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## Electronic Commerce and Non-Resident Aliens: The Internal Revenue Service Versus International Cyberspace Transactions

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# Electronic Commerce and Non-Resident Aliens: The Internal Revenue Service Versus International Cyberspace Transactions

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## I. INTRODUCTION

{1}The year is 1999. Jack Jones has just retired from practicing civil law in the United States and has returned to his home country of Trinidad, just off the coast of South America, where he now resides. Jack has an idea to keep him busy during retirement. He made many contacts in the U.S. legal community and his work is well-respected. So, Jack decided to keep writing for attorneys in the U.S.

{2}He set up a website where he advertised legal writing for all civil law issues. The U.S. law firms send Jack the facts of a case and Jack researches the issue and prepares a written brief. The brief is returned to the U.S. law firm in exchange for a stated fee. All communications, including the transmission of the brief, are conducted over the Internet. Although simple in facts, this transaction begs a number of questions with respect to taxing Jack, a non-resident alien, on the income earned from the U.S. law firm.

{3}How can something that is as measureless, borderless and intangible as the Internet create so many problems with our taxing system? Perhaps the technology of the Internet hit too fast to allow governments and International bodies sufficient time to react. For example, could one have predicted five years ago that law students could obtain Juris Doctor degrees completely online, be eligible to write the applicable state bar exams, and be licensed to practice law upon successful completion of those exams? If someone had the foresight to state that the advancement of a Juris Doctor degree to an American Bar Association (ABA) accredited L.L.M. in International Taxation could be done through correspondence, while the student still worked throughout the day, it would have seemed unbelievable. Five years ago, most people would have certainly answered, "no!!" Yet today, all of those answers have changed.<sup>[1]</sup> In fact, not only has available technology changed, but all former rules and regulations regarding commerce, business, and tax, centering on the physical aspect of transactions, have also changed.

{4}Many parties to the taxing world have written papers on electronic commerce. A great number of these papers specifically deal with how the Internet is pushing Internal Revenue statutes to their limit in their application to certain online transactions. Electronic commerce and Internet taxation are vast areas that need examination and change. The following article deals specifically with electronic commerce, non-resident aliens, and international taxable transactions. More specifically, this paper discusses whether there are ways in which non-resident aliens, such as Jack Jones, who conducts business with the United States through electronic means, can be taxed on their income without actually stepping foot in this country. The Internal

Revenue Service and the private sector both posit their arguments for approaching this scenario.

{5}In addition, there are solutions that are yet to be considered by both sides. This paper engages in a critical analysis of some of the stronger arguments on the issue, and suggests to the courts how to interpret possible future tax law with respect to non-resident aliens conducting international Internet transactions. The issues discussed below are ready to explode onto the scene of the already-established world of international tax. However, before this issue is further examined, one must fundamentally understand what the Internet is and how it works.

### **A. The Internet: How Does This Global Communication System Work?**

{6}The Internet is only one part of the "Information Superhighway" with which society has become familiar. [2] The 'Information Superhighway' refers to all modes of electronic communication - from cable television - to satellite transmissions - to Internet transfers via telephone lines. [3] Through Internet service providers or ("ISP's"), a computer is connected to other networks of computers that carry information to any destination in the world. [4]

{7}The Internet has been referred to as a "spider web" with many different avenues available for travel from point A to point B. [5] For example, once someone has connected to America Online ("AOL") and decides to purchase a book from "Amazon.com", his information travels from point A, the computer station, to point B, "Amazon.com's" ordering database. The information leaves point A (the computer) in one language and is then broken up into recognizable "packets" of information through transmission control protocol / Internet protocol ("TCP / IP"). [6] This process of breaking-up information can be compared to a global language interpreter. No matter what language the sending computer operates under, Apple, Unix, or Windows, the information is broken down into similar packets of information that can be sent to any electronic address in the world. [7]

{8}As soon as the information is sent from a computer and broken down into familiar language, it enters the nearest "computer router." [8] Routers have been compared to postal substations, which ultimately decide how information is directed, until the information reaches its final destination. [9]

{9}The World Wide Web (the "Web") is an application of the Internet that transfers more than mere simple text. [10] The Web makes it possible to transfer text, images, video, and audio from one location to another via the Internet. [11] It is this World Wide Web that allows individuals and companies to perform transactions that were once performed through physical means.

{10}Consider the following example: ABC software company has developed an anti-virus program that has become very popular among computer users. Prior to the inception of the World Wide Web, a local computer user would either order the software from the company via mail, or go to the nearest computer store and purchase the software in person. With the advent of the World Wide Web, a computer user can access the company's website, [12] and download or 'pull' the program from the website, where it will directly load onto the user's hard drive. The user pays for the program through a credit card or some other electronic payment system. The user still has a manual for the software, in electronic format, and a warranty for the software, without the hassle of leaving his home. As will be discussed later, taxing the purchase of the software from a 'mail order' or 'store purchase' transaction is relatively simple, however, taxing the electronic sale is still open to much debate.

### **B. Applying the Internet to International Taxable Transactions**

{11}Considering this discussion, another question arises: how can these communication entities interact with the already existing laws of the Internal Revenue Service with respect to International Tax? Take the

following circumstance: suppose X (a resident of Country A) sold, leased or rented an item to O (a resident of Country B), in exchange for compensation or payment. So far, there are no confusing issues with respect to International Tax. Local tax law decides where and how the income is taxed, and any bilateral tax treaty between Countries A and B would limit X's and O's tax liability, thereby preventing double taxation.

{12}When more facts are added to this scenario, the taxing situation becomes more complex. What happens if resident X sells, leases or rents the same item, but does so through her website located in Country C. Resident O pays for this item, but the payment is made to the website in Country C and remains there. Country C does not tax income. Resident X still derives income and Resident O still receives the item, or use thereof, but neither Country A nor B are able to tax the transaction.

{13}The foregoing example is a form of what is known as electronic commerce. If two or more parties perform taxable transactions using electronic means, electronic commerce takes place.[13] Some of the ways that electronic commerce is generated are through the sale and lease of goods and products, computer software, photographs, services, health care operations, video conferencing sites, gambling sites, stock trading, and banking services.[14] Each of these types of commerce involve taxing issues with respect to income earned. However, if performed completely electronically or completely online, the taxing lines with respect to income become blurred, and the U.S. Treasury automatically becomes concerned that a large portion of revenue is not being taxed.

{14}How much of a concern is this to the IRS, Congress and Internet users? The use of the Internet and World Wide Web has increasingly expanded over the last five years and will continue to expand into the next century.[15] For example, "a survey by e-land ("www.e-land.com") of recent estimates of the number of Internet users worldwide shows a doubling every twelve months, starting at an estimated 8.5 million in 1995 and reaching over 142 million by the year 2000." [16] This translates into a vast number of taxable transactions, in the areas of commerce previously mentioned, that are currently performed without taxing implications.

{15}The U.S. Treasury, like governments all over the world, is trying to frame the Internet in a way to track taxable transactions and apply existing tax laws to those transactions. Besides the Treasury's paper on Global Electronic Commerce,[17] Congress has passed the Internet Tax Freedom Act (the "Act"), which is essentially a three-year moratorium on new taxation of Internet access, and prohibits the imposition of discriminatory taxes on Electronic Commerce.[18] According to Congress, the Act is needed "not just to give the [Inter]net room and time to grow," but also "because the [Inter]net is inherently susceptible to multiple and discriminatory taxation in a way that commerce, when conducted in more traditional ways, is not." [19] The Act also calls for the establishment of a commission [20] to study electronic commerce and "to report back to Congress after eighteen months on whether electronic commerce should be taxed, and if so, how it can be taxed in a manner that ensures such commerce won't be subject to special, multiple, or discriminatory taxes." [21]

{16}Internet users, which are comprised of individuals and companies, are also concerned with how Internet-based transactions will be processed.[22] Certainly, if a company is going to open their doors to electronic commerce, it will want to know how to properly record its taxes on any income generated.[23]

### **C. What Kinds of Taxable Transactions are Being Entered Into on the Web?**

{17}There are many residents of the United States and non-resident aliens who are taking advantage of the moratorium on Internet taxes. Imagine two circles of income; one representing residence-based income, and one representing source-based income. If you reside in the United States, the U.S. can tax your income; this is residence-based income. Moreover, if your income is earned within the geographical boundaries of a particular jurisdiction, that jurisdiction can also levy a tax on your income; this is source-based income.[24]



United States residents are generally taxed on income earned worldwide.<sup>[25]</sup> Therefore, if U.S. residents enter into taxable transactions through the Internet, the United States will tax any income generated.

{18}However, the United States taxes non-resident alien income only in certain circumstances. One circumstance involves taxation of income that is effectively connected to a U.S. trade or business. For example, if a non-resident comes into the United States and sells widgets through a U.S. business, the United States may tax the income generated by the non-resident. However, if a non-resident sells those same widgets to the same U.S. buyer from another country, the income may escape U.S. taxing jurisdiction because it is arguably earned within another jurisdiction.

{19}If the non-resident earns the income within the jurisdiction of another country, the United States would not have proper residence nor source jurisdiction to tax the income. As non-resident aliens sell, lease, or rent either goods, products, or services to U.S. buyers via the World Wide Web, this scenario becomes a reality. Thus far, the United States has been unable to classify this earned income within the residence or source circles discussed above.

{20}Although international Internet taxation affects a U.S. resident's ability to claim a foreign tax credit, mainly because U.S. residents are forever trying to classify income as a foreign source, we must focus on the non-resident aliens performing international taxable transactions over the Internet. More interestingly, if non-resident aliens are situated in a tax haven or income tax-free jurisdiction, the non-residents are effectively using U.S. markets to generate tax-free income - the precise kind of problem that the U.S. Treasury is trying to prevent. The remainder of this paper examines the impact of non-residential alien taxation. Section Two outlines different theories that have developed, either judicially or academically, to explain Internet transactions. Such theories include the analogy concept, modification concept, change concept, and regulation concept. Section Three discusses the origin of the source rules, and how the basic, traditional concepts of source can apply to modern electronic transactions. This section introduces the distinction between the transfer of services and the transfer of property in an electronic atmosphere. Section Four reviews income generated by electronic commerce and the traditional FDAP concepts (i.e., Fixed or Determinable, Annual or Periodic income). The Section further discusses the transfer of property where there is no United States trade or business. Section Five studies income generated by electronic commerce and the traditional "United States trade or business" concepts. This section outlines the problem of non-residents performing taxable transactions on the Internet with U.S. customers, without engaging in a U.S. trade or business in the taxable statutory sense. It describes an alternative whereby an entity may have a deemed U.S. trade or business through a "virtual presence." Section Six proposes a number of responses on how the government and private sector should proceed regarding electronic commerce and related taxing issues. This section states the goals of the United States Treasury in forming policies directed toward the future of electronic commerce, and suggests the extent that the Treasury should listen to the recommendations of the private sector, which are obviously made from a "pro taxpayer" perspective. Finally, Section Seven asserts the need for global cooperation in managing electronic commerce, and discusses the possible role of the Organization for Economic Cooperation and Development ("OECD") in achieving this cooperation among all the countries which provide Internet access.

## **II. THEORIES ON DEALING WITH TAXABLE INTERNATIONAL TRANSACTIONS**

{21}Commercial use of the Internet continues to expand. When the Mosaic browser was introduced in 1993, Congress was not too concerned with Internet use.<sup>[26]</sup> However, as more and more people began using the Internet, Internet issues started appearing in court cases.<sup>[27]</sup> Initially, certain members of the judiciary were uncertain how to resolve these "electronic" issues.<sup>[28]</sup> For example, *It's In The Cards, Inc. v. Fuschetto*<sup>[29]</sup> was a Wisconsin case involving allegedly defamatory statements that were posted onto a computer bulletin

board. The court stated that the magnitude of computer networks, and the consequent communications possibilities did not exist when the libel law statutes were enacted.<sup>[30]</sup> The Court instructed, "applying [these statutes] to cyberspace . . . entail[ed] rewriting statutes that were written to manage physical, printed objects, not computer networks or services."<sup>[31]</sup> The court further reasoned that it was for the legislature, not for the court, to address the application of libel laws to the "Information Superhighway."<sup>[32]</sup> Similarly, *Stratton Oakmont Inc. v. Prodigy Services Co.*,<sup>[33]</sup> involved allegedly libelous statements posted on computer bulletin boards. The *Stratton* court found the Internet was "a developing area of the law, in which it appear[ed] that the law has thus far not kept pace with the technology, so that there was a real need for some precedent."<sup>[34]</sup>

{22}After these initial decisions, a number of theories developed concerning Internet issues. These theories have been applied to electronic commerce over the last six years. The first method analogized Internet transactions to physical transactions, and decided the case on the law that applies to the physical transaction comparison.<sup>[35]</sup> Subsequently, additional thought included modifying certain laws to deal with electronic transactions.<sup>[36]</sup> The third method concerned changing the laws altogether and forming a body of law that specifically addresses the Internet.<sup>[37]</sup> The fourth, and most recent method, dealt with regulating the Internet itself by placing restrictions and requirements for any and all Internet use associated with commerce.<sup>[38]</sup> The next four sections survey some of the ways that these theories apply to Internet transactions.

### **A. The Analogy Concept**

{23}In 1996, as more and more legal issues surfaced with respect to the Internet, "courts routinely attempted to analogize the Internet to other legal systems, activities, and places."<sup>[39]</sup> In a number of cases, courts equated the Internet with " 'this' legal system" or " 'that' particular activity."<sup>[40]</sup> The underlying activity was secondary to the courts; the courts simply "appl[ied] existing legal doctrine to the Internet as a whole. . . ." <sup>[41]</sup>

{24}In April 1996, a Connecticut District Court decided an electronic jurisdictional issue using current law in *Inset Systems Inc. v. Instruction Set Inc.*<sup>[42]</sup> Inset Systems, a Connecticut company, brought a trademark infringement action against Instruction Set, a Massachusetts company, arising out of the use of the Internet domain name "Inset.com."<sup>[43]</sup> Inset Systems was the owner of a federal trademark entitled "Inset."<sup>[44]</sup> The question before the court was whether Instruction Set's activity on its website properly brought itself into the jurisdiction of Connecticut via the state's long-arm statute, thereby meeting the standard established by the U.S. Supreme Court in *World Wide Volkswagen Corp. v. Woodson*.<sup>[45]</sup> The court found jurisdiction, and compared the website to a "continuous advertisement" that purposely directed its advertising activities toward Connecticut on a continuous basis in a manner that the company reasonably could have anticipated being haled into court there.<sup>[46]</sup> This case outlines the dangers that arise when making an analogy with respect to Internet transactions. Although comparing an Internet website with a continuous advertisement is not entirely incorrect, in that the website advertises goods and services on a continuous basis, the analogy alone, without taking any other factors into consideration, leads to inequitable results. First of all, the "purposefully directing" test outlined in *Volkswagen* was stretched to its outer limits in this case.<sup>[47]</sup> Almost everyone dealing with commerce of any type has created a website. Websites can be viewed from every possible jurisdiction in the world. Could you imagine what would happen if all of these companies and individuals were under every jurisdiction for legal purposes? The use of the Internet would be impeded, as companies and individuals fear arbitrary jurisdictional rules.

{25}The defendant in *Inset Systems* claimed that personal jurisdiction was lacking because the Massachusetts corporation did not " 'conduct business in Connecticut on a regular basis,' " and did " 'not maintain an office in Connecticut, nor d[id] it have a sales force or employees in the State.' " <sup>[48]</sup> However, the *Inset* court failed to address the issue of an office in Connecticut or the question of agents and/or employees within the State. <sup>[49]</sup> The court only concentrated on the website reaching Connecticut Internet users, therefore causing Inset to purposefully avail itself of the privilege of doing business with Connecticut.<sup>[50]</sup> By applying straight

advertising laws to Internet websites, the court essentially lowered the threshold of the minimum contacts limitation. They did this by subjecting people, who merely operate websites, to various jurisdictions of forum states without looking to specific types of contact (i.e. selling products or services), that may exist within the particular state in question. The straight analogy concept was not the best way to handle Internet issues, however, it did stimulate the court's thinking about the issue in other ways.

{26} Although a number of cases were consistent with *Inset's* "analogy" concept, *Bensusan Restaurant Corporation v. King*<sup>[51]</sup> served as an important exception. The case involved a small Missouri night club called "The Blue Note," owned by Richard King, which established a website promoting the club's activities and events.<sup>[52]</sup> New York City was also home to a club called "The Blue Note," which was operated by Bensusan Restaurant Corporation,<sup>[53]</sup> and enjoyed world-wide reputation as a top jazz club. Bensusan brought a trademark infringement action against Missouri's "Blue Note."<sup>[54]</sup> King knew of the New York club's reputation and argued that, in addition to the disclaimer placed on his website, the site was passive, in that no products from Missouri's club were being brought into the State of New York, and all purchases took place within Missouri.<sup>[55]</sup>

{27} The court ruled that the website was not causing any infringing activity in New York, and further held that "the mere fact that a person can gain information on the allegedly infringing product is not the equivalent of a person advertising, promoting, selling, or otherwise making an effort to target its product in New York."<sup>[56]</sup> This led the way for courts to rethink the *Inset* line of cases and to treat the Internet as more than a "comparison" to already decided physical cases.

## **B. The Modification Concept**

{28} As opposed to simply analogizing Internet transactions with already decided physical comparisons, courts began to take existing laws and modify them to fit Internet scenarios. In the case of *Zippo Manufacturing v. Zippo.com*,<sup>[57]</sup> the Pennsylvania-based manufacturer of "Zippo" brand lighters brought a trademark infringement action against "Zippo.com," a California-based news service that did business in Pennsylvania.<sup>[58]</sup>

{29} The courts modified a form of "constitutional balancing" in reaching the jurisdictional issue, by stating that "our review of the available cases and materials reveal that the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet."<sup>[59]</sup> This sliding scale approach is similar to other personal jurisdiction tests. At one end of the spectrum, where the "defendant enters into contracts with residents of a foreign jurisdiction that involve knowing and repeated transmissions of computer files over the Internet," jurisdiction is found.<sup>[60]</sup> At the other end of the spectrum, where the defendant simply *posts* information on an Internet website which is accessible to users in foreign jurisdictions, jurisdiction is not proper.<sup>[61]</sup> The court, in essence, stated that, "a passive Website [sic] that does little more than make information available to those who are interested in it is not grounds for the exercise of personal jurisdiction."<sup>[62]</sup>

{30} One must now wonder: how does this apply in a tax sense? If a passive website is not enough to cause a court to "haul the owner/company into the court's jurisdictional reign," how can the Internal Revenue Service ever make an argument that the same website has a physical presence within the United States, or that it serves as a permanent establishment, or United States trade or business? These are important issues to be discussed later in this paper.

{31} Another relevant case, *People v. Lipsitz*,<sup>[63]</sup> found the defendant guilty of fraud for using the Internet to fraudulently sell magazines to U.S. customers.<sup>[64]</sup> The court reasoned that the Internet as a medium is irrelevant in the case of personal jurisdiction.<sup>[65]</sup> The focus is primarily upon the location of the messenger/seller and whether the messenger/seller delivered what was purchased.<sup>[66]</sup> Here, the court found



jurisdiction notwithstanding the use of "cyberspace" as a medium to convey and perpetrate the crime. Obviously, courts were becoming more familiar with Internet issues by seeing through the medium, and looking to the underlying action of the defendant.

{32} Scholars and U.S. government officials also took this "modification approach" to Internet transactions. Many articles that assessed the specific impact of the Internet on activities, such as securities and banking law, concluded that the arrival of the Internet did not necessarily mandate a complete revision of existing laws, but rather, a " 'relatively modest updating and streamlining.' " [67] In the U.S. government report, *A Framework for Global Electronic Commerce*, the ideas of applying modified or expanded versions of current law on Internet transactions was appealing in order to avoid new and unnecessary regulations that would ultimately prevent the growth of the Internet. [68]

### C. The Change Concept

{33} In the academic and governmental spheres, many suggest that the current laws should not be analogized, nor even modified, to deal with Internet transactions. Some critics argue that the Internet is in need of its own law and its own set of regulations to govern electronic transactions. Scholars, such as David G. Post [69] and David R. Johnson, [70] argue that, "geographic, physical borders are a necessary precondition for effective and legitimate lawmaking because rules are enforced and legitimized by the general public within these borders." [71] They further "advocate[] conceiving of cyberspace as a separate 'place' governed by its own legal framework." [72] Other scholars have "called for the negotiation of an international treaty that would remedy the conflict of laws and disputes that are sure to arise from conflicting national legal frameworks." [73] Additionally, some scholars even call for "the development of an Internet code of conduct that would attach to [a] user[']s Internet Service Provider ("ISP") agreements, [74] or alternatively, [for] using the ISP's themselves as contractual gatekeepers." [75]

#### *1. The Provision of Services and the "Change" Concept*

{34} There are two major areas of electronic commerce where this concept of change is most prevalent: (1) the provision of services; and (2) the sale of intangible products. "Service providers, such as bankers, securities dealers, lawyers, and health care professionals, have traditionally" provided their services within the physical presence paradigm. [76] In a recent law review article, Hardy writes, "rendering those services generally necessitated the service provider's entry into the recipient's jurisdiction, or alternatively, the recipient's entry into the jurisdiction of the service provider." [77]

{35} With the use of the Internet, service providers can presumably establish a virtual presence in all jurisdictions without physically entering any one jurisdiction. [78] "Further, if one's business involves the provision of information, such as the legal profession, consulting services, or advertising, or the sale of intangibles, such as securities, insurance, or cash, a website can be the vehicle for delivering th[e]se services," and takes on the characteristics of a carrier medium. [79] For example, the legal services industry is the topic of many debates concerning the "virtual" practice of law. (80) In the case of *Birbrower v. Superior Court*, [81] a California-based client sued a New York-based law firm for malpractice. The court noted that the primary issue was "whether the unlicensed lawyer [was] engaged in sufficient activities in the state, or created a continuing relationship with the California client that included legal duties and obligations." [82] The court further noted its jurisdictional concerns:

[O]ne may practice law in the state in violation of section 6125 [unauthorized practice statute] although not physically present here, by advising a California client on California law in connection with a California legal dispute by telephone, fax, computer, or other modern technological means. Conversely, although we decline to provide a comprehensive list of what activities constitute sufficient contact with the state, we do reject the notion that a person

automatically practices law "in California" whenever that person practices California law anywhere, or "virtually" enters the state by telephone, fax, e-mail, or satellite. . . We must decide each case on its individual facts.<sup>[83]</sup>

{36} Just as the determination of whether a person practices law in a particular state through online services is a fact-specific inquiry, the issues concerning whether the income gained from online services is subject to U.S. taxation also needs to be analyzed upon the facts available.

## *2. The Sale of Intangible Products and the "Change" Concept*

{37} The Internet has changed the way that "intangible products, [such as] software, music, videos, and information contained in books, magazines, and other periodicals," are sold and exchanged.<sup>[84]</sup> Generally, these products are sold in tangible forms such as compact discs, books, video tapes, floppy disks, etc. However, today, sellers and buyers can perform their respective commercial transactions completely online from "anywhere in the world, quickly and inexpensively."<sup>[85]</sup>

{38} There are three major types of legal regulation that require modification in order to deal with the sale of intangibles: (1) regulation governing the sale of explicitly inappropriate information that is normally subject to some kind of censorship; (2) regulation governing intellectual property; and (3) regulations governing local and international taxation.<sup>[86]</sup> To stimulate thought in these areas, the kinds of changes needed with respect to international taxation will be considered.

{39} The U.S. Treasury is concerned with four major barriers to taxation imposed by electronic intangible sales:

- (1) "[T]he buyer and the seller are often difficult to identify in transactions that occur in cyberspace . . .";<sup>[87]</sup>
- (2) "[T]he location of the transaction is often difficult to identify given the geographic [reach] [] of the Internet";<sup>[88]</sup>
- (3) "[T]ax regulators frequently lack enforcement powers to compel disclosure of information pertaining to Internet transactions where at least one party is located offshore";<sup>[89]</sup>
- (4) "[E]lectronic [C]ommerce often does not leave a 'paper trail,' complicating tax investigation even further."<sup>[90]</sup>

{40} According to some scholars and governmental officials, the foregoing issues, dealing with the provision of services and the sale of intangibles, necessitate some form of change from the way that normal transactions were once treated. These issues, along with suggestions for the application of new laws and theories, will be examined and factually analyzed below.

## **D. The "Regulation of the Internet" Concept**

{41} This concept focuses on "regulat[ing] the Internet itself, [rather than] the underlying activities discussed in the prior categories."<sup>[91]</sup> Regulators who proffer this concept include, "governments and Internet groups" who are "develop[ing] internationally accepted technical standards," the Organization of Economic and Commercial Development ("OECD"), "Internet Assigned Numbers Authority ("IANA"), Internet Architecture Board ("IAB"), Internet Engineering Task Force ("IETF"), Internet Society ("ISOC"), and the International Ad Hoc Committee ("IAHC")."<sup>[92]</sup> For example, the OECD published an article entitled *Dismantling the Barriers to Global Electronic Commerce*, where their policy initiatives included:

- (1) to identify major policy problems, their potential solutions, and organizations able to develop and implement them;
- (2) to take stock of the initiatives currently under way and contribute to ensuring consistency and effective co-ordination among them; and
- (3) to develop a consensus between business and government as to some of the guiding principles that will constitute a framework for electronic commerce policies.<sup>[93]</sup>

{42} It is the author's opinion that through regulation of the Internet itself, which does not change in form or use from jurisdiction to jurisdiction, the majority of electronic commerce issues can be solved. Organizations such as the OECD will become indispensable in reaching a global solution to the electronic commerce taxing problem. Through working with governments and business and through international cooperation, both public and private sector needs and concerns regarding electronic commerce can be addressed via Internet regulation that will ultimately benefit all parties involved.

### **III. INCOME AND ELECTRONIC COMMERCE: ASSESSING THE FACTS**

#### **A. Services Income**

##### *1. How does Electronic Commerce Impact Traditional Forms of Services Income?*

{43} "Services income" is generated when the payee performs services for the payor, and the payor compensates the payee for these services.<sup>[94]</sup> The general rule suggests that the place where the services are rendered determines the source of the income. Therefore, gross income from sources within the United States includes payment for services *rendered in the United States*, subject to a limited exception.<sup>[95]</sup>

{44} In the realm of electronic commerce, it is difficult, if not impossible, to link an item of income with a specific geographical location.<sup>[96]</sup> Some critics suggest that performance of services should be considered to have taken place where the services are actually performed, or where the benefits of the service are actually felt, such as, where the customer utilizes the service.<sup>[97]</sup> Both performance and utilization jurisdiction have strong claims to the services income.<sup>[98]</sup> "The performance jurisdiction provides the location from which the service[s] may be conducted," while the utilization jurisdiction supplies the income through consumers and varying markets.<sup>[99]</sup>

{45} This "benefit source" rule has merit with respect to electronic commerce because it ignores the complexities of tracing electronic transmissions through different geographical locations, and concentrates on where the fruits of the services are being exploited and utilized. In the final section of this paper, proposals with respect to "services performed online" are provided as alternatives to current code and regulation treatment.

{46} However, the "benefit source" rule runs contrary to the decision in *Commissioner v. Piedras Negras*,<sup>[100]</sup> which suggests that the "source of the income is the situs of the income-producing service" (i.e., the income producing service is the place of signal transmission).<sup>[101]</sup> This rationale and holding suggest that the jurisdiction to tax lies with the country from where the signal was sent.

{47} What are the dangers of either rule? If the United States employs a situs-based source rule for electronic services, like where the services are originally sent from, U.S. exporters of electronic data could face various forms of double taxation.<sup>[102]</sup> If other countries employ a "place of utilization" source rule while the U.S.

has a "place of performance" source rule, U.S. exporters could face either residence/source or source/source taxation.<sup>[103]</sup> Source/source based taxation would not receive the benefit of a foreign tax credit that may be given to a taxpayer with a residence/source taxation problem.<sup>[104]</sup> Currently, the International communications income rules are the closest rules to electronic services being provided via the Internet.

## 2. *Where are the Services being Performed?*

{48} Does a non-resident need to be present in the United States to be performing services within the U.S.? Under Internal Revenue Code § 863(e), a non-resident can send information from one country (performance jurisdiction) to an individual in another country (utilization jurisdiction) who will ultimately benefit from those services.<sup>[105]</sup> As outlined, international communications income includes "all income derived from the transmission of communications or data from the United States to any foreign country (or possession of the United States) or *from any foreign country or possession of the United States back to the United States.*"<sup>[106]</sup> In general, "[i]n the case of any person other than a United States person, any international communications income shall be sourced outside the United States."<sup>[107]</sup> However, the special international communications income sourcing rule states that "[i]n the case of any person (other than a United States person) who maintains an office or other fixed place of business in the United States, any international communications income [is] attributable to such office or other fixed place of business shall be sourced in the United States."<sup>[108]</sup>

## **IV. INCOME AND THE CONNECTION WITH A U.S. TRADE OR BUSINESS**

### **A. Creating a U.S. Trade or Business Through Electronic Commerce**

{49} Recall that if taxpayers are not U.S. residents, the United States still retains taxing jurisdiction over them if the income earned is effectively connected with "a United States trade or business."<sup>[109]</sup> The following are the factors of a U.S. trade or business: (1) taxpayer must be in business; (2) taxpayer must have significant U.S. activity; (3) taxpayer conducts business directly or through an agent; (4) the activity has the characteristics of a business; and (5) whether the U.S. activity would be undertaken absent the foreign business to which it is related.<sup>[110]</sup>

{50} It has been decided that sales in the United States on a regular basis constitutes *significant activity* that gives rise to a United States trade or business.<sup>[111]</sup> This threshold is met when a foreign taxpayer is present in the United States to demonstrate its product and solicit orders without a U.S. office.<sup>[112]</sup>

{51} This scenario prompts the question whether a website or use of a server constitute a U.S. trade or business? Currently, there is no answer available to this query. The U.S. Treasury Department acknowledges the possibility that the use of a server to generate income is not a significant element in determining whether a U.S. trade or business exists.<sup>[113]</sup> However, U.S. taxing authorities should look carefully toward expanding the scope of a U.S. trade or business with respect to servers and websites because of the potential loss of tax revenue, and the potential unfairness caused by individuals carrying transactions that would be taxed in the physical world, yet evade taxes in the digital world.

### *1. Fixed Place of Business through the Telecommunications Network*

{52} As stated earlier, Internet service providers host a number of websites for a number of different entities, such as individuals, corporations, partnerships. The Internet service provider (the "server") or the website could be located anywhere, which poses difficulty in sourcing income that is generated through their use. The following provides an alternative that narrows the income generated through the use of a website to a



particular source. In essence, if an entity's website has established virtual contact with another entity, and some transaction is performed as a result of that contact which may be subject to U.S. taxing laws, the contact is deemed a "virtual establishment" [114] for U.S. trade or business purposes. Thus, any income arising from such contact is effectively connected with a U.S. trade or business.

{53} Websites are located in cyberspace and any policy to tax source income generated by a website that references the website's location is impracticable. Therefore, the location of the website should be irrelevant to U.S. taxing laws. However, websites are registered to certain individuals, corporations or partnerships. For example, when a website ends in ".com," it generally refers to a particular company that has a definite location. Thus, the first rule in this "virtual establishment" realm is to look through the website to see to whom the website is registered. If there are current registration problems for websites, such as individuals not registering or providing information about their website, the matter can be resolved by mandating through ISP's that all websites provide the bare minimal information required to operate within the Information Superhighway.

{54} The second rule explains the virtual contact mentioned above. This theory suggests that the virtual connection, albeit temporary, creates a "virtual establishment" that allows the seller and the U.S. customer to perform a sales transaction of, for example, a computer program, which would be recognizable and taxable under the Internal Revenue Code. In other words, this "virtual establishment" would satisfy the U.S. trade or business requirement and any sales, services, or manufacturing income would be effectively connected income under I.R.C. § 864(c)(3). [115] Although in theory, the virtual establishment, as a U.S. trade or business, tends to bring income earned through websites into U.S. taxing jurisdiction, it is difficult to apply. At best, the U.S. government could mandate that all websites used for business transactions must be registered. This registration would require certain information be revealed that would identify the true owner of the website.

{55} This theory, however, does not solve the problem of compliance and administration. For example, the question of how the U.S. tracks the virtual connections made is left unanswered. Further, if the U.S. could track these connections, how would the tracker know which connections are used for business purposes? Although the self-assessment tax system would, in theory, account for income earned through the use of websites, the compliance for reporting purposes must be thorough enough to work, yet, simple enough for taxpayers to understand. Perhaps income that is earned through the use of a website can have its own class, and the U.S. Treasury could devise regulations on how to account for such income. Although the foregoing theory has no backing substance in the U.S., it allows taxing authorities to think about the interplay between current tax laws and the workings of the Internet.

## *2. Fixed Place of Business Through an Agency Relationship*

{56} Arguably, forms of "virtual feedback" have the same characteristics of a dependent agent in the United States who helps a seller improve his business. Forst speaks of "intelligent agent" software that could essentially provide all of the services of an agent completely online. [116] "Intelligent agent software or bots (shorthand for robots) . . . could be located at the site of the server [and could] enable the electronic transaction to consist more of receipt and delivery of information." [117]

{57} The issue that intelligent software brings up is whether the presence of software in one country, acting as an electronic agent of a resident of another country, can give rise to a permanent establishment or fixed place of business in the first country. Arguably, the seller has a virtual agent in the U.S. by way of the software. If the United States adopted this rationale, this idea of "virtual agency" could be used to establish a United States trade or business for non-resident aliens conducting business completely online.

## *3. Fixed Place of Business through the Performance of Services*

{58}As stated above, [118] any non-resident alien individual who performs personal services within the United States is engaged in a trade or business within the United States and their income from sources within the United States, including compensation, is subject to tax. [119] The arguments that support the performance of services in the U.S. are outlined above. Although not decided, creating a virtual presence and sourcing services to where this virtual presence is located becomes a possible alternative to the rules outlined above, with respect to place of transmission or place of consumption.

{59}Some jurisdictions may be tempted to regard the effects of advanced communications technology as giving rise to "virtual presence" and, therefore, deemed actual presence for tax purposes. Although video conferencing would not seem to go beyond telephone communications, the presence of a camera say in an operating room would allow a surgeon many miles away to take a very active part in the operation. [120]

#### *4. International Communications Income Revisited*

{60}As stated, if the communications that originate in Costa Rica and proceed to the United States can be attributed to a U.S. office or other fixed place of business, the income would be sourced in the United States. Why is this important? The United States could only tax the seller if the income is sourced in the United States through FDAP, or effectively connected income principles. Current law has not decided whether the seller, with a website in the U.S. selling a product, has a fixed place of business. Therefore, the seller has no immediate worries of being taxed on a net basis in the U.S. on his income. However, if the United States adopts any of the above mentioned theories on what constitutes a U.S. trade or business, virtual connections between website and end-users could constitute a U.S. trade or business and non-resident aliens would be in danger of incurring liability for U.S. tax on their income.

#### **B. Electronic Commerce and Net v. Gross Taxation**

{61}In review, if a non-resident alien has fixed or determinable, annual or periodic, income that has its source in the United States, the U.S. can tax the income. On the same note, if a non-resident alien has a U.S. trade or business, and their income has its source in the United States, the U.S. can tax the income. Further, if a non-resident alien has a U.S. trade or business and their income is effectively connected with the U.S. trade or business, the U.S. can tax the income.

{62}The first issue that must be discussed at this point is whether the non-resident alien can be taxed at a flat thirty-percent rate on their gross income, FDAP items, or whether the non-resident alien can be taxed at graduated rates on their net income, non-FDAP items. The second issue that must be discussed is whether electronic commerce changes the traditional rules governing net versus gross income.

##### *1. Net v. Gross: FDAP Items*

{63}Generally, an FDAP item of income is taxed at a flat thirty-percent rate on the taxpayer's gross income. In order for an FDAP item of income to be taxed at the graduated rates under §§ 1 and 11, the taxpayer first needs to have a U.S. trade or business, and there needs to be an actual connection between the FDAP item and the taxpayer's United States trade or business. [121] There are two tests that will draw the necessary connection: (1) the asset use test; and (2) the business activities test.

##### *a. Asset Use Test, and Electronic Commerce*

{64}Assuming that the seller has a U.S. trade or business through his virtual presence on the U.S. telecommunications system, will his FDAP items of income, sale, lease, rental, royalty, be taxed on a gross basis (thirty-percent withholding tax) or a net basis (graduated rates)? The asset use test suggests that if the FDAP item of income is derived from assets used in or held for use in the conduct of a U.S. trade or business, the FDAP item will be deemed "effectively connected" to the U.S. trade or business of the taxpayer, and will

be subject to U.S. graduated tax rates on a net basis.<sup>[122]</sup>

{65}In order to better understand this test, an assumption must be made. Assume that the United States government has adopted a rule that the exploitation of the virtual connection between the website and the hard drive of the U.S. customer, regardless of location of server or website, constitutes assets in the U.S. that serve the business activities of the taxpayer. Under this assumption, there is an FDAP item of income, a sale of intangibles, and a U.S. trade or business. Arguably, the income here, in the form of sales proceeds, is derived from assets used in the conduct of the U.S. trade or business by exploitation of the virtual connection.

{66}In applying the asset use test to the above scenario, it is crucial to discuss whether the seller has an asset that is held for the principle purpose of promoting the present conduct of the trade or business in the United States. Recall that the seller relies on his website to deliver the product to the end-user. The seller needs to update his website in order to properly send the product to the U.S. customers.

{67}The seller's homepage arguably constitutes an asset that he is holding to promote the conduct of his United States trade or business via the Internet. An asset is defined as property of all kinds of a person.<sup>[123]</sup> The homepage is an intangible asset that is arguably invaluable to the seller's business; for, without the homepage, proper transfer of the product would not occur. With these assumptions, we therefore have income that is effectively connected to a U.S. trade or business, and that is subject to net taxation.

#### *b. Business Activities Test, and Electronic Commerce*

{68}Once again, assume there is an FDAP item of income (i.e., a sale of intangibles), and a U.S. trade or business. In applying the business use test, the results do not drastically change from the above asset use test. The business activities test applies if the activities of the U.S. business by exploitation of the virtual connection are a material factor in the realization of the income, gain, or loss.<sup>[124]</sup> In this case, it is argued that the establishment of the virtual connection is the means used to transfer the product to the U.S. customers. Without the virtual connection, there would be no transfer, and thus, no income. Therefore, following these arguments, the activities of the U.S. business are a material factor in the realization of income, thus satisfying the business use test, and subjecting the income to net taxation. Would the U.S. Treasury be pleased with this answer? Most likely, the U.S. Treasury would be dissatisfied. If business use of the Internet continues to grow into the Twenty-First Century, there is a possibility that all business commerce will be conducted in electronic format, which may effectively undercut the personal services definition found in I.R.C. 864(b).<sup>[125]</sup> In order to avoid losing tax revenue, the United States needs to: (1) modify the tax definition of a U.S. trade or business; (2) distinguish source from residence base taxation; and (3) distinguish property from services within the realm of electronic commerce.<sup>[126]</sup>

## **V. HOW CAN THE UNITED STATES OBTAIN TAXING JURISDICTION OVER INTERNATIONAL INTERNET TRANSACTIONS? PROPOSED RESPONSES**

### **A. The Issues: (1)Source v. Residence; (2)Property v. Service; (3)U.S. Trade or Business**

#### *1. Source v. Residence*

{69}In the U.S. Department of Treasury article *Selected Tax Policy Implications of Global Electronic Commerce*, the Treasury favored a residence-based taxation for electronic transactions.<sup>[127]</sup> The Treasury commented on the status of tax treaties and stated that, for many types of income, the "residence country

[has] an unlimited right to tax income, while limiting or eliminating the source country's right to tax." [128] This policy has merit because the source of an electronic Internet transaction can be difficult, if not impossible, to track.

{70} One of the types of income where the United States has relied exclusively on residence base taxation is international shipping and air transportation income. [129] The OECD model treaty provides that profits from the operation of ships and aircraft in international traffic shall be taxable only in the state in which the place of effective management of the enterprise is situated. [130] The U.S. model treaty confers the exclusive taxing right on the state of residence. [131] The U.S. explains this decision by stating, "since entities engaged in international transportation activities normally will have many permanent establishments in a number of countries, the rule avoids difficulties that would be encountered in attributing income to multiple permanent establishments." [132]

{71} Although resorting to residence base taxation for electronic transactions is a somewhat "easy fix" because as most taxpayers have a place of residence, the idea distorts the policy of taxing non-residents who capitalize on U.S. markets. Re-examining *Commissioner v. Piedras Negras*, [133] the court determined that the source of a person's income is the site of the taxpayer's income producing activity. [134] In that case, the court determined that the source was the transmission of the electromagnetic waves. [135] In a recent article, David Forst explained that [136] the source in *Commissioner v. Piedras Negras* was not the transmission of the electromagnetic waves, because if the signals were sent in a distorted form, there would be no income generated. [137] Instead, the source was the site of the person's income producing activity, weighing many factors such as: (1) where the program was developed; (2) where the ultimate user was located; and (3) where the ultimate beneficiary was located. [138] If the United States could visualize a "bigger picture" with respect to the current source rules and develop a sound balancing test of the factors mentioned in the previous sentence, they may be able to re-source income in the United States, and therefore, obtain taxing jurisdiction over that income.

{72} What is the impact of this approach? First of all, the analysts are creating the term "international electronic information services." There is currently no sourcing law that governs this new term. If this new type of income is adopted, Congress will have to create a sourcing rule for non-resident aliens that coincides with the sourcing rules that already exist in the international context, respecting the policy of neutrality. However, if a similar definition of "international electronic services" income was used for non-residents, the seller's income, as personal services income, would fall under this new category, which seems extremely broad within the electronic commercial realm. Further, there is no justification for the percentage breakdown of seventy-five to twenty-five. This also needs to be examined in the interest of following the principle of neutrality.

## (2) *Property v. Services*

{73} In the U.S. Treasury's recent report on electronic commerce, the government commented on the problems that arise with respect to treating a transaction as a sale of property, tangible or intangible, or treating the transaction as a personal service. [139] The government gave the example of a transaction "involving the performance of professional services [that] may result in the provision of a letter or other document." [140] The government even refers to the "incidental test" mentioned above, with respect to property and services, by stating that, "the aspect of the transaction consisting of the provision of the tangible property is treated as incidental to the performance of the services." [141]

{74} The primary reasons for the distinction between property and services is to determine the source of income for non-residents paying tax in the United States, and for U.S. residents looking to maximize foreign source income for purposes of the foreign tax credit. [142] The "incidental test" described above involves separating the property from the service, and weighing each part with the overall purpose, or primary



purpose, of the transaction. Within the confines of the transfer pricing regulations of the Internal Revenue Code, there is a similar test that deals with rendering services in connection with the transfer of property.  
[143]

{75}"Where tangible or intangible property is transferred . . .and services are rendered by the transferor to the transferee in connection with the transfer . . .a separate allocation with respect to such services shall not be made. Services are rendered in connection with the transfer of property where such services are merely ancillary and subsidiary to the transfer of property. . . . Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact." [144]

{76}In the new regulations dealing with the transfer of computer programs, there is a provision dealing with services that states, "[t]he determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in (b)(1) of this section [transfer of a copyright right or copyright article] is based on all the facts and circumstances of the transaction. . . ." [145]

{77}Similar to the stated tests above, this article suggests a primary purpose test, where the primary purpose of the transaction governs whether there is the performance of personal services, or whether there is a sale of property. Further, under the regulation's facts and circumstances test, the result does not necessarily differ. Therefore, the seller will arguably be transferring services as opposed to property, and the income will be based on the place of performance principles outlined above.

{78}If the line between property and services is less clear, and both are transferred in the same transaction, the I.R.S. can look to the same facts and circumstances test above, or a similar ancillary test, as stated in the transfer pricing regime. If the property is ancillary to the services provided, the transaction will be sourced as a personal service transaction, as opposed to the sale of tangible or intangible property. This allows the U.S. to properly classify transactions and to achieve the tax neutrality desired between electronic and physical mediums.

## *2. U.S. Trade or Business*

{79}The U.S. Treasury white paper further discusses the U.S. trade or business standard with respect to electronic commerce. [146] The term "United States trade or business" was developed with physical commerce in mind. The paper suggests that electronic commerce is the furthest concept from anything physical because business entities can be located anywhere in the world and still transact and collect income from U.S. customers without being physically present in the United States. [147] The paper further explains that the mere solicitation of customers over the Internet, even if it results in the sale of goods, will not rise to the level of a U.S. trade or business. [148] The Treasury contrasts this with foreign individuals maintaining a computer server in the United States which may give rise to sufficient contacts to create a U.S. trade or business, but cautions that individuals can change computer servers, and therefore, computer server locations at will. [149] The overall effect of the paper's discussion of the U.S. trade or business designation is vague and needs to be developed in order to properly tax income on a net basis, as opposed to a gross thirty-percent tax.

## **VI. Conclusion**

{80}The Internet is changing the way that individuals are doing business. Many foreigners have access to the markets of the United States without being physically present in the U.S. Although this creates growth in the global economy, the traditional taxing jurisdiction of the United States is being eroded through this new type of commerce. This paper has outlined major issues with respect to electronic commerce and how the

government should modify and/or extend current concepts and code provisions to deal with these issues. The major issues discussed in the paper dealt with: (1) source versus residence base taxation; (2) property versus services; and (3) the concept of a U.S. trade or business.

{81}Other than the regulations dealing with computer software, there are no specific rules governing the source of electronic Internet transactions. Some have suggested that we source electronic transactions according to the taxpayer's residence. Although this eliminates some very apparent problems with electronic sourcing, it does not support the notion that non-residents should be taxed when they profit from a business conducted with U.S. resources and U.S. markets. A better test for Congress to consider is a balancing test based upon the characteristics of the income. In balancing these characteristics, the true source of the income is unveiled and the U.S. is able to bring more of this non-resident income within its taxing jurisdiction.

{82}Yet another issue that raises concern with Internet transactions is the classification of the income itself. Whether the income stems from the sale or lease of property, or from the performance of services, determines how, and to what extent, the income is taxed. The Internal Revenue Code classifies the transfer of software as property in regulation 26 C.F.R. § 1.861-18 (1999). These regulations apply a facts and circumstances test with respect to electronic services versus property. In certain transactions, services are sometimes the primary purpose of the transaction, while the property serves as a mere mode of transport incidental to the service provided. In these circumstances, the I.R.S. should distinguish between services and property to better classify income, and better equate electronic transactions with physical ones.

{83}The third major issue deals with the concept of a U.S. trade or business. Using a portion of the U.S. telecommunications system, the virtual connection between the website and the end-user, does the seller have a U.S. trade or business? Recall the decision in *Zippo Manufacturing v. Zippo.com*,<sup>[150]</sup> where the court stated that a passive website that does little more than make information available to those who are interested in it, is not grounds for the exercise of personal jurisdiction. If a passive website is not enough to cause a court to "haul the owner/company into the court's jurisdictional reign," it follows that the same website is not enough to deem the non-resident as having a U.S. trade or business. However, if the website is not passive and actually establishes a virtual connection between itself and U.S. customers, arguably, the virtual connection is an asset that serves the business activity of the non-resident taxpayer. This could be deemed a U.S. trade or business, and any income generated, sales, rents, or manufacturing, would be effectively connected with the U.S. trade or business.

{84}Further, with the use of the title passage rules and simple contract terms, the United States could argue that the transfer of property and/or services is not complete until the item reaches the hard drive of the purchaser. In this case, the seller is conducting business where that hard drive is located. If the hard drive is located within the United States, the U.S. has appropriate grounds to argue that the seller has income sourced in the U.S., and that income is attributable to a U.S. trade or business.

{85}Clearly, the issues are confusing and complex. The United States would be tackling an impossible fight if it were to try to solve the electronic commerce problem on its own. In fact, global cooperation is needed for all Internet users to obtain fair and equal tax treatment. This is where the OECD comes into play.

{86}The OECD can be compared to the four economists licensed by the League of Nations in solving the "double taxation" problem that international taxation principles threatened in the early 1900's. Recall that these economists invented fundamental sourcing rules that were adopted, in one way or another, by all nations who participated in global trading. The OECD has already published a number of policy objectives concerning Internet transactions. One of the biggest concerns on a global scale is that of identifying parties to a transaction, and further identifying information about the transaction itself. In *Dismantling the Barriers to Global Electronic Commerce*, the OECD notes that, "digital signatures, electronic signatures, and electronic representations that link individuals and entities to operations in the electronic environment are less

meaningful without certification mechanisms."<sup>[151]</sup>

{87}The OECD suggests a "certification authority" ("CA") to act as an independent, trusted means of verifying information about transactions and transacting parties without improperly invading a taxpayer's privacy.<sup>[152]</sup> Taxing jurisdictions can use this information to properly assess applicable taxes to entities while they perform taxable transactions online without the risk of taxable fraud or understatement penalties. The OECD and other similar bodies can work with governments and the private sector to devise an international interoperability of certification mechanisms for all parties involved to facilitate electronic commerce.

{88}Further, as the OECD has developed a model bilateral tax treaty to resolve many double taxation issues between two countries; perhaps, it can formulate a model multilateral tax treaty to deal with the specific issues of electronic commerce. Many who are close to the issue argue that moving beyond a bilateral tax treaty would be difficult in practice and administration.<sup>[153]</sup> However, multinational treaties have helped reach global cooperation in the area of global financial law.<sup>[154]</sup> Given this cooperation, multilateral treaties between countries that engage in a significant amount of electronic commerce can answer many unresolved questions with respect to classification and jurisdictional issues outlined in this paper. Perhaps, the world is not far from seeing many countries sign a GETT,<sup>[155]</sup> or similar agreement, containing answers on electronic commercial issues.

{89}As stated above, organizations such as the OECD will become indispensable in reaching a global solution to the electronic commerce taxing problem. Through working with governments and business, and through international cooperation, both public and private sector needs and concerns with electronic commerce can be addressed via Internet regulation that provides guidance to persons conducting online transactions. Many hope that the Committee on Electronic Commerce will address and solve the issues discussed in this paper, and end the continuing chaos that electronic commerce inevitably creates.

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<sup>[\*\*]</sup>. **NOTE:** All endnote citations in this article follow the conventions appropriate to the edition of THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION that was in effect at the time of publication. When citing to this article, please use the format required by the Seventeenth Edition of THE BLUEBOOK, provided below for your convenience.

Jonathane M. Ricci, *Electronic Commerce and Non-Resident Aliens: The Internal Revenue Service Versus International Cyberspace Transactions*, 6 RICH. J.L. & TECH. 7 (Fall 1999), at <http://www.richmond.edu/jolt/v6i2/article2.html>.

<sup>[1]</sup>. See Concord University School of Law's online J.D. degree program, available at Concord University School of Law (visited Sept. 24, 1999) <<http://www.concord.kaplan.edu/schoolinformation.htm>>; Regent University School of Law's L.L.M program, available at Regent University School of Law - International

Tax (last modified Aug. 11, 1999) <<http://www.regent.edu/acad/schlaw/llm/html/descrip.html>>.

[2]. See 2 RICHARD D. POMP & OLIVER OLDMAN, STATE AND LOCAL TAXATION 1073 (2nd. ed. rev. vol. 1997).

[3]. See *id.* at 1072.

[4]. See *id.* at 1073.

[5]. See *id.*

[6]. See *id.*

[7]. See *id.*

[8]. See *id.* at 1074.

[9]. See *id.*

[10]. See *id.*

[11]. See *id.*

[12]. A website is a place where individuals and companies store information of all types. Anyone having access to the World Wide Web can access this information, add to it, or pull it from the database of the website.

[13]. See Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* 6 (Nov. 1996), available at (visited Sept. 24, 1999) <<http://www.fedworld.gov/pub/tel/internet.txt>> and <<http://www.ustreas.gov/taxpolicy/internet.html>> [hereinafter *Treasury Paper*].

[14]. See *id.* at 6-9.

[15]. See Riel Miller, *The Internet in Twenty Years: Cyberspace, The Next Frontier?* (visited Sept. 24, 1999) <<http://www.oecd.org/sge/au/highligh.htm>>.

[16]. *Id.*

[17]. *Treasury Paper*, *supra* note 13.

[18]. See Internet Tax Freedom Act, Pub. L. No. 105-277, §§1100-1104, 112 Stat. 2681-719-726 (1998).

[19]. H.R. Rep. No. 105-570(I) (1998) (Additional views of Hon. Christopher Cox).

[20]. There is a current dispute over the composition of the Advisory Commission on Electronic Commerce (the "Commission"). There is a planned commission meeting in June, and two groups have filed suit against the Commission seeking a preliminary injunction to prevent this planned meeting from taking place. The plaintiffs in the suit include the National Association of Counties and the U.S. Conference of Mayors. They charge "that the [C]ommission is skewed unfairly toward business interests that will not respect state and local concerns over the possibility of the Internet becoming a 'tax haven.'" Jeremy Holmes, *Electronic Commerce: NACO, USCM May Seek Injunction to Block Commission's June Meeting*, 70 DAILY TAX REP. (BNA), G-4 (Apr. 13, 1999).



[21]. Michael K. McChrystal, et al., *Regulating Electronic Commerce*, 72-JUN WIS. LAW. 14, 17 (1999).

[22]. See *Taxation: Just One Aspect of Emerging Electronic Commerce Landscape*, 7 TAX COMPLIANCE J., Winter 1999, available at (visited Sept 24, 1999)

<[http://www.vertexinc.com/taxcybrary20/Tax\\_Outlook/tax\\_outlook\\_ec.html](http://www.vertexinc.com/taxcybrary20/Tax_Outlook/tax_outlook_ec.html)>.

[23]. See *id.*

[24]. OECD, *Dismantling the Barriers to Global Electronic Commerce*, available at (last modified Oct. 16, 1997) <<http://www.oecd.org/dsti/sti/it/ec/prod/DISMANTL.HTM>>.

[25]. *Id.*

[26]. See generally Michael A. Geist, *The Reality of Bytes: Regulating Economic Activity in the Age of the Internet*, 73 WASH. L. REV. 521, 531 (1998) (discussing how companies such as Microsoft did not consider the Internet to be important but was considered by many users to be a place where traditional laws would be replaced by self-regulation.)

[27]. *Id.* at 532.

[28]. *Id.*

[29]. 535 N.W.2d 11 (Wis. App. 1995).

[30]. See *id.* at 14.

[31]. *Id.*

[32]. *Id.*

[33]. 24 Media L. Rep. 1126 (1995) available in 1995 WL 805178 (N.Y. Sup. 1995) (not reported in N.Y.S.2d) (citations are references to page numbering in Westlaw).

[34]. See *id.* at \*1.

[35]. See *It's in the Cards, Inc.*, 535 NW. 2d. at 14.

[36]. See *id.*

[37]. See *id.*

[38]. See *id.*

[39]. Geist, *supra* note 26, at 533.

[40]. *Id.*

[41]. *Id.*

[42]. 937 F. Supp. 161 (D. Conn. 1996).

[43]. *Id.* at 162-63. Internet domain names, which have become a part of commercial advertising, enable users to access Web sites simply by typing in a name such as "www.inset.com." Domain names, the subject of

several other litigated cases, are administered in the United States by a government-appointed agency, Network Solutions, Inc. (NSI) and are distributed on a first come, first serve basis. Geist, *supra* note 26 at 574 n.59.

[44]. *See Inset Systems Inc.*, 937 F. Supp. at 163.

[45]. 444 U.S. 286, 297 (1980).

[46]. *See Inset*, 937 F.Supp. at 165.

[47]. *See Geist*, *supra* note 26, at 533.

[48]. *Inset*, 937 F.Supp. at 164 (quoting defendant's response to plaintiff's assertion that the court has jurisdiction over the defendant).

[49]. *See id.* at 164.

[50]. *See id.*

[51]. 937 F.Supp. 295 (S.D.N.Y. 1996), *aff'd*, 126 F. 3d 25 (2d Cir. 1997).

[52]. *See id.* at 297.

[53]. *Id.*

[54]. *See id.* at 298.

[55]. *See id.* at 299.

[56]. *See id.*

[57]. 952 F.Supp. 1119 (W.D. Pa. 1997).

[58]. *See id.* at 1120-21.

[59]. *See id.* at 1124. (citation omitted).

[60]. *Id.*

[61]. *See id.* (emphasis added).

[62]. *See id.*

[63]. 663 N.Y.S.2d 468 (1997).

[64]. *See id.* at 476.

[65]. *See id.* at 474.

[66]. *See id.*

[67]. Geist, *supra* note 26, at 549 & 574 n.164 (quoting John C. Coffee, Jr., *Brave New World?: The Impacts of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1233 (1997)); and citing Amelia H.

Boss & Jane Kaufman Winn, *The Emerging Law of Electronic Commerce*, 52 BUS. LAW. 1469, 1491 (1997) (stating "[E]xisting principles of commercial law can and will be adapted to meet the new demands of these [electronic commerce] business practices"). *Id.*

[68]. *See* The White House, *A Framework for Global Electronic Commerce*, available at (visited Sep. 22, 1999) <<http://www.doc.gov/ecommerce/framewrk.htm>>.

[69]. David G. Post was a 1995 Visiting Associate Professor of Law at Georgetown University Law Center and a current member of the Electronic Frontier Foundation.

[70]. David R. Johnson serves as chairman of Counsel Connect, the online meeting place for the legal profession, and is co-director of the Cyberspace Law Institute.

[71]. *See* Geist, *supra* note 26, at 547 (citing David G. Post and David R. Johnson, *Law and Borders: The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367, 1368-70 (1996)).

[72]. *Id.* (citing Post & Johnson, *supra* note 68, at 1378).

[73]. *Id.* at 548 (citing Alexander Gigante, *Ice Patch on the Information Superhighway: Foreign Liability for Domestically Created Content*, 14 CARDOZO ARTS & ENT. L.J. 523 (1996)).

[74]. *Id.* (citing Robert L. Dunne, *Deterring Unauthorized Access to Computers: Controlling Behavior in Cyberspace Through a Contract Law Paradigm*, 35 JURIMETRICS J. 1, 11-14 (1994)).

[75]. *Id.* (citing I. Trotter Hardy, *The Proper Legal Regime for "Cyberspace,"* 55 U. PITT. L. REV. 993, 1028-32 (1994)).

[76]. *Id.* at 561.

[77]. *Id.*

[78]. *See id.*

[79]. *Id.*

[80]. *See id.* at 563-564; *see also* Mark Hankins, *Ambulance Chasers on the Internet: Regulation of Attorney Web Pages*, 1 J. TECH. L. & POL'Y 3 (1996) available at (visited Sept. 21, 1999) <<http://journal.law.ufl.edu/~techlaw/1/hankins.html>>.

[81]. 949 P.2d 1 (Cal. 1998).

[82]. *Id.* at 5.

[83]. *Id.* at 5-6.

[84]. Geist, *supra* note 26, at 566.

[85]. *Id.*

[86]. *See id.* at 566-67.

[87]. *Id.* at 567.

- [88]. *Id.*
- [89]. *Id.*
- [90]. *Id.*
- [91]. *Id.* at 568.
- [92]. *Id.* citing Alexander Gigante, *Blackhole in Cyberspace: The Legal Void in the Internet*, 15 J. MARSHALL J. COMPUTER & INFO. L. 413, 426-33 (1997).
- [93]. OECD, *supra* note 24.
- [94]. See BORIS BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION § 66.25 (1998).
- [95]. See 26 I.R.C. § 861(a)(3) (1994 & Supp. 1997) (emphasis added). The U.S. source rule does NOT apply to services performed by a non-resident alien individual (1) who is in the U.S. for not more than 90 days during the tax year, (2) who receives no more than \$3,000 for his services, and (3) the services must be performed as an employee of a non-resident. (emphasis added). *See id.*
- [96]. See Ned Maguire, et. al., *Deloitte and Touche Offers Comments on Tax Policy Implications of Global Electronic Commerce*, 15 TAX NOTES INT'L 1483, 1490 (1997); and John K. Sweet, *Formulating International Tax Law in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles*, 146 U. PA. L. REV 1949, 1967-68, 1971 (1998).
- [97]. See Sweet, *supra* note 96, at 1969-70.
- [98]. See *id.* at 1968.
- [99]. *Id.*
- [100]. 127 F.2d. 260 (5th Cir. 1942).
- [101]. *Id.* at 261.
- [102]. See Sweet, *supra* note 96, at 1969-70.
- [103]. See *id.*
- [104]. See *id.*
- [105]. See I.R.C. § 863(e)(1994) (Special Rules For Determining Source).
- [106]. I.R.C. § 863(e)(2) (emphasis added).
- [107]. I.R.C. § 863(e)(1)(B)(i).
- [108]. I.R.C. § 863(3)(1)(b)(ii).
- [109]. See I.R.C. §§ 871(b), 882(a)(1994). The author notes that the phrase "a United States trade or business" is a term of art specifically defined in the United States Tax Code. See I.R.C. § 864 (b) (1994). For



ease of reading, however, the phrase will not be denoted with quotation marks each time the phrase is used in this paper.

[110]. See BITTKER & LOKKEN, *supra* note 94 at § 66.105.

[111]. See Thomas Kesoglou, Note, *International Tax Complications: Can Personal Services Constitute a U.S. Trade or Business on the Internet*, 22 RUTGERS L. REC. 4, ¶25 (Oct. 6, 1997) <<http://pegasus.rutgers.edu/~record/>>, citing Hanfield v. Commissioner, 23 T.C. 633 (1955) and I.R.C. § 865(b) (Supp. III 1997), 861(a)(6) (1994) (emphasis added).

[112]. See Rev. Rul. 56-165, 1956-1 C.B. 849.

[113]. See *Treasury paper*, *supra* note 13.

[114]. A Virtual Establishment is a term defining the contact that a website makes with an individual, or entity, for the purposes of performing a taxable transaction. This does not include any discussion or analysis with respect to a treaty term or tax treaty laws.

[115]. See I.R.C. § 864(c)(3) (1994).

[116]. See David Forst, *The Continuing Vitality of Sourced Based Taxation in the Electronic Age*, 15 TAX NOTES INT'L 1455, 1470 (1997).

[117]. *Id.*

[118]. See *supra* Part III.A.2.

[119]. See I.R.C. § 864(b) (1994); *but see* I.R.C. § 864(b)(1)(B) (1994) exempting personal services performed by non-resident alien present in the U.S. for less than 90 days and where earnings are less than \$3,000.

[120]. Maguire, et. al., *supra* note 96, at 1494.

[121]. See 26 C.F.R. § 1.864-4 (1999).

[122]. See I.R.C. §§ 864(c)(2)(A), 864(c)(2)(B).

[123]. See *generally* Black's Law Dictionary 112 (7th ed. 1999).

[124]. See *id.*

[125]. See Kesoglou, *supra* note 111, at 39.

[126]. See *id.*

[127]. See *Treasury Paper*, *supra* note 13, at 19.

[128]. *Id.* at 18.

[129]. See Forst, *supra* note 116, at 1462.

[130]. See *id.* (citing OECD Model Treaty, art. 8 (1)).

[131]. *See id.* (citing U.S. Model Income Tax Treaty, art. 8 (1)). For additional information see *TaxResources - Tax Treaties*, available at (last modified Aug. 2, 1998) <<http://www.taxresources.com/html/taxsites/treaty.html>>.

[132]. *Id.*

[133]. 127 F.2d 260 (5th Cir. 1942).

[134]. *See id.* at 261.

[135]. *See id.*

[136]. *See* Forst, *supra* note 116.

[137]. *See id.* at 1464.

[138]. *See id.*

[139]. *See Treasury Paper*, *supra* note 13, at 26.

[140]. *Id.*

[141]. *Id.*

[142]. *See id.* This paper does not discuss the foreign tax credit.

[143]. *See* 26 C.F.R. § 1.482-2(b)(8) (1999).

[144]. *Id.*

[145]. 26 C.F.R. § 1.861-18(d) (1999).

[146]. *See* Kesoglou, *supra* note 111, at 31, *citing* the *Treasury Paper*.

[147]. *See* *Treasury Paper*, *supra* note 13, at 20-21.

[148]. *See id.* at 21.

[149]. *See id.*

[150]. 952 F.Supp. 1119 (W.D. Pa. 1997).

[151]. *See* OECD, *supra* note 24.

[152]. *See id.*

[153]. *See* Sweet, *supra* note 96, at 2008 (citing H. David Rosenbloom, *Sovereignty and the Regulation of International Business in the Tax Area*, 20 CAN. - U.S. L.J. 267, 268 (1994)).

[154]. *See id.* (citing David E. Spencer, *OECD Information Exchange Recommendations Are a Significant First Step in Resolving Tax Evasion*, 8 J. INT'L TAX'N 353, 383-84 (1997)) (stating "it is clear how significant multilateral regulatory cooperation on global financial law issues has been since 1980, when the degree of such multilateral regulatory cooperation that would develop could not have easily been foreseen.").

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