there are over 6,000 jurisdictions that may levy, to some extent, sales taxes on commercial transactions. The lack of a uniform federal sales tax or a uniform state sales tax creates an onerous burden on out-of-state vendors obliged to collect sales taxes on remote sales.

The issue of whether a state can impose such obligation is not novel. To date, the question has revolved around out-of-state mail catalog vendors or vendors with no physical presence in the particular state. However, the advent of e-commerce, the increasing value of Internet sales, and the ability to reduce certain tangible goods – such as books or music – to digitized (or intangible) form, has caused the federal and state governments to focus on alternative avenues for collecting sales and use taxes while allowing the Internet to continue its exponential growth.

At the outset, it is important to clarify that the federal Internet Tax Freedom Act (PL 105-277, 10/21/98) does not affect a state's ability to impose sales/use taxes on e-commerce. Rather, the ITFA places a moratorium on state and local taxes on Internet <u>access</u>, unless such taxes were passed and enforced prior to October 1, 1998, and prevents the states from levying multiple or discriminatory taxes on e-commerce. The ITFA expired on October 21, 2001. Since then, both the House and the Senate have grappled with whether to extend the moratorium, the duration of such extension and whether any measure should ease the laws that prevent the states from taxing remote sales.

Not surprisingly, several competing bills have been introduced in Congress concerning Internet tax. H.R.1552, the Internet Tax Nondiscrimination Act, seeks to extend the current ITFA moratorium for an additional two years, until 2003.[1] Originally, it the bill called for an extension of six years. HR 1552 has passed the House, and should be considered by the Senate shortly. Senate bill, S. 1567, sponsored by Sen. Byron Dorgan (D-ND), among others, essentially mirrors HR 1552, except that it extends the moratorium for four years and includes provisions that would allow the states to tax e-sales, provided that states are able to streamline and simplify their existing tax systems.[2]

---

[1] H.R. 1552 was introduced by Reps. Christopher Cox (R-Calif.) and Robert Goodlatte and Tom Davis (Rs-Va.).

[2] Sen. Dorgan has become the overwhelming advocate for those states and entities that want to tax e-transactions. Regardless of his support, however, Sen. Dorgan recognizes the complexity of the issue and the fact that the state's current taxing schemes would present daunting obstacles for any e-retailer.

A. Taxation Of Remote Vendors

Currently, a state's ability to subject a remote vendor to its sales/use tax régime is dependent on such vendor's nexus with the state. Nexus typically requires the vendor to have some link or relation with the state such that imposing tax collection obligations on the vendor is not unfair to the vendor or prejudicial to interstate commerce. These determinations are subject to scrutiny under the Due Process Clause and the Commerce Clause of the US Constitution, respectively, by either state or federal courts. Establishing nexus is further complicated by the fact that state laws vary tremendously, and typically, state law, subject to federal constitutional decisions, is used to qualify nexus. Thus, states may make contradictory decisions in cases involving similar, if not identical, fact patterns.

The most obvious manner of establishing nexus is physical presence within the state in question. In cases in which the vendor has no physical presence or employees in the state, other factors are considered, including, among others, agency issues, the presence of tangible (and in some cases intangible) assets, or relationships maintained with third parties. Of particular importance to the issue of nexus in the e-commerce and traditional remote vendor arena are the United States Supreme Court decisions in *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967), and *Quill Corporation v. North Dakota*, 504 U.S. 298 (1993).

The essential ruling of the *Bellas Hess* is that companies that limit their commercial activities to communicating with customers in a state, either by mail or by common carrier, do not have sufficient nexus with such state to allow the imposition of sales or use tax collection obligations.

Quill continued to establish nexus criteria. In *Quill*, North Dakota sought to impose on a remote vendor the obligation to collect use taxes on sales made to North Dakota. The vendor, a Delaware corporation, sold goods to North Dakota customers through catalogs and advertising in national magazines. The company did not have any offices, property or employees in the state. However, it licensed software to North Dakota customers for purposes of placing orders and, in the year in question, it sold $1 million dollars to in-state customers. North Dakota law imposed an obligation on the corporation to collect use taxes on sales to in-state customers on the basis that it solicited North Dakota customers on a regular basis.

The *Quill* Court amended prior due process decisions, ruling that a remote vendor is not required to have a physical presence in a state to justify imposition of sales/use tax collection obligations. Rather, to achieve nexus, the vendor has to conduct business purposefully, or to take advantage of the consumer/business market, in that state. Despite this holding, however, the Court ruled North Dakota's efforts unconstitutional because they burdened interstate commerce. In dicta, the Court noted that Congress has the prerogative to legislate authority to the states to impose sales/use tax collection obligations on out-of-state vendors.[3]

---

[3] This uncertainty caused barnesandnoble.com, a subsidiary of Barnes and Noble, to warn, initially in its May, 1999 Form S-1, that future imposition of domestic and/or foreign sales and

Thus, *Quill* stands for the proposition that despite some connection therewith, states cannot impose sales/use tax collection obligations on mere remote vendors without a congressional mandate. Discussions focus on the patent disadvantage current law imposes on main street vendors or vendors with a physical presence in a state. Such disadvantage is further exacerbated by the increasing trend to digitize goods.

With regard to electronic transactions, physical presence tends to be minimized, but the other criteria referred to above become more relevant. For example, California law stipulates that the use by remote vendors of Internet computer servers to create or maintain a website will not be a factor to determine nexus, regardless of whether such in-state hosting service is used to facilitate the placement of orders (Cal. Rev. & Tax. Regs. § 1684). Consequently, the use of an ISP in California, in and of itself, will not result in establishing nexus. However, if the computer telecommunications network is owned, directly or indirectly, by the remote vendor, California law considers the vendor to be engaged in business in California and subject to sales/use tax collection obligations (Cal. Rev. & Tax. Code § 6203).

To avoid the burden of collection obligations, some multi-state or national vendors have established subsidiaries to operate their mail order or e-commerce business. Assuming such subsidiaries comply with standard practices of keeping their operations wholly distinct from the parent, they should only be obligated to collect sales/use taxes on sales made in states where they have property or employees. Federal courts have yet to decide definitively what activities the parent may perform on behalf of their subsidiaries. Again, state court decisions are inconsistent and provide no surety for this corporate organizational strategy. The following acts by the brick and mortar parent, if performed on a consistent basis, are likely to influence a court's ruling: advertising the remote vendor in the brick and mortar, facilitating on-line orders in the brick and mortar; giving refunds for, or exchanging, merchandise purchased remotely; honoring gift certificates purchased remotely; and providing repair services or technical support.

Two recent examples of the divergent manner in which the states are interpreting the overall issue of nexus and the attempts of the states' taxing authorities to impose the obligation of collecting sales taxes on remote sales are: the decision of the California Board of Equalization in *In the Matter of Borders Online, Inc.* (September 26, 2001); and the opinion of a Tennessee Chancery Court in *America Online, Inc. v. Johnson* (Docket No. 97-3786-III, March 31, 2001).

The Borders Online case, the California Board of Equalization agreed with the state's Sales and Use Tax Department that Borders Online ("B.Online") was obligated to collect use tax on sales made to California because B.Online customers were given the option of exchanging merchandise purchased on the Internet at the separate brick and mortar Borders bookstores.

use tax collection obligations is a risk factor and may represent "a material, adverse effect on bn.com's business, financial condition, results of operations or prospects."

The decision was based primarily on certain representations made on the B.Online website concerning the e-tailer's return policy, which read, in pertinent part, as follows –

> You may return items purchased at borders.com to and Borders Books and Music store within 30 days of the date the item was shopped.

Such policy appeared on the B.Online website until August 1999. It was removed when California taxing authorities notified the Internet company that such policy arguably subjected it to use tax collection obligations.

The Board of Equalization ("BOE") agreed. It based its decision on the 1999 return policy, stating that the policy effectively rendered Borders the California representative of B.Online. As such, the BOE rationalized that the *Quill* nexus test was satisfied. The BOE further based its decision on the fact that although the return policy in question was removed from the B.Online website over two years ago, B.Online was unable to disavow current application of the policy. In addition, the BOE relied on the fact that customers returning merchandise from B.Online received a cash refund, while those desiring to return items from a Borders competitor were merely awarded store credits.

The BOE applied the foregoing facts to the California statute that determines whether an out-of-state company is engaged in business in California for purposes of imposing tax collection obligations, Cal. Rev. & Tax Code § 6302(c)(2). The operative language of that section stipulates that any retailer having an in-state representative under its control was subject to tax collection obligations.

The B.Online decision is surely to be appealed. Viewed objectively, it is unclear whether the BOE can substantiate its ruling that Borders acted as a representative under the control of B.Online. Accepting as accurate the BOE's contention that Borders accepts returns of B.Online merchandise and that it issues cash refunds, it is unlikely that a court will characterize such accommodation as a representative arrangement. The BOE chose to ignore two critical arguments: 1) Borders does not charge B.Online for its services; and 2) Borders offers such services to benefit its customers, not to promote the business of B.Online. A court may find these dispositive. Moreover the courts should also consider that the BOE decision is contrary to similar cases involving e-retailers and brick and mortar companies, like Bloomingdale's and Saks. Like so many other issues related to e-commerce, however, the courts will have to carve definitive guidelines.

The second example of the divergent application of the concept of nexus is the decision of a Tennessee Chancery Court in *America Online, Inc. v. Johnson*, Docket No. 97-3786-III, March 31, 2001. As in *Quill*, Tennessee sought to impose sales and use tax collection obligations on AOL on the basis of substantial nexus. AOL's contacts in the state comprised the presence of equipment and software in Tennessee, agreements with in-state subscribers and contractual arrangements with companies to provide local access to AOL users.

The Chancery Court adopted a restrictive view of the holdings in *Bellas Hess* and *Quill*. The court rejected the state's argument on the basis that AOL did not have offices or employees in Tennessee and that nexus cannot be established by mere fact that a company either leases, or itself subleases, equipment in the state. It further stated that the software AOL has in Tennessee is worthless, in and of itself, and could thus not be a factor in establishing nexus. The ruling implies that, in Tennessee, substantial nexus is only achieved by a physical presence in the strictest sense. In this regard, it ignores wholly the admonition of the *Quill* Court that nexus is not established solely on the basis of physical presence in the traditional sense. It further disregards the *Bellas Hess* reference to owning property in the state or willfully advertising merchandise (or in this case, a service) within the state.

Perhaps the most troubling aspect of the decision is the court's unwillingness to adapt precedents to new commercial and technological realities.[4] Both *Bellas Hess* and *Quill* suggest that nexus need not be established solely by the presence of a work force or an office. In the age of e-commerce, equipment can result in the physical presence required for substantial nexus, particularly if the equipment is located in-state and is used systematically to derive income from in-state sources. Clearly, that is the case of AOL in Tennessee and perhaps every other state. Whether such equipment is owned, leased or subleased by the remote vendor or service provider should not be a factor. Rather, the purpose and objective of the equipment, if not de minimus, should be scrutinized. Indeed, under the California statues cited above, it is arguable that AOL would be deemed as doing business in the state on the basis of such equipment, particularly if the equipment is used solely for the benefit of AOL.[5]

The Tennessee court also rejected the notion that AOL software in the state resulted in substantial nexus. The court did note that the software created a presence, but that, in and of itself, such software was worthless. In contrast, Texas has used the licensing of software to in-state users as the basis for imposing use tax collection obligations. (Comptroller of Public Accounts, Doc. No. 36,237 (July 21, 1998).)

Clearly, the Tennessee case presents facts that other state courts may consider sufficient to establish substantial nexus: the physical presence of leased or subleased equipment; the physical presence of software; and contractual agreements with end users and third party service suppliers. This underscores the importance of uniform rules and applications to allow e-commerce and traditional remove vendors to operate confidently in a certain legal environment.

---

[4] Indeed, discussing the physical presence standard of *Bellas Hess*, the *Quill* Court indicated that the ruling in that case might well have been different had the case been brought today.

[5] A case of historical interest is *Union Oil Co. of Cal. v. State Bd. Of Equalization*, 386 P.2d 496 (Cal. 1963)(upholding the state's right to impose use tax collection obligation based on a company's lease of tangible property). This case predates both the California statues cited herein and *Bellas Hess*. In addition, it is noteworthy that the supreme courts of Arkansas, Oklahoma and Oregon have held that property in a state is sufficient to create nexus sufficient to state <u>income</u> tax liability. This concept was rejected by Kentucky. It is unclear whether state courts will be willing to apply the same reasoning to the sales/use tax arena.

B. Striving For Certainty

Several public sector and private sector groups in the United States have examined the issue of taxing e-commerce transactions and imposing sales and use tax collection obligations on remote vendors. Some of these groups are the Advisory Commission on Electronic Commerce (ACEC), formed pursuant to the Internet Tax Freedom Act, the National Governors Association, the Multistate Tax Commission, and the Joint Venture: Silicon Valley Network. The issues such groups have addressed include: the complexity and lack of uniformity of current sales/use tax régimes imposed by the various states; the undue burden that compliance may place upon remote vendors; and the source of e-commerce transactions, i.e., whether the transaction should be taxed at the vendors' venue or at the point of consumption. These issues are also common topics at the international level.

To date, there has been no consensus reached on how e-commerce should be taxed. Indeed, not even the nineteen members of the ACEC were able to pass, with the required 2/3 majority, any of the substantive proposals they discussed. Thus, the ACEC's report, issued in April 2000, fails to provide to Congress any concrete recommendation or finding.

The various groups reviewing the issue of e-commerce taxation agree that current sales/use tax laws must be simplified. Forced compliance with a myriad tax régimes will place a tremendous burden on remote vendors, both monetarily and in terms of human resources. Suggestions have been made concerning the need to establish a uniform sales/use tax scheme, either at the federal level or at the state level through the adoption of a model law. If the federal government were to impose a national sales/use tax, the states' power to determine the taxes imposed on internal commerce, and to administer such taxes, would be diminished. In addition, a federal tax would affect the revenue of cities and localities. Typically, these jurisdictions do not share in the sales/use taxes collected at the state level; they only receive a portion of state income taxes. For that reason, state laws may authorize them to impose an additional sales tax for local revenue collecting purposes. However, a federal tax would place the same tax collection obligations on all vendors, remote and brick and mortar. Such parity would also be achieved if the states adopt a uniform law in a timely manner.

Regardless of what system is ultimately adopted, either a federal tax or a uniform tax adopted by the states, collection and compliance remains an issue. If levied at the federal level, taxes will have to be collected and apportioned to the states in accordance with the sales generated in each state. Again, the individual states would have to address the issue of additional sales/use taxes levied by cities and municipalities. Third party collection entities have been discussed as a manner of reducing the administrative burdens on remote vendors who may find themselves in a position of collecting and filing returns on a multi-state basis.

One Arizona State legislator has proposed in speeches given to local groups that credit card companies would be ideal collection entities. He notes that credit card companies are familiar with the various state sales/use tax systems and that filing returns on behalf of their merchant account clients would be a natural extension of their operations.

Neither of the foregoing options is applicable to the collection of sales/use taxes on purchases from foreign vendors. This issue must be addressed at the federal level through the amendment of existing tax treaties or the negotiation of new treaties. At the international level, the same problems of uniformity, compliance, collection and apportionment would have to be resolved. Moreover, the larger issue of jurisdiction to enforce such collection obligations would have to be adequately addressed.

An alternative to the adoption of a federal sales/use tax would be a federal definition of nexus to establish uniform rules and to allow remote vendors to determine with certainty whether they are obligated to collect sales/use taxes on sales to a particular state. In the event a remote vendor is not subject to compliance requirements, the state taxpayer would be responsible for paying the use tax on items purchased either through mail or through the Internet. Currently, most taxpayers are not aware of what a use tax is, or of their obligation to pay it. Conversely, most states have not made an effort to educate taxpayers concerning these issues or to collect such tax. If the states are successful in collecting use taxes, their ability to continue to impose both state and local sales/use taxes would be preserved. Additionally, since use taxes are collected on all remote sales, regardless of whether the vendor is located within the United States or abroad, the issue of taxing international sales to in-state taxpayers would be resolved.

On its individual tax return, Maine includes a line for the self-assessment by taxpayers of a use tax. The Maine use tax is imposed on purchases from remote vendors valued at $1,000 or more. The taxpayer has the option of calculating the exact amount of use tax owed, or of assessing a percentage (.04%) of his state adjusted gross income. The taxpayer must include a figure on the use tax line, even if only zero. In the event he does not, the state will assess an amount, presumably based on the taxpayer's adjusted gross income. The return instruction forms indicate that the use tax reported is subject to audit, as well as the imposition of penalties and interest. The individual tax forms of Connecticut, Idaho, Indiana, Kentucky and Wisconsin also include a line for reporting use tax liability.

Sourcing e-commerce is also problematic. Any remote sale may either be sourced at the vendor's venue or at the purchaser's point of consumption. Again, no consensus has been reached on this issue, and there are advantages and disadvantages to either approach.

Taxing sales at the location of the seller would minimize the vendor's administrative burden: it would only have to comply with the laws of, and file a return in, one state. Additionally, the consumer's privacy would be conserved to a larger degree. However, the seller location approach necessitates strict, uniform definition of where a vendor is located. Remote vendors may have various sites: corporate headquarters; satellite offices; order placement centers; customer service or call centers; warehouses. Rules establishing which site determines the sales/use tax rate are required. Moreover, this approach may cause companies to engage in "tax jurisdiction shopping:" choosing the state where the least, or no, tax is levied. This may distort sales tax collections and affect jurisdictions that impose higher rates. Currently, five states do not levy a sales tax: Alaska; Delaware; Montana; New Hampshire; and Oregon. Jurisdiction shopping may also lead to competition between states to attract companies by offering distinct incentives, fiscal or otherwise.

Taxing sales at the point of consumption represents a more traditional approach to the assessment and collection of sales/use taxes, allowing such taxes to benefit the jurisdiction in which the consumer resides and which provides a market to the remote vendor. The state in which the remote vendor is physically located would still levy an income tax on the vendor, and would thus not lose revenue. Tax jurisdiction shopping would not be an issue. However, the burdens on vendors' compliance and multi-state filing obligations would continue to exist. Again, such burdens may be eased by third party collection entities. Taxation at the consumer's location conforms with the OECD approach.

E-commerce also forces authorities to determine whether sales/uses taxes should be levied on intangible goods. Not surprisingly, states vary in their taxation of intangibles. For example, California and South Carolina do not levy sales tax on electronically transferred software. In contrast, Texas does. Uniform definitions or laws taxing intangibles are required to resolve the problem.

To date, the group that has most successfully addressed these issues is the Streamlined Sales Tax Project. In December 2000, it passed the proposed Streamlined Sales and Use Tax Agreement ("Agreement"). The draft text was amended slightly in January 2001.[6] Overall, however, the changes were insubstantial. The purpose of the Agreement is to simplify current state sales/use tax régimes to create uniform rules, ease compliance burdens and provide the certainty required by business interests. Equally important, from the perspective of the states that adopt and effectively implement the Agreement, it may serve as the underlying basis for states to impose sales/use tax collection obligations on remote vendors. Uniform rules, applicable to all, would abrogate the *Quill* Court's concern about burdened interstate commerce.

States that ratify the Agreement will have to amend their internal sales/use tax rules to conform to the terms of the Agreement. The Agreement will enter into force once five states become signatories thereto. Individual states would continue to manage their own tax laws and to set applicable rates.

The highlights of the Agreement include: the adoption of harmonized definitions of products and services for purposes of imposing and collecting sales/use tax; the simplification of determining applicable rates by using a zip code-based system and standardized sourcing rules; the removal of sales/use tax liability thresholds and caps; the development of sales tax compliance software to be used by companies that have not developed their own programs; and the creation of third party collection agents, referred to as Certified Service Providers. To the chagrin of many analysts, however, the Agreement fails to define intangible goods.

The Agreement's sourcing rules generally dictate that goods and services will be taxed at the point of receipt. In-store purchases will be taxed in accordance with the rate applicable at the point of purchase. Traditional remote purchases will be sourced at the

---

[6] For the text of the Agreement and information on the Streamlined Sales Tax Project, visit the group's website at www.streamlinedsalestax.org.

point of delivery. For digital sales, the address of the purchaser will determine the applicable rate. If such address is not known or available, the point from which the product or service is provided, or the location of the server from which the product is downloaded, will be controlling. In an attempt to minimize forum shopping, the Agreement stipulates that intermediary servers that operate as digital transfer points will be disregarded.

Currently, nine states are reported to have proposed, or intend to propose, Streamlined Sales Tax Project legislation: Indiana; Iowa; Kansas; Minnesota; Nebraska; North Carolina; Utah; Wisconsin; and Wyoming.

As expected, there does exist competing model legislation. The National Conference of State Legislators has passed its own version of the Agreement, omitting certain controversial provisions, mostly related to common product definitions.[7] In addition, several conflicting bills have been introduced in the United States Senate and House of Representatives that would allow the states to collect sales/use tax to differing degrees. It is expected that the Senate Commerce Committee will begin debating the issue in the near future.

The lack of consistent laws and definitions lend uncertainty to the future ability of the United States to establish clear tax régimes for e-tailers and consumers. To benefit from the burgeoning e-economy, concrete steps must be taken to harmonize existing sales/use tax régimes to simplify collection, compliance and administration. From the plethora of efforts and apparent meager results, it is clear that there is still a long and indecisive road ahead.

II. European Union

In June 2000, the Commission of the European Communities issued a proposal for consideration by the European Parliament and Council amending existing value added tax (VAT) rules with specific regard to digital transactions involving merchants and final consumers. In late November 2000, the EU rejected the proposal and asked the European Commission to amend the draft. In June of this year, the same basic proposal was re-introduced, with substantially the same reaction by the member states. Regardless, it is still worthwhile to analyze the proposal to understand the EU approach to this problem.

Current VAT rules are embodied in the Sixth Directive on VAT. The explanatory memorandum accompanying the proposal notes that the proliferation of e-commerce requires the amendment and evolvement of the tax compliance, control and enforcement mechanisms in effect.

In 1997, the European Commission began to explore the possible impact e-commerce would have on the EU's value added tax régime. Such study resulted in the adoption of a set of guidelines that formed the basis for further discussions as well as established the European Union's role at the October 1998 OECD Ottawa meeting on indirect

[7] The Conference's website is www.ncsl.org.

taxation (OECD Ministerial Conference "A Borderless World -- Realising the potential of Electronic Commerce").

Such guidelines provided the fundamental notions adopted by the EU's ECONFIN Council for the modification of the VAT system. The Council advocated three principal concepts. First, the existing tax structure of EU member countries should be adapted to address the realities of electronic commerce, and thus, there is no reason to impose new taxes on electronic transactions. Second, for purposes of applying VAT, electronic deliveries should be characterized as the supply of services, not goods. Third, the EU VAT régime should only apply to services consumed in Europe. The June 2000 proposal seeks to amend existing VAT rules in accordance with these principles.

Unless specified otherwise, the current VAT system does not provide for the imposition of VAT on services provided by non-EU suppliers to the EU customers. On certain B2B transactions, the EU entity is required to self-assess a VAT pursuant to a reverse charge mechanism. However, the rules do not apply uniformly to the vast array of services that comprise e-commerce transactions. Thus, many electronic services are not subject either to VAT or to the reverse charge mechanism. Moreover, only businesses are required to employ such procedure. As a consequence, services supplied by non-EU persons to private consumers in the EU are not subject either to VAT or to taxation by self-assessment. Finally, current regulations fail to provide that electronically delivered services shall be exported from the EU VAT-free.

Taken as a whole, the existing VAT structure and reverse charge mechanism may prejudice the EU supplier vis-à-vis non-EU entities, affecting the competitiveness of EU businesses and potentially limiting the growth of e-commerce within the community. Interestingly, the background section of the Commission's proposal focuses on the economic disadvantages EU e-service providers may suffer as a result of current VAT rules. However, no mention is made of any economic distortion that may be imposed on EU brick and mortars with regards to EU e-service providers.

To remedy the disparity in treatment between EU and non-EU suppliers, the proposal first defined the services subject to VAT, if supplied electronically for consideration:

- cultural, artistic, sporting, scientific, educational or similar activities, including the activities of the organisers of such activities, and where appropriate, the supply of ancillary services . . . this includes all forms of broadcasting as well as other sound and images released and delivered by electronic means;

- software: this includes for example computer games;

- data processing, and explicitly including computer services including web hosting, web-design or similar services;

- the supply of information.

Suppliers of e-services would first determine whether they were required to collect and account for VAT on a particular sale. Pursuant to existing VAT procedures, EU business consumers who are registered for VAT purposes must self-assess applicable VAT rates in accordance with the reverse charge procedure. Such registered entities are referred to as "taxable persons." If the services are provided to private consumers, however, the e-service supplier must collect VAT. Consequently, the supplier must ascertain whether its customer is a business or a private consumer. In current commercial practice, a taxable person provides its VAT registration number to the vendor. The vendor then verifies such number with the tax authorities of the member state in which the business is located or has a permanent establishment. In e-transactions, the vendor, regardless of its location, must be able to verify customer VAT registrations. The EU has already begun the process of up-dating the VAT Information Exchange System and making it available on-line.

Under the proposal an e-service provider would be held liable for the VAT on a transaction with an EU taxable person unless: 1) he acts diligently, within the standard commercial uses and practices of the sector in question; and 2) he verifies the customer's VAT registration number through a consistent, independent source, such as the VAT Information Exchange System. If the vendor satisfies these conditions, he shall not be subject to tax liability on the transaction. Such liability shifts to the customer. Thus, the supplier should keep careful record of the steps he takes to comply with these requirements.

The proposal adopted a dual approach to sourcing applicable electronic transactions. E-services would be sourced at the point of consumption if the service were provided by an EU vendor to an EU business located in another member state. In such instance, the VAT rate imposed by the member country in which the customer has its business or has an establishment to which the services are provided would be applied to the transaction in question. If the customer does not have a business or a fixed establishment, the rate of the country in which it has its permanent address or usually resides would be charged.

If the e-services were provided by an EU supplier to an EU consumer (business or private) located in the same member country as the supplier, the VAT rate of the member country in which the supplier is located would be charged. Although it appears that this is consistent with sourcing the service at the point of consumption, the proposal characterizes this approach as sourcing at the point of supply, *i.e.*, sourcing at the location of the vendor.

The proposal further addressed the tax treatment of sales by EU suppliers to non-EU customers and, conversely, from non-EU suppliers to EU customers. E-services provided by EU suppliers to non-EU customers, regardless of whether they are businesses or private consumers, shall be exempt from VAT. However, services provided by non-EU vendors to EU consumers would be subject to VAT. As discussed above, if the EU consumer is a business (a taxable person), such customer would self-assess VAT at the rate of the member state in which he has his business, the establishment to which the service is provided, his permanent address or his usual residence.

If the EU customer is a private consumer, the non-EU supplier would be responsible for collecting VAT on the underlying transaction. To facilitate compliance and to ease administrative burdens, non-EU e-service suppliers would have been required to register for VAT purposes in one of the community's member countries. Once the non-EU vendor was registered in a community member, it was deemed to have a fixed establishment in such country. All sales made by such non-EU supplier to EU private consumers would be subject to the VAT rate of the country in which the supplier is registered. Thus, in contrast to other transactions, such sales would be sourced at the intra-community location elected by the supplier. To a limited extent, this would have resulted in VAT jurisdiction shopping on the part of the non-EU vendors. It is noteworthy that the registration requirement was only imposed on non-EU vendors with annual sales to the EU exceeding 100,000 Euro.

Enforcement of provisions related to the VAT registration requirement for non-EU vendors is an obvious issue community and member country authorities shall have to resolve. Obtaining effective jurisdiction over such vendor is another. Unlike United States discussions which acknowledge the need to enter into treaties or international agreements to enforce compliance with domestic sales tax schemes, the EU appeared to be attempting to resolve the issue unilaterally by imposing registration requirements on non-EU vendors. Interestingly, the Commission's proposal alluded to the possibility of linking tax compliance to the ability to enforce intellectual property rights. "Legitimate operators will moreover wish to ensure that they have access to legal protection and remedies in respect of infringements of copyright and other intellectual property rights. To this end, they will also wish to ensure that they respect their own legal and regulatory obligations."[8]

The principal reason the proposal was rejected was the concern of members states that only low-VAT members would benefit from the non-EU vendor sales due to the jurisdiction shopping discussed above. Regardless, the EU was the first entity to make concrete proposals to resolve this nagging issue. Moreover, it is likely that the EU will be the first to actually pass consumption tax legislation and effectively implement it. Given the US federal system, even if the Streamlined Sales and Use Tax Agreement were adopted tomorrow, it would take years for the individual states to overhaul their current tax systems to allow the Agreement to function.

[3] Proposal, p. 10.