E-BIRTH: STARTING UP AND GETTING REAL WITH E-BUSINESSES

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1. Introduction

The business context in which we wrote this article is quite a bit different than the one the Planning Committee may have been contemplating when we were invited last May to address the Institute. The past several months have been characterized by a series of developments that are reshaping our thinking about e-business – what it is, what works and what doesn't and what we should expect next. These developments will even affect the way we do tax planning – usually a lagging indicator of what is going on in the business world.

The topic we will consider today is the tax aspects of e-business in its early stages. Our Committee (and indeed your two presenters) may have been thinking of the birth of a new dot-com, healthy but innocent, with the unlimited enthusiasms, horizons and energies of youth. The world was to be its oyster – but it turned out to be a shell game. The so-called "pure play" e-business was once the dominant puppy in the litter, free of burdensome inventory, factories and adult supervision. But pure play turns out, in all too many cases, to have been a well-disguised runt. Whoever let the dogs out, in the words of the song, they all ran across the street and got hit by trucks and other fixed assets.

What instead we are looking at is a marketplace where realism has set in. Traditional measures of value – revenues, profits, return on investment, sustainable growth and competent management – have staged a comeback. Investors – and prospective employees - are looking before they leap. The successful new dot-com business of the end of the Y2K will have to be technology-enabled and flexible but it will also have good management, adequately capitalization and profits. We will no longer think of a business as well capitalized if its resources consist of a pile of cash which has been pre-committed to Super Bowl commercials and refurbished warehouse space in the Mission District.

The statistics for the dot-com shakeout are sobering: Over 22,000 dot-com employees have been laid off and the combined market value of the Bloomberg US Internet Index of

280 dot-com companies was down $1.755 trillion in November from its peak.[1] Clearly, "e" has met the real world.

Nevertheless, the statistics for Internet usage assure us that e-business is here to stay. There are 377 million Internet users worldwide.[2] Forrester Research Inc. projects at least $10 billion worth of goods will have been purchased online during the 2000 holiday season. The worldwide Business-to-Business (B2B) market will grow from $145 billion in 1999 to $7.29 trillion in 2004.[3] The Yankee Group estimates that in the U.S. along, nearly $3 trillion in transactions will migrate to electronic exchanges within the next 5 years.[4] The Internet's share of total U.S. B2B companies will soar from 3% in 2000 to 42% in 2005.[5]

So we are faced with the apparent paradox of a situation in which the importance of e-business and the Internet continues to grow just as the market has savaged the companies whose businesses are most closely associated with e-business. Of course the savagery may be partly artificial – a necessary correction to the 85% rise in 1999. But the likely result, at least in the short to medium term, is for the market and investors to turn their backs on pure play dot-coms – and so the early stage businesses we thought we would be talking about when we took on this topic in the spring are going to look rather different in the cold winter of the NASDAQ's discontent.

2. An E-Tax Primer

2.1 Defining the Subject Matter

In thinking about how to approach this topic in a manner helpful to tax practitioners, we think the first point to be made is that e-business is business. It follows that there is no separate defined body of law on e-tax. Rather, our task is to think through how to apply the tax system we already have to business conducted through electronic means.

Our starting point is therefore an understanding, at least in broad strokes, of e-business. Tax professionals have tended, in the past, to apply their skills with relative indifference to the nature and details of the businesses seeking their advice. There are rules specific to certain industries, no doubt, such as oil and gas or banking and insurance, and there are rules specific to certain types of income or deductions that are more commonly encountered in some industries than in others. But more often than not, tax professionals have tended to focus on the application of general rules without gaining a close understanding of the business and industry.

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1 See Kleinbard, "The $1.7 trillion dot-com lesson". (http://www.cnnfn.com/2000/11/09/technology/overview/). According to the Bloomberg website on December 26, 2000, the index had fallen over 65% in 2000. Note, all Internet websites to which citations are made in this paper were visited in December 2000.

2 NUA Internet Survey

3 Gartner Group, Inc., January 26, 2000 report.

4 The Yankee Group, April 24, 2000 report.

5 Jupiter Communications, October 11, 2000, US B2B Internet Trade Projections.

Such an approach will not succeed with e-business. Tax planners will have to understand how e-business works in a greater level of detail, we believe, than has hitherto been the norm.[6] Let us therefore try to classify the various e-business models that practitioners will encounter:

- Pure play: Describes a business that only transacts day-to-day business with its customers through e-commerce.

- Bricks and mortar: Describes a business that operates from and transacts business with its clients at physical locations.

- Clicks and mortar: Describes a hybrid business that transacts business with its customer both through e-commerce and at physical locations.

Another method of classification, again using expressions that are in widespread usage, relates to the clientele:

- B2C ("business to consumer"): Business in which transactions are predominantly between businesses and consumers.

- B2B ("business to business"): Business in which transactions are predominantly between two or more businesses.[7]

While the Internet has not created any completely new types of business, there are a number of types of business that are particularly suited to or dependent on the Internet. These include:

- Digital marketplaces – these are companies that provide websites where members can, among other things, buy and sell goods and services through on-line catalogs, as well as auctions and reverse auctions (a reverse auction is an auction where sellers compete to bid down the price).

- Application service providers – these are software companies that provide customers with the ability to run software online rather than by downloading an entire package to the customers' computer.

- Internet service providers – communications companies that provide access to the Internet.

What the Internet has done is to change the way almost every business deals with its customers and, increasingly, its suppliers and workers. E-mail access has become as necessary for every business as the telephone or, more recently, the fax machine.

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[6] The current climate, in which tax planning of any kind is under the Washington microscope of perceived abusive "tax shelters", will assuredly accentuate this trend.

[7] The acronym B2W has been coined to describe transactions between a business and its workforce. Although B2W presents tax-planning opportunities, these are outside the scope of this paper.

Business presence on the web varies widely, ranging from the purely informational website, through the e-commerce-enabled sites capable of accepting orders on-line, to fully-fledged extranets that allow a company to transact business with suppliers and customers who will have significant access to the company's internal data. But some form of presence on the web is no longer just an option for serious business; it is a necessity. The questions no longer are "Do you have e-mail?" and "Do you have a website?" to "What's your e-mail address?" and "What is your website address?" If not now, then soon, the question will be about the details of website capabilities which everyone – customers, employees, suppliers and governments - dealing with a business will assume to be part of the normal capabilities of the business.

2.2 Tax Issues Online

After throwing a lot of e-business vocabulary at the reader, what is the interplay between these concepts and the income tax system as we now know it? As we noted earlier, our task is to apply the tax system we already have to e-business yet e-business has many faces.

a. Commerce Sans Frontières

Local, regional and national organizations - societal groups - provide for their societies by providing an infrastructure for societies members. Societies demand such infrastructure from these organizations or governments. Societies elect, appoint, or divine individuals and groups of individuals to provide a set of rules with which the societies' members comply for the greater benefit of society. The policing of the rules, the construction of an infrastructure and the management of society have a cost. Historically, governments charged taxes and tariffs of societies members to cover the cost of governing. In modern times, those taxes have been incorporated into the marketplace as a percent of the trade.

In the past, locating the person, the income or the property sought to be taxed was, in the overwhelming majority of cases, relatively straightforward, with most of the problems arising where two or more governments had a legitimate claim to impose a tax. In the e-business world the questions, philosophically and jurisprudentially, are still the same – which governments have the right to tax and in what order of priority?

These questions have generally been answered by testing the nexus or connection between the taxing jurisdiction and the candidate taxpayer sought to be taxed. The jurisdictional concepts of residence and source at first blush do not fit easily with e-business. The nature of the Internet is that it is not concerned with boundaries, physical or legal. Nevertheless, some means have to be found to extract from businesses that operate online or using e-business tools a reasonable contribution towards the costs of government.

b. Residence and Source-Based Taxation

The federal income tax system in the United States is constructed on the jurisdictional concepts of residence and source of income. These concepts provide the basis for establishing nexus between the taxing authority and the income to be taxed. In this

respect, the direct tax systems of the individual states of the United States and of most foreign countries are essentially the same.

Residence refers to the place to which the taxpayer is most strongly attached by personal ties and continuous presence; the United States, unlike most counties, also claims jurisdiction to tax its nonresident citizens as if they were residents. The residence of a corporate entity is determined in the United States by place of incorporation. Other countries look at the place of central management and control; most U.S. states test for commercial domicile, a concept somewhat akin to central management and control.

Source of income refers to the place to which the income at issue has the closest economic connection. Typically this is the place where the economic activity occurs that gives rise to the income. Plainly, there is room for disagreement on how to assign a source to a particular class of income. An example of this that is particularly relevant in the e-business context is distinguishing between a transfer of rights relating to intellectual property, the sale of goods and the provision of services. We will explore this in greater detail below.

In the remainder of this paper, we will examine the state tax concept of "nexus" and various jurisdictional concepts of international tax; we will relate them to the way business is done online and we will try to point out the choices and issues faced by on-line businesses in the early stages. We are not tax theorists and this paper is not an academic dissertation – what follows is an examination of these issues from the standpoint of the practitioner.

3. State and Local Tax Considerations

3.1 The Constitutional Requirement of Nexus

State and local tax planning is one area where practicing tax professionals and constitutional law intersect. After watching the country and the Constitution survive the Florida election, however, it seems reasonable to think that we can survive having to take constitutional issues into account in undertaking tax planning.

Under the U.S. Constitution, the Commerce Clause and Due Process Clause require nexus between the taxpayer and the state before a state can have jurisdiction to impose a tax.[8] Due Process Clause standards are generally lower than those of the Commerce Clause. The Due Process Clause requires only "minimal contacts." The Commerce Clause requires "substantial nexus.[9] Therefore, due process requirements may not meet Commerce Clause standards. Both constitutional requirements apply to direct and indirect taxes.

The Due Process Clause is concerned with fundamental fairness and notice. In the context of state taxation, its principal requirement is that the taxpayer be given "fair

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8 U.S. Constitution, Article 8 (Commerce Clause); 14th Amendment. (Due Process Clause).

9 See *Quill Corp. v. North Dakota* 504 U.S. 298 (1992)

warning").[10] Due process requires a minimal connection between a state and a corporation for the state to impose taxes. The due process "minimum contacts" nexus test may be satisfied without requiring physical presence in a particular state. The United States Supreme Court has held that under a due process analysis, "The simple, but controlling question is whether the state has given anything for which it can ask return."[11]

By contrast, the Commerce Clause is concerned, in part, with the effects of state regulation on interstate commerce. The foundation for modern jurisprudence on the requirements of the Commerce Clause is the 1977 case *Complete Auto Transit, Inc. v. Brady*.[12] In *Complete Auto Transit*, a gross receipts tax case, the U.S. Supreme Court made clear that the out-of-state taxpayer had to have "substantial nexus" in a state before it could impose a tax. Although the case involved an indirect tax, its holding applies equally to taxes on income.[13]

3.2 Substantial Nexus

With regard to what constitutes "substantial" nexus for purposes of the Commerce Clause, the U.S. Supreme Court has at least stated that physical contacts that do not go beyond a "slightest presence" will not satisfy the substantial nexus requirement.[14] Further, in *Quill*, the Court stated "[a]lthough title to a `few floppy diskettes' present in a state might constitute some minimal nexus, in *National Geographic*, . . . we expressly rejected a "slightest presence" standard of constitutional nexus."[15] However, an out-of-state manufacturer that used in-state independent contractors to locate potential customers and to promote its products was held to have the "slightest physical presence" in New York, creating nexus with the state.[16]

Some state courts have recently begun to define "substantial" as "demonstrably more" than a "slightest physical presence." For example, systematic visits by sales representatives to 19 customers an average of four times per year constituted "demonstrably more" than the "slightest physical presence" in the state, thereby creating substantial nexus.[17] Sales and general managers who spent approximately two weeks annually instate assisting independent representatives in soliciting sales provided "demonstrably more" than a "slightest presence" in the state for substantial nexus purposes.[18] A Michigan manufacturer that had a full time, resident independent

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10 See *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

11 *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

12 430 U.S. 274 (1977).

13 See, e.g., *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (1993), *cert. denied* 510 U.S. 992 (1993); Hellerstein & Hellerstein, State Taxation, 3d Ed. (Warren, Gorham & Lamont 1998) at ¶ 4.11.

14 *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977).

15 *Quill Corp.*, 504 U.S. at 315, n. 8.

16 *In re Ohio Table Pad Co., Inc.*, DTA No. 815122 (Feb. 5, 1998), aff'd, DTA No. 815122 (April 22, 1999)..

17 *Orvis Co. Inc. v. Tax Appeals Tribunal and Vermont Information Procession, Inc., v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995), cert. denied, 516 U.S. 989 (1995).

18 *Magnetek Controls, Inc. v. Michigan Department of Treas.* 562 N.W.2d 219 (Mich. Ct. App. 1997). See also Michigan Department of Revenue Administration Bulletin (RAB 98-1), incorporating the holding of Magnetek.

contractor in New Jersey and an office in New York was held to have "demonstrably more" than the "slightest presence" in these states. However, visits by the taxpayer's president to customers in up to 25 states, spending no more than four days per year in any given state, were deemed insufficient to create nexus because they did not create more than the slightest presence in those states.[19] An out-of-state manufacturer that used in-state independent contractors to locate potential customers and to promote its products was held to have "demonstrably greater" than the "slightest physical presence," creating nexus with the state.[20] On the other hand, twenty trips into New York by company, along with occasional visits by an independent contractor representing the company in the solicitation of advertising, did not constitute something "demonstrably more" than "slightest physical presence" in the state. Therefore, the substantial nexus requirement was not met.[21]

Despite the absence of a bright-line test for analyzing the degree of contacts necessary to create substantial nexus, some types of in-state items generally will establish nexus including:

a. In-State Office

The maintenance of an office or other place of business in a state is sufficient to create nexus in that state. There apparently does not have to be a transactional relationship between the in-state office and the sales made into the state. The presence of an in-state office will create nexus for all the taxpayer's activities in the state, not just those activities associated with the in-state office.[22]

b. Employees

The presence of employees or agents in the state who engage in the regular and systematic solicitation of orders is sufficient to create nexus in the state under Commerce Clause and Due Process Clause standards. However, U.S. Public Law 86-272, 15 U.S.C. 381-384, does prevent states from imposing a net income tax on sellers of tangible personal property based solely on in-state solicitation. Beyond Public Law 86-272, which states individually and through the Multistate Tax Commission, have generally tried to interpret pretty narrowly, several recent decisions have validated the position that employees' occasional or sporadic visits to the state do not create nexus. [23] In addition,

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[19] *Gear Research v. Michigan Department of Treas.* (Mich. Tax Trib. Dkt. No. 227850 (July 15, 1997)).

[20] *In re Ohio Table Pad Co., Inc.*, DTA No. 815122 (Feb. 5, 1998), aff'd, DTA No. 815122 (April 22, 1999).

[21] *In Matter of NADA Services Corp.*, No. 810592 (N.Y. Div. Tax App. Feb. 1, 1996).

[22] See *National Geographic Society v. California Bd. of Equalization*, *supra*, n. 14. A home office of a sales representative typically will not create nexus.

[23] *In re Appeal of Intercard, Inc*., 14 P.3d 1111 (Kan. 2000) (use tax - 11 visits by employees to install card-readers over a four-year period); *Care Computer Systems Inc. v. Arizona Dep't of Revenue*, No. 1049-93-S (Ariz. Bd. of Tax App. Apr. 4, 1995) (Arizona sales tax: employees in-state 21 days to provide customer training); *In re NADA Services Corp.*, No. 810592 (N.Y. Div. Tax App. Feb. 1, 1996) (New York: 20 trips into New York by company, coupled with sporadic visits by an independent contractor representing the company in the solicitation of advertising did not constitute something "demonstrably more" than the "slightest physical presence."); *Florida Dep't of Revenue v. Share Int'l, Inc*., 676 So.2d 1362 (Fla. 1996), *cert. denied*, 117 S. Ct. 685 (1997) (Florida sales tax: employees' presence at three-day seminar); New York Dep't of Taxation and Finance Advisory Opinions, TSB-A-97(6)C (Mar. 24, 1997);

some states have enacted legislation that allows employees to visit the state on a limited basis without creating nexus.[24] But quite a few decisions and rulings have gone the other way, with states successfully taking the position that visits to a state are sufficient to subject an out-of-state corporation to taxation.[25]

c. Independent Contractors

Whether income tax nexus is created by independent contractors in the state is not as certain, in particular where the independent contractor is not working as an agent for the out-of-state taxpayer.[26] However, the Supreme Court has ruled that a sales representative working as an independent contractor can create a use tax collection duty for the out-of-state corporation employing the contractor.[27] The Multistate Tax Commission has issued a bulletin indicating that repairs performed by employees and independent contractors under a warranty program covering the sale of computers by out-of-state computer companies creates nexus.[28] Issued just before Christmas 1995, this particular gift to the computer industry was not well received and although 26 states signed on to the bulletin, it has yet to be tested by a court.[29]

d. Property

The presence of property, real or tangible, in the state usually will constitute sufficient presence to create nexus. However, the Virginia Department of Revenue has clarified that an out-of-state company that uses a Virginia web-hosting facility to provide power

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TSB-A-97(7)C (Mar. 26, 1997) (New York state franchise tax: employees' presence at trade shows and seminars).

[24] *Tenn. Code Ann.* §67-4-804(a)(7)(C) (presence of employees, products, or samples at trade shows, seminars, or the like will not subject a corporation to the state's corporate franchise/excise (income) taxes if attendance does not exceed 20 days per year.); *Cal. Rev. & Tax Code*, Section 6203(e). out-of-state "retailer" does not create nexus if its sole physical presence in the state is at a trade show or convention for less than eight days, during any 12-month period.

[25] *Orvis Co. Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995), *cert. denied*, 516 U.S. 989 (1995) (New York: sales and use tax: systematic visits by sales representatives to 19 customers an average of four times per year constituted "demonstrably more" than the "slightest physical presence" in the state); Alabama Dep't of Revenue, Rev. Rul. 95-005 (Oct. 18, 1995) (Alabama foreign franchise tax: regular visits by marketing representative, though infrequent); *Brown's Furniture, Inc. v. Wagner*, 665 N.E.2d 795 (Ill. 1996), *cert. denied*, 117 S. Ct. 175 (1996) (Illinois: regular and frequent deliveries by employees into a state which also served to establish and maintain an in-state market); *Town Crier, Inc. v. Illinois Department of Revenue*, No. 1-98-4251 (Jun. 30, 2000) (Illinois use tax: out-of-state furniture company that made 30 deliveries into the state in its own trucks over greater than a two-year period and entered the state five times to install window coverings); Michigan Department of Revenue, RAB 98-1 (Michigan: activities, such as solicitation of sales, repairs and maintenance, collection activity, installation, employee training, and customer technical assistance, will create nexus for an out-of-state corporation if conducted for 10 or more days in a twelve-month period); Michigan Department of Revenue, RAB 99-1 (May 12, 1999) (Michigan use tax: two-day presence by employees or representatives in the state).

[26] A California sign manufacturer that used independent contractors to solicit sales and install signs in Texas had nexus for sales and use tax purposes. The only contacts with Texas were one visit by an independent contractor to solicit sales and one two-day visit by another to install a sign. Tex. Comp. Of Pub. Accts., Hearing No. 36,048 (Sept. 3, 1998). ·

[27] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

[28] Multistate Tax Commission, Nexus Program Bulletin, "Computer Company's Provision Of In-State Repair Services Creates Nexus" NB 95-1 (Dec. 20, 1995), reproduced at 95 State Tax Notes 246-71.

[29] Hanlon, "MTC's Nexus Bulletin Raises Computer Industry Hackles", 96 State Tax Notes 19-20 (Jan. 29, 1996).

and bandwidth connections to internet servers will not establish nexus in Virginia for sales and use tax purposes, even if it owns or leases servers in Virginia.[30]

More problematic, and of great relevance to e-business, is the question of whether the presence of intangible property can create nexus. The most prominent case in this area is the *Geoffrey* case, notwithstanding (or, as some states might have it, because of) the U.S. Supreme Court's having declined to review the decision of the South Carolina Supreme Court.[31] Geoffrey, Inc. is the Delaware holding company for the Toys 'R Us chain. It had no physical presence at all in South Carolina but licensed its trade names and trademarks to a corporate affiliate that conducted business in that state. The South Carolina Supreme Court held that the corporate parent had nexus for South Carolina income tax purposes, despite having no employees, offices or tangible property in the state. Since the licensing agreements allowed the use of trade names in the state, from which it derived income, the court concluded that Geoffrey had purposefully directed its activities toward South Carolina so as to create "substantial nexus" for Commerce Clause purposes. The court also held that the presence of the intangibles in the state created the requisite "substantial nexus" for Commerce Clause purposes.

In response to *Geoffrey*, many states have enacted similar statutes or regulations that adopt an economic presence standard. The authors found that as many as 26 states have adopted a position based on Geoffrey in the form of a regulation, an administrative ruling or an audit position, although in some states the application of the rule has been limited to financial institutions.[32] Nevertheless, *Geoffrey* remains a controversial case and there is still considerable resistance to the notion that the ownership of intangibles, especially trademarks, should be sufficient to create nexus.[33] As discussed in more detail below, the report of a majority (but not the congressionally mandated two-thirds majority) of the Advisory Commission on Electronic Commerce recommended overturning *Geoffrey* on this point.[34]

e. Nexus Based on Attribution

In addition to nexus based on traditional concepts of presence, there are a number of ways states may contend that nexus based on the activities of an in-state entity. Nexus by attribution may be based on theories of agency or corporate affiliation; in addition, states sometimes try to use alter ego theories based on the notion that the in-state corporation is a sham entity. Nexus by attribution has been used predominantly in efforts by states to enforce collection of use taxes, but it has also found its way into the income and franchise arena. Attributional nexus is an important issue for an e-business to consider as it enters

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30 Ruling of Virginia Commissioner of Revenue, P.D. 00-53 (Apr. 14, 2000).

31 *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E. 2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

32 California is not one of these states, however.

33 See also the criticisms of *Geoffrey* in *Cerro Copper Producers, Inc. v. Alabama Dept. of Revenue*, No. F. 94-444, Alabama Dept. of Revenue Administrative Law Division (Ala. 1995) reprinted in State Tax Notes (Jan. 1, 1996) at 65 and discussed in Hardesty, Electronic Commerce: Taxation and Planning (Warren Gorham & Lamont), also available on-line at http://www.ecommercetax.com, at ¶ 15./3[9][b].

34 See ¶3.4b below.

relationships with third parties that may affect nexus. Before entering into these arrangements, an e-business should analyze the nexus implications.

(1) **Agency.** Under an agency theory, an out-of-state entity may have nexus if its in-state affiliate acts as its agent.[35] This principle has been established for some time in use tax cases but has more recently begin to appear in income tax cases as well.[36]

Agency is a non-tax state law concept and it will perhaps surprise no one to learn that state courts differ on exactly when a principal-agent relationship exists, as opposed to a relationship between independent principals. A finding of agency generally requires that the in-state entity be under the authority and control of the out-of-state seller. This means more than two parties having contractual obligations to each other. For example, a California court of appeal held that an out-of-state mail-order seller was not responsible for collecting use taxes on sales made to California residents after being acquired by a corporation that was doing business in California.[37] The court determined that neither the parent nor the subsidiary corporation was the alter ego or agent of the other for any purpose. Neither solicited orders for the products of the other, and neither accepted returns of the merchandise or otherwise provided services for customers of the other. Each owned, operated, and maintained its own business assets, conducted its own business transactions, hired and paid its own employees, and maintained its own accounts and records. The corporations did not have integrated operations or management. A New York administrative law decision similarly held that a parent corporation was not the agent of its subsidiary for the production and distribution of catalogs and flyers so as to impose use tax on the subsidiary for the parent's mailing of catalogs and flyers to New York residents because the subsidiary exercised no authority or control over the parent with respect to the mailing of catalogs.[38]

The Multistate Tax Commission has taken a position that in-state warranty repair services conducted by or for out-of-state computer companies will create nexus for corporate income and franchise, and sales and use taxes.[39] The MTC maintains that performing warranty repair services creates nexus even if the services are performed by third-party repair service providers. The MTC further maintains that performance of the activities on the seller's behalf creates an in-state physical presence and that the provision of warranty

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35 *See, e.g., Scripto, Inc. v. Carson,* 362 U.S. 207 (1960) and *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue,* 483 U.S. 232 (1987). See also *Minnesota Tribune Co. v. Commissioner of Taxation,* 37 N.W.2d. 737 (Minn. 1949).

36 *Amway Corp. v. Director of Revenue,* 794 S.W.2d 666 (St. Ct. Mo. 1990) (Taxpayer held liable to corporate income tax even though the company had no employees or property in state based on activities of the taxpayer's distributors); Vermont Department of Taxes Formal Ruling 95-04 (Apr. 25, 1995) (fulfillment company created nexus for its out-of-state client because it acted as an agent in performing the operations for client).

37 *Current, Inc. v. State Board of Equalization*, 24 Cal. App. 4th 382 (Cal. Ct. App. 1994).

38 *Matter of the Petition of Service Merchandise of Fishkill, New York,* Nos. 812709 and 812710 (N.Y. Div. Tax Apps., Mar. 21, 1996).

39 See footnotes 28 and 29 above.

repairs is a regular and systematic business activity directed to the establishment and maintenance of the in-state market.[40]

(2) **Affiliate and Unitary Nexus.** Several states have attempted to confer nexus on an out-of-state taxpayer based solely on its relationship to another entity that is doing business in the state. The arguments in favor of a finding of nexus come in two principal varieties – nexus based on the presence of an affiliate and nexus based on a unitary business relationship between the in-state and out-of-state businesses.

Affiliate nexus has had a difficult time in the courts and it has only been asserted in the context of sales and use taxes. As a general matter, courts require more than ownership of a corporate affiliate within the state to create nexus between the state and the out-of-state parent or subsidiary. In particular, they have held that ownership of stock is not the same as ownership of the corporation's assets. [41]

"Nexus statutes" providing that nexus exists for sales and use tax purposes when an affiliate of an out-of-state company is physically present in the state, notwithstanding that the out-of-state company has no physical presence, have been found by some courts to be unconstitutional.[42]

On the other hand, the unitary theory, which has not been widely used, asserts that an out-of-state entity that is engaged in a unitary business with an in-state entity is taxable in the state based on the unitary relationship.[43]

Where separate corporate entities are engaged in a single (*i.e.*, unitary) business they are required to report business income on a combined basis. The constitutionality of the unitary system has been upheld on many occasions in the context of taxes on income but attempts to extend it to sales and use tax jurisdiction have failed. The states use various definitions of a unitary business, but as a general rule unity will be found where the

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[40] National Nexus Program Bulletin 95-1 (Dec. 20, 1995). The bulletin notes that at least 26 states apply this nexus position, including: Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Idaho, Kansas, Maine, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, New Jersey, New Mexico, North Dakota, Oregon, Texas, Utah, and Washington. California initially voted to follow Nexus Bulletin 95-1, however, in March 1996, the California State Board of Equalization withdrew its support for the bulletin and the Franchise Tax Board subsequently voted to have the state's name removed.

[41] *SFN Shareholders Grantor Trust v. Indiana Dep't of State Revenue*, 603 N.E.2d 194 (Ind. Tax Ct. 1992) (out-of-state holding company held not liable for Indiana income tax even though its wholly-owned subsidiary did business in Indiana and owned a warehouse in the state; held further that separate corporate entities of the holding company and the subsidiary should not be disregarded and ownership of stock does not equate to ownership of the underlying assets).

[42] *Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (1994) striking down former California Rev. & Tax Code §6203(g), which required collection of use tax in the case "retailers owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business within the state." The court held that the parent corporation's physical presence in California did not confer nexus over its out-of-state mail order subsidiary.

[43] See *Armco, Inc. v. Hardesty*, 303 S.E.2d 706 (W. Va. 1983), *rev'd on other grounds*, 467 U.S. 638 (1984).

related companies are part of the same corporate group and their business activities are interdependent.[44]

The unitary theory is really a variation of the unsuccessful affiliate nexus theory. As a theory for finding nexus, it is flawed. It is really a method of measuring the income to an in-state business and should not become an independent method of causing out-of-state businesses to be subject to the state's taxing jurisdiction.

(3) **Alter Ego and Sham Corporations.** Under the alter ego theory, an out-of-state entity is subjected to a state's taxing jurisdiction based on the in-state presence of a related entity acting as its alter ego. To succeed with an alter ego theory, a state must essentially demonstrate that the separate corporate existence of an out-of-state entity should be ignored. In theory, alter ego arguments have a difficult time in light of the *Moline Properties* case, a leading Federal income tax decision of the Supreme Court that made it very difficult to ignore the separate existence of corporations.[45] In practice, however, the alter ego theory tends to be thrown in and confused with agency arguments on one end of the scale and sham transaction arguments on the other.[46]

3.3 Public Law 86-272

One significant difference between the Due Process Clause and the Commerce Clause concerns the scope of Congress' authority to interpret or limit the scope of the respective nexus requirements created by the two Clauses. Generally, Congress cannot legislate away due process; but the Commerce Clause expressly entitled Congress to regulate interstate commerce and thereby define substantial nexus.

Congress has not explicitly availed itself of this opportunity very frequently in the state tax area but it has done so with the Internet Tax Freedom Act and, nearly 50 years ago, it did so in Public Law 86-272.[47] Public Law 86-272 states that an out-of-state entity that does no more than send employees into a state to solicit sales of tangible personal

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[44] In California, for example, there must be some flow of value between different parts of the business. That flow may consist of goods, services or the provision of financial assistance. This requirement is the subject of a considerable amount of case law. *Edison California Stores, Inc. v. McColgan,* 30 Cal.2d 472, (1947) ("If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary"). Second, the business must be under common control. If more than one corporation is involved in the conduct of the unitary business, the percentage of common control must be greater than 50%. See *Butler Brothers v. McColgan*, 17 Cal.2d 664, 678, 111 P.2d 334 (1941), aff'd, 315 U.S. 501 (1942) (". . .the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operation."; *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983); California Rev. & Tax. Code § 25128.

[45] 319 U.S. 436 (1943)

[46] *Avco Financial Services Consumer Discount Co. v. Director, Div. of Taxation,* 494 A.2d 788 (Sup. Ct. N.J. 1985); *CIT Financial Services Consumer Discount Co. v. Director, Division of Taxation,* 4 N.J. Tax 568 (N.J. Tax Ct. 1982) ("where the separate corporate entities of related corporations are not preserved in the conduct of their overall business, each corporation is regarded as the agent or alter ego of the other so that the presence of one corporation in a state is the presence of the other.").

[47] The text of Public Law 86-272 is reproduced as an Addendum to ****.

property cannot be subjected to a corporate net income tax despite the fact that the company has a sufficient physical presence in the state for Commerce Clause nexus purposes.

As noted earlier, states interpret Public Law 86-272 as narrowly as they can. Orders solicited in the state must be sent out of state for approval or rejection and must be filled from inventories maintained outside the state. A modest deviation from the confines of Public Law 86-272 can result in a company being found to do business.[48]

The Multistate Tax Commission has issued a statement interpreting Public Law 86-272, which some 20 states, including California, and the District of Columbia have adopted and many other states informally follow or consider it.[49] The Statement lists both protected and unprotected activities. A copy of the Statement is reproduced as Appendix A along with a list of items that have in the past been treated by California as going beyond the "mere solicitation of orders":

The breadth of these listings has been narrowed by a U.S. Supreme Court case, *Wisconsin Department of Revenue v. Wrigley*, which held that solicitation includes activities, other than maintaining an office, that are ancillary to solicitation and serve no other purpose than furtherance of solicitation of orders.[50] The Court held that an activity is not ancillary if the taxpayer would engage in the activity whether or not it had sales representatives in the state and chose to assign the activities to the representatives. For example, having a representative provide training or warranty repairs would go beyond an ancillary activity. On the other hand, holding a sales meeting with representatives in the state or conducting training activities for sales representatives would be regarded as ancillary.

One other issue worth noting is the question of whether delivery of goods by an out-of-state seller to an in-state customer goes beyond the protection of Public Law 86-272.

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[48] See, e.g., *Brown Group Retail, Inc., v. Franchise Tax Board*, 44 Cal. App. 4th 823; 52 Cal. Rptr. 2d 202 (nexus found where out-of-state footwear manufacturer had two employees in California who provided a service to independent retail distributors, free of charge, to help the retailers establish and enhance their retail outlets; held, this went beyond solicitation or ancillary activities under *Wrigley Bros. s*tandard); *Kelly- Springfield Tire Co. v. Bajorski*, 635 A.2d 771 (Conn. 1993) (annual credit manager visits to customers). See also three advisory opinions issued in March 1997 by the New York State Division of Taxation application of P.L. 86- 272: TSB-A-97(6)C (foreign corporation came into New York for 10 days during the taxable year to participate in two five-day trade shows to display goods; held, a de minimis activity in excess of solicitation); TSB-A-97(7)C (foreign corporation wished to conduct three one-day seminars in New York each year to train retailers on proper methods for fitting company's prosthetic devices; held, activity was not ancillary to solicitation because corporation would be giving technical advice on the use of its products after delivery to the customer but activities would constitute de minimis activities protected under P.L. 86-272); TSB-A-97(8)C (post-delivery backhauling activities in New York went beyond solicitation of orders protected by P.L. 86-272; while backhauling activity, by itself, might be de minimis, company also engaged in backhauling activities unrelated to delivery of company's products, and produced 4 percent of total revenues in New York, held, activities were more than de minimis).

[49] Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272, adopted July 11, 1986; revised Jan. 22, 1993 and July 29, 1994, reproduced at 95 State Tax Notes 60-148.

[50] 505 U.S. 214 (1992).

Several states have sought to impose tax on income where the seller delivered goods other than by the U.S. Postal Service or by common carrier (especially using the seller's own trucks). When challenged, state courts have often invalidated these efforts.[51]

3.4 Nexus in the World of E-Business

a. The Requirement of Physical Presence

The jurisprudence of the Due Process and Commerce Clause nexus requirements will be tested by e-business.

The starting point for most analysis in this area is the U.S. Supreme Court decision in *Quill Corp. v. North Dakota*. Quill's contacts with North Dakota were limited to sending catalogs into the state and delivering goods by U.S. Mail or common carrier. *Quill* examined a number of its non-tax decisions involving adjudicatory jurisdiction and held that "comparable reasoning" justified the use of similar Due Process standards in the state tax (legislative jurisdiction) context.[52] *Quill* and the cases it cites generally stand for the proposition a corporation can be subject to jurisdiction in states where it purposefully avails itself of an economic market in a state. Although *Quill* did not involve the Internet or e-commerce of any sort, it did involve mail order catalogs, a business that clearly bears many resemblances to e-commerce. It has therefore been the case on the lips of every interested party in the e-tax debate.

Quill has been an unpopular decision with state tax authorities. Some states have argued that *Quill* only applies to sales and use taxes but many courts addressing the issue have determined that the same nexus rules should also apply for income/franchise tax purposes.[53] Nonetheless, other courts have been sympathetic to efforts to limit its scope. For example, in the case of an out-of-state fuel oil company that used common carriers in delivering its product, the Rhode Island Supreme Court held that since the taxpayer's activities amounted to more than mere "communication with its customers in the State by U.S. mail or common carrier," the company had a substantial nexus with the state.[54] In this case, the out-of-state seller's only contact with the state was fuel-oil delivered via common carrier. The taxpayer was found to have substantial nexus with the state because it retained title, possession, and risk of loss over the oil until it reached the delivery point inside the state. The court held that the taxpayer's activities created in practical effect a physical presence within the state which satisfied the substantial nexus requirements.

States may be hard pressed to successfully argue that businesses using the Internet to conduct e-business would have nexus in jurisdictions where they do not have physical presence. For example, the U.S. Supreme Court has held in dicta in a

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51 E.g., *Department of Taxation v. National Private Truck Council*, 486 S.E.2d 500 (Va. 1997).

52 *Quill Corp. v North Dakota*, 504 U.S. 298 (1992), citing *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *Shaffer v. Heitner*, 433 U.S. 186 (1977); and *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). *Quill* overruled or distinguished (depending upon your point of view) National *Bellas Hess, Inc. v. Dept. of Revenue of State of Illinois*, 386 U.S. 753 (1967).

53 See *J.C. Penney National Bank v. Johnson*, 19 SW 2d 831 (Tenn. Ct. App. 1999) and *Matter of K-Mart Properties, Inc*., No 00-04 (Taxation and Revenue Dep't of N.M., Jan. 31, 2000).

54 *Koch Fuels v. Clark*, 676 A.2d 330 (R.I. 1996), cert. denied, 117 S. Ct. 301 (1996).

telecommunications tax case that "[w]e doubt that states through which the telephone call's electronic signals merely pass have a sufficient nexus to tax the call."[55]

Nevertheless, we may expect to see states trying out issues such as whether an Internet service provider's equipment should be attributed to an out-of-state vendor that utilizes the equipment in receiving the ISP's services. To date, litigation involving this issue has been limited to non-tax disputes, in which the presence of nexus has been examined only from a Due Process perspective. Perhaps the best-known example is the *CompuServe* case.[56] In *CompuServe*, a Federal appeals court held that electronic contacts via an ISP results in personal jurisdiction under the Due Process Clause where the defendant, a Texas resident, subscribed with an Ohio Internet access provider and placed computer software on the access provider's system for purchase by Internet users. The defendant entered into a software registration agreement with the access provider. The court found that the defendant had purposefully availed itself of the privilege of acting in Ohio by subscribing with the access provider, entering into the software registration agreement, and loading and advertising the software on the access provider's system. It seems doubtful that these contacts, which were found to meet the minimum contacts required by the Due Process clause, would be found to satisfy the substantial nexus requirements of the Commerce Clause.

A moment's thought will reveal the difficulty of any argument that the use of an ISP's equipment should alone confer nexus in the state where the equipment is located. The logical next step would be an argument that a factory that purchased power from another state would have nexus in that state by virtue of its use of the power generator's equipment or that a company that made a telephone call that passed through a switch in another state would have nexus in that state. But the Internet has proved itself capable of generating a lot of such woolly thinking.[57]

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55 *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989).

56 *CompuServe, Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996). Compare *Bensusan Restaurant Corp. v. King*, 937 F.Supp. 295 (S.D.N.Y. 1996), where the U.S. District Court for the Southern District of New York held that electronic links via the Internet do not result in personal jurisdiction under the Due Process Clause of the U.S. Constitution. The Missouri defendant operated a club in Columbia, Missouri under the same name as a famous New York City club, the Blue Note, operated by the plaintiff. The defendant created a website which was open to anyone with web access any person with access to the web could electronically access the site and obtain information regarding the defendant's club. The site included a logo that the New York plaintiff asserted infringed on its copyright. The court dismissed the case because the defendant had "done nothing to purposefully avail himself of the benefits of New York." The court distinguished *CompuServe*, supra, noting that the defendant neither entered into contracts with persons in New York nor specifically targeted New York.

57 On the other hand, see N.Y. Dep't of Tax. and Fin., TSB-M-97(1)C, (1)S (Jan. 24, 1997) (nexus is not created through advertising via the Internet nor will mere displaying of an out-of-state company's advertising on a New York server or through a New York Internet service provider create nexus for sales and use or corporate franchise tax purposes.); *JS&A Group, Inc. v. Cal. State Board of Equalization*, Cal. Ct. of App., 1st Dist., No. A075021 (Mar. 10, 1997) (out-of-state taxpayer whose only contact was agreement with local broadcasters and cable television operators to broadcast its advertisements in California did not have nexus for sales and use tax purposes).

b. The Internet Tax Freedom Act and the Advisory Commission on Electronic Commerce

After a slow start, Congress got itself involved in the debate on the taxation of the Internet and in 1998, Congress enacted the Internet Tax Freedom Act.[58] The Act imposed a three-year moratorium on certain Internet-related state and local taxes. The IFTA created an advisory commission to study the potential state and local, as well as federal and international, tax treatments of Internet transactions.

The Commission got off to a bad start because of arguments about the balance of appointments between representatives of business and state and local governments. It managed to reach a fairly broad measure of consensus on many of the issues but in the end found itself unable to agree on a final report, which it delivered to Congress on April 12, 2000. The Act required that any "finding[s] or recommendation[s]" had to be agreed upon by at least two-thirds of its members. The Commission, chaired by Virginia Governor James Gilmore, could not reach the required two-thirds majority on any proposal relating to nexus standards with respect to sales and use taxes or "business activities" taxes (i.e. taxes on income).

A majority of members, essentially the business representatives and Governor Gilmore, voted for a proposal that would confirm the result in *Quill* by continuing to require physical presence and listing certain factors that would not create substantial nexus. The listing below relating to income taxes illustrates the finding of the majority that physical presence will be required to constitute nexus. Lacking a two-thirds majority, the impact of the report is doubtful:

> For purposes of clarifying the circumstances that determine whether a seller has sufficient nexus with a state to be required to meet business activity and income tax reporting and payment obligations of that state, the following factors would not be taken into account:
> (a) a seller's use of an ISP that has physical presence in a state;
> (b) the placement of a seller's digital data on a server located in that particular state;
> (c) a seller's use of telecommunications services provided by a telecommunications provider that has physical presence in that state;
> (d) a seller's ownership of intangible property that is used or is present in that state [thereby reversing *Geoffrey*];
> (e) the presence of a seller's customers in a state;
> (f) a seller's affiliation with another taxpayer that has physical presence in that state;
> (g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state [reversing MTC National Nexus Program Bulletin 95-1];
> (h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller's Website or catalogue to be returned to the other party's physical location within that state;
> (i) the advertisement of a seller's business location, telephone number, and Website address; and

[58] 47 U.S.C. 151 nt

(j) a seller's sales and use tax registration with that state and/or a seller's collection and remittance of use taxes for that state.

The majority's proposal has been harshly criticized. For example, David Hardesty, author of one of the leading treatises on the taxation of e-business[59], described the result in these words: "The report, which was approved 10 to 8, comes from a Commission no closer now to agreement on the issues plaguing taxation of electronic commerce than when it was formed a year ago. Gilmore, who opposes taxation of electronic commerce, squandered the opportunity to deliver to Congress a strong report, by making no real attempt to lead the ACEC to a solution that addresses the concerns of both online vendors, and the states that seek to tax them. The report will be worthless as a document upon which Congress can act."[60]

Hardesty is hardly alone. Despite Governor Gilmore's siding with the majority, it was reported within days of the report's release that 36 governors – Democrats and Republicans – had signed a joint letter and six had signed individual letters opposing the report's proposals – along with 100 academics and two retailers groups.[61] (We point out that among the governors who did not sign were Gray Davis of California, George Pataki of New York, then Governor of Texas and now President George W. Bush and his brother Jeb Bush of Florida.)

The substantive basis for criticisms of the Commission is the concern of most state governments that the playing field between e-business and bricks and mortar businesses be level, a concern obviously shared by the latter. On a procedural note, Hardesty and others note that the Commission was given a balanced membership of government representatives and business representatives (although the bricks and mortar retailers were completely unrepresented) and a directive to make recommendations with a two-thirds majority, thereby encouraging or even mandating a consensus result. The simple majority does not represent consensus on the fundamental issues.

As with many government responses to technology, it may turn out that the members of the Commission and the observers were fighting the last war rather than the next. March 2000, when the Commission held its last meeting, was the high point of the pure play dot-com frenzy on the stock market. Not only did the dot-com companies begin at just that time to take an unrelenting (and at the time of writing) unfinished thrashing on Wall Street, it turns out that they may be unable to compete or even survive without physical presence in their markets. Moreover, bricks and mortar companies that migrate to e-business are better off becoming clicks and mortar companies rather than abandoning the competitive advantages of their fixed assets, tangible and intangible.

What we may expect in future is the continuation of efforts to bring about some greater uniformity in the sales and use tax area and greater simplicity in administration. More

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[59] Op. cit. at footnote 33.

[60] Hardesty, "E-Commerce Tax Commission Issues One-Sided Final Report", E-Commerce Tax News (April 2, 2000), http://www.ecommercetax.com/doc/040200.htm.

[61] "Governors, Academics Reject Internet Panel's Final Report", Tax Notes, Apr. 24, 2000, p. 487

guidance on nexus in the area of taxes of income may not be reached before the Supreme Court issues further clarification on *Quill* in some as yet unidentified future case.

And finally, it should be observed that at least so far as sales and use taxes are concerned, the frenzy is primarily a B2C issue. As a general rule, any one making an on-line purchase is required to pay a use tax on a purchase from a seller without nexus in the purchaser's state. Private retail customers are no more exempt from this requirement than anyone else. The problem is that if the sellers need neither charge and collect the use tax nor even make information filings, the tax is enforcement proof where the buyers are individuals who do not make use tax returns. Most businesses do make such returns or are otherwise large enough purchasers to make audit and collection efforts economical.

c. The Streamlined State Sales Tax Project

As the ACEC report was going to Congress, a group of 26 states organized the Streamlines Sales Tax Project. Working diligently through 2000, the group, by then expanded to 38 out of the 45 states that impose a sales tax, received input from states and business, worked on model legislation and undertaken some technology testing. By December 22, the Project had developed and agreed a model Uniform Sales and Use Tax Administration Act and a model Streamlined Sales and Use Tax Agreement and approved a motion to forward the models to the states for the 2001 legislative sessions.[62]

Under the Agreement, states agree to amend their own laws to conform to the requirements of the Agreement, and to cooperate with one another. The Agreement enters into force after it has been signed by five states. To enter into the Agreement, a state must modify its tax laws to incorporate the provisions of the Agreement. The model Uniform Act sets out both the authority to enter into the Agreement and the substantive provisions which the states have agreed to include in their sales and use tax laws.

The key feature of the Agreement is that states may not enter into the Agreement unless they amend their laws to achieve a series of objectives summarized in section 6 of the Uniform Act, reproduced here in its entirety. The Agreement provides a significant amount of detailed requirements on standards for the implementation of these objectives.

> a. Uniform State Rate. The Agreement must set restrictions to achieve over time more uniform state rates through the following:
> 1. Limiting the number of state rates.
> 2. Limiting the application of maximums on the amount of state tax that is due on a transaction.
> 3. Limiting the application of thresholds on the application of state tax.
>
> b. Uniform Standards. The Agreement must establish uniform standards for the following:

[62] The text of the Act and the Agreement can be found at the Project's website, http://208.237.129.206/sline/124amdedactandagrmt.pdf.

1. The sourcing of transactions to taxing jurisdictions.
2. The administration of exempt sales.
3. The allowances a seller can take for bad debts.
4. Sales and use tax returns and remittances.

c. Uniform Definitions. The Agreement must require states to develop and adopt uniform definitions of sales and use tax terms. The definitions must enable a state to preserve its ability to make policy choices not inconsistent with the uniform definitions.

d. Central Registration. The Agreement must provide a central, electronic registration system that allows a seller to register to collect and remit sales and use taxes for all signatory states.

e. No Nexus Attribution. The Agreement must provide that registration with the central registration system and the collection of sales and use taxes in the signatory states will not be used as a factor in determining whether the seller has nexus with a state for any tax.

f. Local Sales and Use Taxes. The Agreement must provide for reduction of the burdens of complying with local sales and use taxes through the following:
1. Restricting variances between the state and local tax bases.
2. Requiring states to administer any sales and use taxes levied by local jurisdictions within the state so that sellers collecting and remitting these taxes will not have to register or file returns with, remit funds to, or be subject to independent audits from local taxing jurisdictions.
3. Restricting the frequency of changes in the local sales and use tax rates and setting effective dates for the application of local jurisdictional boundary changes to local sales and use taxes.
4. Providing notice of changes in local sales and use tax rates and of changes in the boundaries of local taxing jurisdictions.

i.[63] Monetary Allowances. The Agreement must outline any monetary allowances that are to be provided by the states to sellers or certified service providers.

j. State Compliance. The Agreement must require each state to certify compliance with the terms of the Agreement prior to joining and to maintain compliance, under the laws of the member state, with all provisions of the Agreement while a member.

k. Consumer Privacy. The Agreement must require each state to adopt a uniform policy for Certified Service Providers that protects the privacy of consumers and maintains the confidentiality of tax information.

[63] The Streamlined Sales Tax Project's numbering does not include a paragraph g. or h.

l. Advisory Councils. The Agreement must provide for the appointment of an advisory council of private sector representatives and an advisory council of non-member state representatives to consult with in the administration of the Agreement.

Under the Agreement, sellers would be divided into three categories:

- A Model 1 seller is one that has selected a Certified Service Provider as its agent to perform all the seller's sales and use tax functions, other than the seller's obligation to remit tax own its own purchases. Model 1 sellers will be able to contract with Certified Service Providers to act as their agent for the collection and remittance of sales and use taxes. As the seller's agent, the Certified Service Provider is liable for sales and use tax due each member state on all sales transactions it processes for the seller. Absent fraud or misrepresentation, the seller in turn will not be liable to the state for sales or use tax due on transactions processed by the Certified Service Provider; and in the absence of probable cause to believe that the seller has committed fraud or made a material misrepresentation, the seller will not be subject to audit on the transactions processed by the Certified Service Provider.

- A Model 2 seller is one that has selected a Certified Automated System to perform part of its sales and use tax functions, but retains responsibility for remitting the tax.

- A Model 3 Seller is a business (including an affiliated group) that has sales in at least five member states, has total annual sales revenue of at least $500 million (or a lower amount which may be agreed to by the states acting jointly), has a proprietary system that calculates the amount of tax due each jurisdiction, and has entered into a performance agreement with the member states that establishes a tax performance standard for the seller.

Another key feature is the centralized registration system. The member states are required to provide an online registration system that will allow sellers to register in all the member states. By registering, the seller agrees to collect and remit sales and use taxes for all taxable sales into the member states, including member states joining after the seller's registration. The Agreement and the Act both make clear that registration with the central registration system and the collection of sales and use taxes in the member states may not be used as a factor in determining whether the seller has nexus with a state for any tax.

About a month after adoption of the models, on January 27, at a meeting in Savannah, Georgia, the National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce unanimously approved amended versions of the Streamlined Sales Tax Project's act and agreement. The amendments dealt with a variety of issues, including the use of uniform definitions of food which had been opposed by the vending machine industry, among

others and several governance issues. The Conference action left some uncertainty as to whether the leadership of the initiative remained with Streamlined Sales Tax Project's leadership, composed of state tax administrators, or had shifted to the Conference, a political body that some might view as more receptive to the views of business and lobbyists.[64] Perhaps as good a summary of any of the parallel approaches of the Project and the National Conference of State Legislatures was KPMG partner Jeff Friedman's reported comment that "The states' focus seems to be on ensuring that the greatest number of states participate in the project, which is a worthy goal. However, a consequence of achieving this goal is to dilute the amount of simplification contained in the model legislation to expand its attractiveness to the greatest number of states. Therefore, doing so lessens its effect and impact on ensuring that the tax system is simplified."

In the meantime as of the date of writing, nine states (Indiana, Iowa, Kansas, Minnesota, Nebraska, North Carolina, Utah, Wisconsin, and Wyoming) had introduced SSTP legislation or were reported to be planning to do so in the near future.[65]

3.5 Living in the Material World

For an e-business, the critical state tax issue is how to handle expansion into new markets. Further, as e-businesses expand their physical operations into new states as a result of changing e-business models they must determine exactly what level of presence they will need to establish in these markets to achieve their business goals. Once they determine what their level of presence in these new markets will be, consideration must be given to the state and local tax effects of that increased presence. E-businesses must be aware of what activities in a state will create "nexus" and whether doing so will be a good or bad tax result for the company.

E-businesses also need to be concerned with the "sourcing" of the income among the states and what items of income will be included in the tax base in each state where the company has nexus. Sourcing refers to determining the state to which a multistate sale will be attributed. These determinations must be made for both sales and use tax and income/franchise tax purposes.

a. Limitations of the Pure Play Model

Under current constitutional standards, a B2C seller with all of its operations in a single state or a limited number of states and shipped all of the goods it sold by U.S. Postal Service or common carrier would likely not have had to collect sales or use tax on any sales shipped outside of its home state (and any other states with which it had nexus). However, some dot-coms have determined that such a business model, while limiting the

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[64] D. Sheppard, "NCSL Executive Panel Approves Amended Streamlined Legislation" 2001 State Tax Today 20-37 (Jan. 29, 2001); Hardesty, "Streamlined Sales Tax Gets Political", http://ecommercetax.com/doc/021101.htm (Feb. 11, 2001).

[65] Wyoming became the first state to enact "streamlined" sales tax legislation when the Governor signed HB 259 (Chap. 147) into law on March 1, 2001. Shortly thereafter, South Dakota enacted SB 166 on March 5, 2001, to provide for a 15-member Streamlined Sales Tax Project Task Force. The task force is charged with studying the final report of the multistate SSTP and to report its findings to the Legislature and governor by December 1, 2001.

need for sales and use tax collection, also hampered the company's efforts to generate sales in those states. Thus, many of these companies have decided that they are better off engaging in certain marketing and sales efforts in additional states even if it does mean creating nexus and having to collect the state's tax. B2C sellers that are facing such issues need to be aware of exactly what activities in which they can engage in a state before they will have a tax collection obligation on sales into the state. Constitutional law, no less than the detailed interpretations of individual states, matters here.

Under the "virtual company" business model followed by many dot-coms in the early stages of B2C Internet selling, a company would exist only on the Internet with almost no physical presence anywhere. Dell Computer still follows this model. Thus, it would not have to collect sales tax on any of its sales outside of its home state. Most companies have since abandoned this concept and adopted more of a "clicks and mortar" approach to their business strategy, i.e., have created more physical contacts with states through their own activities or through contractual arrangements with third parties. These companies have determined that establishing the types of contacts in a state that will create nexus, as set out above is vital to the continued viability of their business, even at the cost of eliminating the competitive advantage that not having to charge sales tax created for them. Gateway Computer is an example of a company that followed this path.

Many brick and mortar companies initially isolated their dot-com businesses in separate entities apart from their retail operations. The purpose was to assure that almost no sales tax would have to be collected on Internet sales because only the retail operation, which was in a separate entity, would have nexus outside the company's home state. A well-publicized example is bn.com, the dot-com "affiliate" of Barnes & Noble. The dot-com sales entity would only be located in one state and would not have a tax collection, or tax payment, obligation outside of its home state. However, entering into such a strategy for a dot-com subsidiary also meant eliminating certain customer service functions for the dot-com entity sales. For example, purchases made through the dot-com subsidiary could not be returned at the local retail outlet; they had to be shipped back to the dot-com entity. If the local stores took the returns some states would construe that as creating nexus for the dot-com subsidiary because the retail store was acting as the agent of the dot-com entity and helping to establish and maintain a market for it in the state.

Companies establishing such "nexus containment" subsidiaries for their dot-com B2C operations soon faced angry customers who did not like the fact that goods that they purchased over the company's website could not be returned at the local retail store. While some companies still operate nexus containment subsidiaries, many of these companies have since determined that the better long-term strategy is to accept the returns at the stores as well as the resulting obligation to collect taxes on sales into states where stores are located. As the process of collecting sales tax on multistate sales becomes more simplified, there will likely be few companies for which a use tax nexus containment strategy will be useful or prudent.

b. Determining the Location of a Sale

As more dot-coms begin to broaden the number of states in which they have a physical presence, another issue they will have to confront is how their multistate sales will be sourced for both sales tax and income/franchise tax purposes.

(1) Sales and Use Taxes

For sales tax purposes, sales of tangible personal property are generally sourced to the state where title to the goods passes, which is generally the state where the customer is located. Thus, it is fairly simple for a dot-com to determine if it has sufficient contact in the state to establish nexus there and then collect tax on the sale there if the sale is taxable.

Where it can become more complicated is when something other than tangible personal property is sold over the Internet, e.g., services or digitized goods. If, for example, the sale is completed by the customer downloading software over the Internet, it may be difficult for a dot-com seller to determine exactly where that buyer is at the time he makes the purchase, e.g., the seller could be accessing the Internet with a laptop in any state and buying software with a credit card. In certain circumstances the seller may have no information regarding where the buyer is and thus will be unable to make a determination as to whether the company has nexus in the state where the sale takes place. The likely outcome in this situation is the dot-com seller will be responsible for ascertaining the billing address of the buyer at the time of the sale and then sourcing the sale based on that address. However, most states have not yet formulated a clear position on the sourcing of sales in this scenario for sales tax purposes.[66]

(2) Income and Franchise Taxes

With respect to income/franchise taxes, multistate taxpayers are required to apportion their income among the states in which they have nexus. Income is usually apportioned using a three-factor formula consisting of property, payroll and receipts.[67] For purposes of determining which states a company's receipts are earned in, sales of tangible personal property are generally sourced to the "destination" state, i.e., the state to where the goods are shipped or delivered.[68] In many states, a throwback rule applies where the sale is to the U.S. Government or to a state or foreign country where the seller is not subject to tax.[69] For this purpose, a seller may be subject to tax if the state or foreign country actually imposes tax or has jurisdiction to tax but either does not have a tax or does not choose to impose it.

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66 See, "NTA Issues Report on E-Commerce Tax Policy, Part 2" by David Hardesty, August 30, 1999, E-Commerce Tax News, http://ecommercetax.com/doc/083099a.htm.

67 Most states utilize a three-factor formula; however, see RIA State Tax Handbook for state-by-state listing.

68 Uniform Division of Income for Tax Purposes Act ("UDITPA") §16 (1957), followed by many, if not most, states that impose a tax measured by income.

69 UDIPTA § 16(b).

This is usually a fairly simple determination for a multistate seller to make. A dot-com making B2C sales of tangible personal property will generally have an address for the customer to ship the goods to and the receipts from the sale will be sourced to that state if the seller has nexus there. However, as with sales and use taxes as discussed above, the determination becomes more complicated when services or digitized products are sold over the web.

Where a multistate sale of services takes place, most states will source the sale according to where the "income producing activity" takes place, based on costs of performance.[70] Where services are performed over the Internet, as opposed to being performed by an individual located in a particular state, it is sometimes difficult to isolate where those costs of performance are incurred. Similarly, if digitized goods are sold over the Internet the seller might not be aware of what the destination state is. For example, if a customer in Texas buys software over the Internet using a credit card and downloads it onto his computer, then it would seem logical that Texas would be the destination state for that sale. However, will the seller always be able to determine which state the customer has downloaded the software in? Again, the logical rule would be to require the seller to request the billing address of its customers before making a sale. Of course, this is not always feasible and is not always the most accurate determination of destination.

Even if the seller is able to determine the billing address of the buyer, and the seller has nexus in that state, the sale will not automatically be taxed in that state. The seller must also determine whether the item being sold is taxable under the state's laws. For example, the sale of the downloaded software discussed above would not likely fit under most state's definitions of a taxable sale for sales and use tax purposes because most states only impose their sales tax on sales of tangible personal property and certain services. However, this does not prevent many of these states from arguing that such sales should be taxable anyway because they are essentially the economic equivalent to sales of tangible property. Thus, a dot-com seller of digitized goods that expands its nexus creating activities into new states in order to increase sales will likely be challenged by a state if it attempts to treat these sales as non-taxable even if the statute imposing the tax does not address such sales.

Similarly for income/franchise tax purposes it cannot be assumed that simply because the seller has nexus in a state and makes sales into that state over the Internet that those sales will be apportioned to that state. It is important to carefully examine the state's particular sourcing rules to determine if they address such sales. Most states' laws have yet to catch up with e-business transactions and thus may be subject to more than one interpretation when being applied to Internet sales. Also, several states have specifically excluded certain Internet transaction from their tax bases in an effort to encourage e-businesses to locate in the state. Before engaging in any activities that will create nexus in new jurisdictions, and thus create new filing obligations, it is important that the state tax laws be carefully examined to determine whether the activity does truly create a new tax collection, or tax payment, obligation.

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[70] UDIPTA § 17.

Finally, creating nexus is not always detrimental. For example, in some cases creating nexus in another state will allow a company to apportion income out of the state where it is headquartered for income/franchise tax purposes. If the company is headquartered in a high tax rate state and makes most of its sales into lower tax rate states, then its overall tax liability might be lowered by filing additional income tax returns.

4. International Tax Considerations

4.1 Existing Rules – An Overview

E-business is business, as we have said before. The consensus of the international tax community, in both the government and private sectors, is that the taxation of e-business should not require a whole new conceptual framework.[71] Here is an overview of the current framework from a U.S. perspective.

a. Taxation of U.S. persons

The United States taxes U.S. persons (i.e., individual citizens and residents and corporations organized in the United States) at graduated rates on worldwide income from whatever source derived, net of deductions allowed by law.[72] If the U.S. person incurs tax to a foreign country on income derived from a foreign source, a credit (the foreign tax credit) is allowed against U.S. tax.[73] This credit is extended, in the case of dividends received by a U.S. corporation making direct investments (10% or more) in a foreign corporation, to the tax paid by the foreign corporation on the U.S. corporation's share of income.[74] The credit is limited to the amount of U.S. tax attributable to foreign source income and is calculated separately for eight specific categories and one general category of income.[75]

Generally, U.S. persons are not taxed currently on income earned by foreign corporations in which they hold shares, but only when they either receive distributions from the corporations or sell the shares. However, there are significant anti-deferral limitations that have swallowed up large portions of this otherwise beneficial treatment. These

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71 "Selected Tax Policy Implications of Global Electronic Commerce" released on November 21, 1996 at ¶ 6.2 ("A fundamental guiding principle should be neutrality. Neutrality requires that the tax system treat economically similar income equally, regardless of whether earned through electronic means or through more conventional channels of commerce. [. . .] The best means by which neutrality can be achieved is through an approach which adopts and adapts existing principles — in lieu of imposing new or additional taxes.") and see also ¶ 7.1.1. The paper is reproduced at http://www.ustreas.gov/taxpolicy/internet.html. Organisation for Economic Co-operation and Development (OECD) Directorate for Financial, Fiscal and Enterprise Affairs, Committee On Fiscal Affairs (CFA), "Electronic Commerce: A Discussion Paper on Taxation Issues" (Sep. 17, 1998; released Oct. 10, 1998) at page 4 ("The CFA also believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles, although new or modified measures are not precluded provided that they are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.") The paper is reproduced at http://www.oecd.org/daf/fa/e_com/discusse.pdf.

72 §§ 1 (individuals) and 11 (corporations). All unprefixed statutory references are to the United States Internal Revenue Code of 1986, as amended.

73 § 901.

74 § 902.

75 § 904.

include the controlled foreign corporation (CFC) rules, the foreign personal holding company (FPHC) rules and the passive foreign investment company (PFIC) rules.[76] These rules either treat income, particularly passive investment income, as currently taxable or impose an interest charge on tax ultimately imposed on distributions. The CFC rules also impose current taxation on (a) profits from certain related party transactions, where a CFC buys products and services from or sells products or services to a related party, except for sales or purchases within the CFC's jurisdiction of incorporation[77], and (b) indirect repatriation of CFC profits into the United States.[78]

b. Taxation of foreign persons

The United States taxes foreign persons (i.e., nonresident alien individuals and corporations[79] organized outside the United States) on income effectively connected with a trade or business within the United States if (a) the income has a U.S. source, or (b) in two cases, if the income is attributable to a U.S. office or fixed place of business. Trade or business income is taxed at the same graduated rates applicable to U.S. persons.[80]

The United States also taxes foreign persons on certain types of U.S. source income (e.g., investment income such as interest, dividends, rents and royalties). Such U.S. source investment income is taxed at a flat rate of 30%, with no deductions.[81] However, the U.S. taxation of interest is subject to numerous statutory exemptions that have almost swallowed up the rule.[82]

Capital gains of foreign persons are not taxed unless they are effectively connected with a U.S. trade or business or are real estate-related. If the gains are real estate-related, they are treated as if they were effectively connected with a U.S. trade or business and, accordingly, taxed at graduated rates.[83]

U.S. bilateral income tax treaties, which largely conform to international norms, frequently modify these rules. Treaties generally require that, as a prerequisite to taxation of business income, the foreign person's presence in the United States constitutes a permanent establishment, meaning an office or other fixed place of business, subject to a number of standard exceptions.[84] They also tend to reduce or eliminate the flat rate of taxation of interest and royalty income and reduce the taxation of dividends, typically to 5% where the shareholder is a corporation holding at least 10% of the shares of the dividend payor and 15% in other cases.

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76 § 951 et seq. (subpart F) (CFCs); § 541 et seq. (FPHCs); § 1291 et seq. (PFICs).

77 § 954.

78 § 956.

79 By foreign corporations, we mean an entity, not incorporated or organized in the United States that is treated as a corporation under the U.S. federal entity classification regulations. § 7701(a)(4) and Treas. Reg. § 301.7701-2(b).

80 § 871(b) (individuals); § 882 (corporations).

81 § 871(a) (individuals); § 881 (corporations).

82 Notably, the portfolio interest exemption, § 871(h)(3) (individuals), § 881(c) (corporations); and the bank deposit interest exception, § 871(i) (individuals), § 881(d) (corporations).

83 § 897 (codifying the Foreign Investment in Real Property Tax Act of 1980).

84 The definition of a permanent establishment is discussed in ¶ 4.3 below.

c. Double taxation, allocation of income and expense and transfer pricing

Taxpayers operating in the international arena are faced with the potential of double taxation of the same economic income for a number of reasons. Two (or more) countries may claim that the taxpayer is a resident of that country. Similarly, two or more countries may claim that the same income, under their respective source rules, has a source in that country; even if the source rules in two countries are identical for each category of income, the countries may classify income differently. As we shall see, this is a problem that can arise frequently in the context of e-business income and has been extensively studied by the Committee on Fiscal Affairs of the Organisation for Economic Cooperation and Development (OECD).[85] On the expense side, countries may disallow expenses or allocate expenses so as to limit their utility to the taxpayer and they may do so inconsistently.[86]

Finally, because international business often operates through multiple entities, it would not be sufficient for all countries to use consistent rules for defining residence, determining the source of income, classifying the income and allocating expenses. It is also necessary for cross-border transactions between or among members of the same group to be properly priced. To assure that it has primary jurisdiction to tax income earned by a multinational group, the United States has enacted extensive transfer pricing rules.[87] Other developed nations and increasing numbers of other countries have adopted transfer pricing rules and are enforcing them with increasing vigor and skill.

d. Withholding taxes and information reporting

To administer and collect taxes, the United States increasingly relies on third party information reporting and tax withholding mechanisms. In the international area, these include the requirement that tax be withheld on compensation and investment income paid to foreign persons, on a foreign person's share of income earned by partnerships and on various forms of income related to foreign investments in U.S. real property.[88] Extensive reporting rules apply in relation to foreign corporations and trusts associated with U.S. persons.[89] Foreign persons not engaged in a U.S. trade or business are

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[85] See, e.g., *Boulez v. Commissioner*, 83 TC 584 (income treated as services income by United States and royalties by Germany; the two countries were unable to reach agreement under the competent authority procedure prescribed by the 1954 income tax treaty then in force). The OECD work is discussed at ¶ 4.4 below.

[86] No country has interest expense allocation approaching those of the United States in complexity and harshness to domestic taxpayers. See Treas. Reg. § 1.861-9T *et seq.* See also *National Westminster Bank PLC v. United States*, 99-2 USTC ¶50,654 (Ct. Cl. 1999) (CCH) (interest allocation provisions applicable to foreign taxpayer engaged in business in the United States held in conflict with U.S. income tax treaty obligations).

[87] § 482 and Treas. Reg. § 1.482-0 *et seq.*; see also the extensive penalty provisions and documentation requirements in § 6662 and regulations thereunder.

[88] §§ 1441 and 1442 (withholding on investment income), 1445 (FIRPTA withholding) and 1446 (partnership withholding).

[89] See, e.g., §§ 6038 (reporting by U.S. persons in relation to interests in foreign corporations and foreign partnerships); 6038A (reporting by U.S. corporations of transactions with 25% or greater foreign owners); 6048(a) (reporting relating to foreign trusts); Treas. Reg. § 1.1461-1(c) (reporting of payments of compensation and investment income to foreign persons).

generally not subject to the information reporting and back-up withholding rules applicable to U.S. persons, but must often certify as to their foreign status in order to avoid such withholding.

e. Indirect Taxes

The international application of indirect taxes is generally beyond the scope of this paper. We will say only that these taxes are of great significance to businesses of all sorts and to e-business as much as any other kind. Outside the United States, most countries that impose gross receipts taxes do so through some form of value added tax. The best-known value added taxes are those imposed by the members of the European Union (EU), which apply to both goods and services. Just as state sales taxes do not apply to out-of-state sales, VAT typically does not apply to exports from the EU countries to other countries. The so-called acquisition taxes on sales (supplies in Eurospeak) of goods and reverse charges on supplies of services operate somewhat similarly to use taxes in situations where the supplier is not liable to charge the tax.

The EU has recently developed significant concerns about the collection of tax on software imported through electronic download rather than on a physical medium such as a disk. It proposed rules that would require every non-EU software vendor with annual sales to private individuals above 100,000 euros (about $95,000) to register for and charge VAT on sales of software. This proposal has engendered controversy no less heated than the comparable issues considered by Governor Gilmore and the Advisory Commission on Electronic Commerce.[90] In addition to the expected complaints from U.S. software vendors, several EU member states expressed concerns that the proposal would allow vendors to register in just one EU country and that most, if not all, would choose to register in Luxembourg, the EU state with the lowest VAT rate – 15%. In light of these and other objections, the EU is now rethinking how to it can reconcile the goals of a fair system that would protect sellers of digital goods and maintain the integrity of VAT. [91]

4.2 Three Keys: Trade or Business; Classification of Income; and Source of Income

To implement the broad scheme of taxation described above requires a closer examination of the answers to the following key questions:

- **Trade or Business.** Is the activity giving rise to the income of a trade or business? If so, where and how is the trade or business conducted?

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[90] Readers who would like to learn more about this area should review the EU paper on VAT and e-commerce European Commission, Directorate General XXI, Customs And Indirect Taxation, VAT And Other Turnover Taxes XXI/98/0359 (Apr. 3, 1998) reproduced at http://europa.eu.int/comm/taxation_customs/french/publications/working_doc/taxation/interim_report_on_electric_commerce_en.pdf; "Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means" (June 7, 2000), reproduced at http://europa.eu.int/comm/taxation_customs/proposals/taxation/com349_2000/com2000_349en.pdf.

[91] See Hardesty, "EU Withdraws Proposals for VAT on Digital Sales" (Feb. 4, 2001), reproduced http://ecommercetax.com/doc/020401.htm

- **Classification of Income.** What class or type of income is involved – for example, sales, services, rents or royalties?

- **Source of Income.** How is the income sourced within a particular jurisdiction?

The order in which these questions should be addressed is not always clear. We believe that for purposes of presentation, the most efficient method, as we did in our discussion of state tax issues, is to start by examining the taxpayer's activity within the taxing jurisdiction. We then classify the income so that we can determine which source rules to apply.

The starting point is, therefore, the trade or business. In the international context, this tends to reduce itself into the matter of whether the taxpayer's activities within the taxing jurisdiction were conducted through a fixed place of business or "permanent establishment."

If the taxpayer is found to be engaged in business outside its home jurisdiction, and especially if found to be so engaged through a permanent establishment, the taxpayer usually will be subject to taxation at rates comparable to those imposed by that country on its own residents. If the taxpayer is not engaged in any business in the foreign jurisdiction, the income will more typically be taxed at a flat rate or may escape taxation altogether. In the United States, as we have already seen, the net income of a foreign taxpayer from a trade or business is taxed at the same graduated rates that apply to domestic taxpayers; but non-business income will either be taxed at a flat 30% (or lower treaty rate) or, in the case of capital gains, not at all. Most other countries similarly tax the income of foreign persons at a flat rate (commonly between 20% and 25%) on non-business income.

Capital gains similarly are not taxed unless connected with a business or, in a number of countries, if the gain relates to a direct investment (more than a threshold percentage of between 10 and 25%) in a corporation, the gain may be subject to tax.[92] Finally, the United States and many other countries impose an additional tax on remittances by branches of foreign corporations.[93] The branch tax is designed to treat the branch as if it were a separately incorporated local subsidiary and to impose the equivalent of a withholding tax on dividends.

The amount of income that may be taxed either as business income or as non-business or investment income will usually depend on the nature of the income is involved. Most countries usually tax income of a foreign taxpayer only if the income has a local source. The source rules in turn differ according to the class of income. In the e-business arena, as we will see, the classification and source of income is more difficult to determine compared to the income from the manufacture and sale of a physical product.

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[92] For the sake of completeness, we note that gains from real estate are often taxed irrespective of whether connected with a business. In the United States, real estate-related gains are deemed to be effectively connected with a U.S. trade or business. IRC § 897(a).

[93] IRC § 884(a).

4.3 Trade or Business and Permanent Establishment

a. E-Business and Taxable Presence

The relative mobility of many e-businesses has made the application of existing permanent establishment ("PE") principles to e-business models a common point of discussion even before the explosion of dot-com companies.

What constitutes a PE is relevant in several circumstances:

- Where a foreign business resident in a treaty country does business in the United States.
- Where a U.S. business does business in a treaty country.
- Where a U.S. business does business in a nontreaty country that uses the PE concept as a minimum threshold for imposing business taxes.

The definition of a PE has achieved a significant, even remarkable, degree of international conformity.[94] Generally, a PE is defined by Article 5(1) of the OECD Model Tax Convention as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". Article 5(2) continues by stating that a PE specifically includes:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop, and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Article 5(4) also includes a common list of "preparatory or auxiliary" exceptions to the PE status. If an enterprise limits its activities to the listed exceptions, then no PE will result. The exceptions usually include the following activities:

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

[94] The discussion below refers to the model income tax convention promulgated by the OECD.

- the maintenance of a fixed place of business solely for any combination of the above activities *provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*
- a server can constitute a PE without any human intervention.

The italicized portion above is not found in the U.S. model income tax treaty but in all other respects the U.S. model tracks the language of this paragraph. Both the OECD and U.S. models further state that a building site or construction or installation project constitutes a PE only if it lasts more than twelve months.[95]

An enterprise may also create a PE as a result of the activities of a dependent agent, if such agent has and regularly exercises the authority to conclude contracts on behalf of the enterprise in the host jurisdiction.

b. OECD Proposals to Clarify the Commentary on Article 5

Given the above definition of a PE, the most commonly asked PE question in the e-business context has been whether the placement and operation of a web server in a particular jurisdiction (usually a high-tax jurisdiction) will create a PE in that jurisdiction. If the web server creates a PE, then some amount of income must be attributed to the PE and subject to tax. The OECD has addressed the PE issue (as well as the income attribution issue in draft form) and has adopted the amendments to the Commentary on Article 5 of the OECD Model Tax Convention.[96]

The OECD publishes Commentary on each of the 30 articles in the OECD Model Tax Convention. Courts and tax authorities have referred to the Commentary in applying the provisions of the articles of treaties modeled on the Convention.[97] In an effort to clarify how the provisions of Article 5 regarding the creation of a PE should be applied in the context of e-commerce, the OECD proposed that seven new paragraphs be added to the Commentary on Article 5. The OECD issued this initial draft and solicited comments regarding the proposals in October of 1999. After receiving comments on the initial draft proposals, the OECD issued a second draft of the proposed commentary in March of 2000.

In summary, the initial draft of the proposed Commentary include the following:

(1) Fixed automated equipment, e.g., a computer server, operated by an enterprise may or may not constitute a PE – the result generally depends on the functions performed through the server.

(2) An Internet website comprised of software and electronic data stored on and operated by a computer server does not involve any tangible property and, therefore,

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95 OECD Model Tax Convention Article 5(3).

96 Copies of the clarification to the Commentary on Article 5 of the OECD Model Tax Convention can be found at http://www.oecd.org-daf/fa/treaties.

97 For example, in Taisei Fire and Marine Ins. Co., 104 T.C. 535, 548-557 (1995), the U.S. Tax Courts looked to OECD Commentary for guidance

the website (as distinguished from the computer server) cannot itself constitute a "place of business" within the meaning of Article 5.

(3) The mere conduct of business through a website hosted on a server owned and operated by an independent Internet Service Provider ("ISP"), without more, cannot constitute a PE. However, if the company that conducts business through the website rents the server on which the website is hosted, then the server may constitute a fixed place of business of that company.

(4) A computer server may constitute a PE with or without human intervention.

(5) As in more conventional cases, a computer server must be "fixed" in order to constitute a PE, i.e., the server must be located at a certain place for a sufficient period of time to become "fixed" within the meaning of Article 5.

(6) The activities of an ISP will not ordinarily constitute a PE of a company that conducts business through a website hosted on a server owned and operated by the ISP under the dependent agent rule of Article 5, because the ISP will not conclude contracts on behalf of the hosted company and/or the ISP will be engaged in a legally and economically independent trade or business.

(7) Where the operations conducted through a server are limited to "preparatory or auxiliary" functions, the server should not constitute a PE. Where the functions performed through the server include activities that form in themselves an essential and significant part of the commercial activity as a whole, the server may constitute a PE.

c. Revised Draft Commentary

The OECD revised draft proposal made the following additional points:

(1) Web hosting contracts are generally not contracts for renting disk space or servers, even though part of the consideration may be computed by reference to the amount of disk space used by the client. Therefore, generally, such a web-hosting contract will not create a PE of the hosted company.

(2) Various countries have different views on the extent (if any) to which human involvement with automated computer servers is or is not necessary to create a PE in the e-business context.

(3) Examples of activities that, by themselves, would generally be regarded as "preparatory or auxiliary" within the meaning of Article 5 include:

- providing a communications link (much like a telephone line) between suppliers and customers;

- advertising by a company of its own goods or services (not banner advertising by one company of another company's goods or services);
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise; and
- supplying information.

(4) Various countries have different views on the extent to which certain core functions that go beyond preparatory or auxiliary activities, e.g., sales activities, carried on through a server will create a PE. However, a fully automated server, i.e., one that includes contract conclusion, payment processing and product delivery, generally will create a PE if other criteria are satisfied, i.e., the server is "fixed" in a specific location, etc.

d. Final Changes

On December 22, 2000, the OECD Committee on Fiscal Affairs adopted changes to the commentary on Article 5 concerning the application of the current definition of permanent establishment in the context of e-commerce.[98] The Committee described the consensus reached among the members as follows:

- A website cannot by itself define a permanent establishment;

- A website-hosting arrangement does not result in a permanent establishment;

- An Internet Service Provider normally does not become a dependent agent or a permanent establishment of a business; and

- The location of computer equipment that is used for a core business activity can constitute a permanent establishment.

Some countries, such as the United Kingdom, made clear that under no circumstances can the presence of computer equipment without personnel constitute a permanent establishment; Spain and Portugal, by contrast, believe that this is possible. The commentary, while extremely influential, is not binding on OECD members or other countries that choose to negotiate treaties based on the OECD model.

The Committee also indicated that it was continuing to review the broader implications of e-commerce for the Convention. It made particular reference to one of the Technical Advisory Groups it has established, whose work is considered in the next portion of this article.

4.4 Characterization and Source of Income

As previously explained, if a U.S.-based company has a PE in a country with which the U.S. has an income tax treaty in force, some amount of "business profits" (within the meaning of the treaty) will be attributable to the PE and subject to tax in the foreign

[98] The commentary is reproduced in Appendix B.

country. In the absence of such a PE, the foreign country will not have the power to tax "business profits" of the U.S.-based company.

However, the foreign country will have the power to tax certain types of income derived by the U.S. company from sources within the foreign country, even in the absence of a PE. With respect to these types of income, it is the sourcing that determines whether the foreign country may tax the income. Moreover, the source of the income is determined by the character of the income. Thus, the characterization and source rules that apply to these types of income determine the tax treatment of the income. In the e-business context, the characterization/source controversy revolves around whether an item of income is characterized as royalty income, rental income, service income or sale proceeds.

a. Character of income from e-business transactions

(1) **Provision of service/service fee.** Certain e-business models produce income from the provision of services. This characterization is significant for two reasons: First, the source and taxability of income derived from the provision of services is generally determined by where the services are performed; and, second, in the e-business context, the location where the services are performed is often determined by server placement, which may be altered to provide the desired result.

(2) **Sale of goods/sale proceeds and lease/rental income.** Other e-business models produce income derived from the sale of tangible goods. For example, when Amazon.com sells a book or an electronic organizer, the transaction is classified as a sale of a good and the income is characterized as sale proceeds. Similarly, the sale of shrink-wrapped software, i.e., the transfer of a perpetual right to use a copy of a computer program, is generally characterized as a sale of a good that produces sale proceeds. This is the case under U.S. federal income tax regulations, as well as under most bilateral income tax treaties.[99]

(3) **License/royalty income.** In some instances, an e-business activity may appear to involve the use or exploitation of copyrights or other forms of intangible property. To the extent that consideration is paid for the right to use intangible property, the consideration may be characterized as royalty income. If the consideration is characterized as royalty income, then the source of the income is determined by where the intangible property is used. For example, if a Japanese customer pays royalties to a U.S. company for the right to exploit the U.S. company's intangible property in Japan, then a withholding tax would apply at the 10% rate provided in the U.S.-Japan income tax treaty.[100] Assuming the U.S. company is in a taxable position in the U.S., the withholding tax may be fully creditable.

Most U.S. software companies have encountered the above scenario with respect to the sale of software products to Japanese distributors and/or customers. However, in the

[99] Treas. Reg. § 1.861-18. See, generally, Karlin & Smith, "On-Line, Off-Base: The Computer Program Final Regulations Miss an Opportunity" 10 J. Int'l. Tax'n 5 (1999).

[100] The withholding tax rate under Japanese domestic law is 20%

software context, the above scenario has often involved a further complication, i.e., the U.S. and Japanese tax authorities have disagreed on the proper characterization of consideration paid by the Japanese distributor or customer for the various rights transferred in connection with the software transaction. The IRS may have classified the transaction as a sale, while the Japanese National Tax Administration may have classified the transaction as a license. Accordingly, the income derived from the transaction might have been characterized as sale proceeds in the U.S. and as royalty in Japan. If the NTA viewed the consideration as a royalty, it would impose the Japanese withholding tax. However, since the IRS may have viewed the consideration as sale proceeds, it would not consider the withholding tax properly imposed (sale proceeds not attributable to a PE are not subject to tax under the treaty). This inconsistent classification has led to competent authority proceedings and, apparently, to the disallowance of claimed U.S. foreign tax credits. It also motivated the IRS to issue the computer program regulations and the OECD to revise the Commentary on Article 12 of the OECD Model Tax Convention.

b. Classification of software transfers

(1) **U.S. computer program regulations.** The U.S. computer program regulations classify cross-border software transactions as sales and licenses of copyright rights, sales and leases of copyrighted articles, the provision of services for the development or modification of a computer program, and the provision of know-how relating to computer programming techniques. The analytical core of the regulations is the distinction made between copyright rights and copyrighted articles (a "copyrighted article," as defined in the regulations, is a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device).

The primary function of the regulations is to provide some certainty with respect to characterization of software transactions. Once the transactions are classified, e.g., as sales of copyrighted articles, the appropriate source rules may be applied to the income derived from the transactions. The various results are illustrated in the table below.[101]

[101] This table was first published in Karlin & Smith, op. cit. note 99 and is reproduced with permission.

	Copyrighted Article	Copyright Right
Inventory		
Sale - fixed or contingent price	Title passage rule for property purchased and sold (§§ 861(a)(6) and 862(a)(6)); *see* § 863 mixed source apportionment rules for property manufactured in and sold outside the U.S. or vice versa. U.S. source if sale by nonresident seller attributable to U.S. office or other fixed place of business - *see* § 865(e)(2)(A); *but see* § 865(e)(2)(B) foreign use/foreign office exception. *See also* § 865(h) elective foreign source treaty override.	The Regulations do not contemplate the possibility that a copyright right may be sold as inventory. However, a reading of § 865(d)(1)(A) would suggest that the inventory exception of § 865(b) can apply to the fixed price component of a sale of intangible property held as inventory.
Non-inventory		
Sale - fixed price	Residence of taxpayer (§ 865(a)), except for gain not in excess of depreciation adjustments where U.S. source gain is the portion of such gain which U.S. depreciation adjustments bear to all such adjustments (§ 865(c)). Foreign source if sale by U.S. resident seller attributable to foreign office or other fixed place of business - *see* § 865(e)(1). U.S. source if sale by nonresident seller attributable to U.S. office or other fixed place of business - *see* § 865(e)(2)(A). *See also* § 865(h) elective foreign source treaty override.	Same - *see* §§ 865(d)(1)(A) and (d)(4).
Sale - contingent price	Residence of taxpayer (§ 865(a)). Foreign source if sale by U.S. resident seller attributable to foreign office or other fixed place of business - *see* § 865(e)(1). U.S. source if sale by nonresident seller attributable to U.S. office or other fixed place of business - *see* § 865(e)(2). *See also* § 865(h) elective foreign source treaty override.	Deemed royalty - Place of use (§ 861(a)(4) and 862(a)(4)) - *see* § 865(d)(1)(B) - requires further classification of copyright right as "intangible" under § 865(d)(2).
Lease/License	Rent - sourced by place of use (§ 861(a)(4) and 862(a)(4)).	Royalty – sourced by place of use (§ 861(a)(4) and 862(a)(4)).

(2) **OECD revised Article 12 Commentary.** On September 29, 1998 (about the same time that the U.S. Treasury and IRS issued the U.S. computer program regulations), the OECD issued a revision to paragraphs 12 to 17 of the Commentary on Article 12 (Royalties) of the OECD Model Tax Convention. The purpose of the revision was to adopt principles substantially similar to those included in the U.S. computer program regulations for classifying software transactions and characterizing the income derived from those transactions.

c. OECD TAG reports

With respect to cross-border software transfers, the U.S. computer program regulations and the OECD revised Commentary on Article 12 should go a long way towards eliminating inconsistent classification controversies. However, similar issues will be presented with respect to a whole host of other e-business transactions. In recognition of this fact, the OECD Committee on Fiscal Affairs (which has undertaken a major consideration of the tax issues raised by e-commerce and related technologies) created five Technical Advisory Groups (TAGs), of which one of the most important is the TAG on Treaty Characterisation of E-Commerce Payments.[102] The TAG has issued two reports, the first on March 24, 2000, and the second on September 4, 2000.

The third and final report was issued on February 1, 2001.[104] The following represents the author's efforts to summarize this report. In some cases, a summary does not do justice to the complexity of the issues and the reader should consult the actual text of the final report.

No.	Category of Income	TAG's Proposed Treaty Classification
1	Electronic order processing of tangible products	Article 7 Business Profits
2	Electronic ordering and downloading of digital products	Article 7 Business Profits
3	Electronic ordering and downloading of digital products for purposes of commercial exploitation of the copyright	Article 12 Royalty
4	Updates and add-ons	Article 7 Business Profits - note that the example assumes no agreement to produce updates or add-ons for a specific customer.

[102] The members of the TAG on Treaty Characterisation of E-Commerce Payments are IBM, NTT Data, Reed Elsevier, the Software Coalition and Walt Disney Corporation. The countries represented are Australia, Chile*, Germany, India*, Israel*, Norway, Philippines*, Japan, United Kingdom and the United States (* indicates a non-OECD member country).

[104] The final report is available on the OECD website at http://www.oecd.org/daf/fa/treaties/Treatychar_finalrep.pdf and. It should be noted that the TAG agreed with representatives from Chile, India, and Israel that payments for downloaded software should be considered business profits, falling under article 7 of the OECD model tax treaty, and the downloading or acquisition of digital intangible products with limited duration does not result in a royalty payment under the treaty. India and Israel in particular are home to numerous software developers.

No.	Category of Income	TAG's Proposed Treaty Classification
5	Limited duration software and other digital information licenses	If provided by tangible medium - unanimous agreement to treat as Article 7 Business Profit
6	Single-use software or other digital product	Provision of services
7	Application Hosting - Separate License, e.g., personal license to execute software on remote server or by download to client's RAM	Article 7 Business Profits, to be treated as provision of services rather than rental payments
8	Application Hosting - Bundled Contract, e.g., software provider also hosts program	Article 7 Business Profits
9	Application Service Provider ("ASP")	Similar treatment to Categories 7 and 8
10	ASP License Fees, i.e., paid by ASP to software provider	Article 7 Business Profits
11	Website hosting	Article 7 Business Profits - Same as Category 7
12	Software maintenance	Mixed payment
13	Data warehousing	Article 7 Business Profits
14	Customer support over a computer network	Generally Article 7 Business Profits, but in some circumstances could be provision of know-how treated as royalties
15	Data retrieval, e.g., ability to research information on-line	Article 7 Business Profits
16	Delivery of exclusive or other high-value data	Article 7 Business Profits
17	Advertising	Article 7 Business Profits
18	Electronic access to professional advice (e.g., consultant, legal, medical or other professional)	Article 7 Business Profits - generally to be treated as technical where this distinction is relevant
19	(Undivulged) technical information	Article 12 Royalties
20	Information delivery (to subscribers)	Article 7 Business Profits
21	Access to interactive website	Payment for services - no part of the fees would be technical
22	Online shopping portals (digital marketplaces)	Article 7 Business Profits
23	Online auctions	Article 7 Business Profits
24	Sales referral programs (e.g., Amazon.com associates program or other similar affiliation program)	Article 7 Business Profits

No.	Category of Income	TAG's Proposed Treaty Classification
25	Content acquisition transactions	Where existing content purchased, Article 12 Royalties; where new content specifically created and website operator acquires the copyright, Article 7 Business Profits (in effect treating the provision of the content as a work for hire)
26	Streamed (real time) web based broadcasting	Article 7 Business Profits
27	Carriage fees (content provider pays website operator to carry content)	Article 7 Business Profits
28	Subscription to a web site allowing the downloading of digital products	Akin to category 2 rather than 21

4.5 Illustration of the OECD's Work

The OECD proposals on the definition of a PE and the classification of the income under the Treaty Characterisation TAG may be illustrated by applying the principles to three examples.

> **Example 1 - Traditional Software Sales.** Assume that a U.S.-based software company (Softco) develops stand-alone software applications for home and business use on personal computers. Softco typically develops new releases of its products every other year. The worldwide market for Softco products is split 50/50 between U.S. and foreign users. Softco distributes its products through both retail distribution channels and by direct download over the web (i.e., electronic software delivery). These sales are commonly referred to as shrink-wrap and click-wrap sales, respectively.

Softco's income will generally constitute business profits under Article 7 and will be taxable only in those jurisdictions where Softco has a PE.[105] Under Article 5, the retail distribution channels generally will constitute a PE only if the distributors are branches or dependent agents of Softco.

If Softco locates servers outside the U.S. and uses those servers to electronically deliver products to customers, then there is an issue as to whether the servers create a PE in the countries of location. If Softco uses the servers solely for the purpose of electronic software delivery, that function likely is considered preparatory and auxiliary and the servers should not create a PE. However, if the servers are automated to conclude contracts, accept credit card payments and deliver product electronically, then the servers may be considered to create a PE in the countries of location.

However, it appears that if the servers do not belong to Softco but Softco merely rents space on a server provided by an independent third party ISP, then Softco should not have a PE as a result of the servers.

[105] See TAG final report, Category 2.

> **Example 2 - B2B Marketplace.** Webco operates an electronic marketplace on the web through which its U.S. and foreign members buy and sell industry-specific goods. Webco facilitates the members' transactions and charges a per-transaction fee for its efforts. Webco also provides banner advertising on its website for industry-related goods and services.

The final TAG report makes it clear that Webco's digital marketplace income, both from transaction fees and banner advertising, will be treated as generating business profits taxable only if there is a PE.[106]

Webco could conduct its digital marketplace on servers located anywhere in the world where appropriate Internet infrastructure is available, regardless of its place of incorporation. For example, Webco could be incorporated in Ireland and operate its marketplace on servers owned by it and located in Ireland. On the other hand, Webco could be incorporated in Ireland and operate its marketplace on servers located in the U.S. and Japan.

Webco may have a PE as a consequence of server ownership; placement and operation if the functions performed by it through the servers go beyond preparatory or auxiliary activities. For example, if Webco is incorporated, managed and controlled in Ireland, but its web-servers are located in the U.S. and Japan, Webco may have a PE in the U.S. and in Japan if the functions performed through the servers located in those countries exceed preparatory or auxiliary activities. In contrast, if Webco is incorporated, managed and controlled in Ireland and all functions that comprise the totality of its business activity are conducted in Ireland (i.e., through its servers located in Ireland and through its offices in Ireland), then it should not have a PE in either the U.S. or Japan, regardless of whether its members are resident in and execute transactions through its marketplace from the U.S. and Japan.

> **Example 3 - Application Service Provider.** Assume a U.S.-based software company (Netco) develops software products for home and business use on personal computers and workstations. Earlier releases of Netco products were sold for traditional installation and use on customer computers. New releases, however, will be made available to customers over the web through an ASP or application service provider model. Netco customers will download and install a relatively small amount of Netco code that permits the customers to access the Netco website and use Netco products, so long as the customer pays (and continues to pay) Netco a periodic user fee. As Netco develops new releases of existing products, the new releases are made available to new and existing customers over the web.

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[106] Category 23 (online auctions, where Webco is not a principal in the market transactions) and 17 (advertising). See also *Piedras Negras Broadcasting Co. v. Commissioner*, 127 F.2d 260 (8th Cir. 1942), aff'g. 43 B.T.A. 297 (1941). The fact that Category 23 specifically refers to Webco not taking title is presumably intended to reinforce the fact that Webco is a service provider not a trader, in which case the outcome might differ according to how the nature of the good or service that was the subject matter of the transaction and other aspects of the transaction.

As in our other examples, the final report of the Treaty Characterisation TAG would treat all of the income as business profits. However, under some treaties where payments for services of a technical nature are treated like royalties or are otherwise taxable by a source country without Netco having a PE, the TAG has reserved its position pending further study.

If Netco locates servers outside the U.S., whether Netco will have a PE in the country of server location will depend on the functions performed by Netco through its servers and whether those functions include activities that form in themselves an essential and significant part of the commercial activity as a whole.

* * * * *

Five years ago, when one of the authors wrote his first paper on the intersection of electronic commerce and international taxation, virtually nothing had been written on the subject, governments, business and tax practitioners were just awakening to the issues that the Internet might create. This scarcity has been replaced by years of plenty. Today, terabytes of materials from governments and commentators all over the world crowd the electronic fields. The barriers to entry for pundits into these fields appear to be as low as the barriers that enabled the dot-coms to make their dash for glory - only to see glory dashed.

The shape of future regulation of this area by governments trying to collect a reasonable share of direct and indirect taxes is still developing. The outlines are becoming clearer, however. Governments are grasping the need to update the jurisdictional underpinnings of their tax systems to deal not so much with new forms of income as with the speed, flexibility and diversity of e-business. The challenge is for governments to find ways to tax income derived primarily from intellectual effort and information management rather than from physical goods without disrupting the development of e-business as a tool for more efficient commercial activity. The challenge for taxpayers is to plan for the uncertainty and to structure the transformation of their businesses into e-businesses with tax considerations as an integral part of business planning.

Appendix A. Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272

Originally adopted by the Multistate Tax Commission on July 11, 1986
Revised version adopted by the MTC Executive Committee on January 22, 1993 Second revision adopted by the Multistate Tax Commission on July 29, 1994

Public Law 86-272, 15 U.S.C. 381-384, (hereafter P.L. 86-272) restricts a state from imposing a net income tax on income derived within its borders from interstate commerce if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property, which orders are to be sent outside the state for acceptance or rejection, and, if accepted, are filled by shipment or delivery from a point outside the state. The term "net income tax" includes a franchise tax measured by net income. If any sales are made into a state which is precluded by P.L. 86-272 from taxing the income of the seller, such sales remain subject to throwback to the appropriate state which does have jurisdiction to impose its net income tax upon the income derived from those sales.

It is the policy of the state signatories hereto to impose their net income tax, subject to State and Federal legislative limitations, to the fullest extent constitutionally permissible. Interpretation of the solicitation of orders standard in P.L. 86-272 requires a determination of the fair meaning of that term in the first instance. The United States Supreme Court has recently established a standard for interpreting the term "solicitation" and this Statement has been revised to conform to such standard. *Wisconsin Department of Revenue v. William Wrigley, Jr.*, Co., [505] U.S. [214], 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992). In those cases where there may be reasonable differences of opinion as to whether the disputed activity exceeds what is protected by P.L. 86-272, the signatory States will apply the principle that the preemption of state taxation that is required by P.L. 86-272 will be limited to those activities that fall within the "clear and manifest purpose of Congress". . See *Department of Revenue of Oregon v. ACF Industries, Inc*., et al., [510] U.S. [332], 114 S.Ct. 843, 127 L. Ed.2d 165 (1994), *Cipollone v. Liggett Grou*p, Inc., 505 U.S. [504], 112 S.Ct. 2608, 120 L. Ed.2d 407, 422 (1992); *Heublein, Inc. v. South Carolina Tax Com.*, 409 U.S. 275, 281-282 (1972).

The following information reflects the signatory states' current practices with regard to: (1) whether a particular factual circumstance is considered under P.L. 86-272 or permitted under this Statement as either protected or not protected from taxation by reason of P.L. 86-272; and (2) the jurisdictional standards which will apply to sales made in another state for purposes of applying a throwback rule (if applicable) with respect to such sales. It is the intent of the signatory states to apply this Statement uniformly to factual circumstances, irrespective of whether such application involves an analysis for jurisdictional purposes in the state into which such tangible personal property has been shipped or delivered or for throwback purposes in the state from which such property has been shipped or delivered.

I. NATURE OF PROPERTY BEING SOLD

Only the solicitation to sell personal property is afforded immunity under P.L. 86-272; therefore, the leasing, renting, licensing or other disposition of tangible personal property, or transactions involving intangibles, such as franchises, patents, copyrights, trade marks, service marks and the like, or any other type of property are not protected activities under P.L. 86-272.

The sale or delivery and the solicitation for the sale or delivery of any type of service that is not either (1) ancillary to solicitation or (2) otherwise set forth as a protected activity under the Section IV.B. hereof is also not protected under Public Law 86- 272 or this Statement.

II. SOLICITATION OF ORDERS AND ACTIVITIES ANCILLARY TO SOLICITATION

For the in-state activity to be a protected activity under P.L. 86-272, it must be limited solely to solicitation (except for de minimis activities described in Article III. and those activities conducted by

independent contractors described in Article V. below). Solicitation means (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order.

Ancillary activities are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities that a seller would engage in apart from soliciting orders shall not be considered as ancillary to the solicitation of orders. The mere assignment of activities to sales personnel does not, merely by such assignment, make such activities ancillary to solicitation of orders. Additionally, activities that seek to promote sales are not ancillary, because P.L. 86-272 does not protect activity that facilitates sales; it only protects ancillary activities that facilitate the request for an order. The conducting of activities not falling within the foregoing definition of solicitation will cause the company to lose its protection from a net income tax afforded by P.L. 86-272, unless the disqualifying activities, taken together, are either de minimis or are otherwise permitted under this Statement.

III. DE MINIMIS ACTIVITIES

De minimis activities are those that, when taken together, establish only a trivial connection with the taxing State. An activity conducted within a taxing State on a regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) shall normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the State is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a non-trivial connection with the taxing State, then such activity exceeds the protection of P.L. 86-272. Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing State is not determinative of whether a de minimis level of activity exits. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the taxing State is inconsistent with the limited protection afforded by P.L. 86-272.

IV. SPECIFIC LISTING OF UNPROTECTED AND PROTECTED ACTIVITIES

The following two listings - IV.A. and IV.B. - set forth the in- state activities that are presently treated by the signatory state as "Unprotected Activities" or "Protected Activities". Such listings may be subject to an amendment by addition or deletion that appears on the individual signatory state's Signature Page attached to this Statement. [Note: a list of states that have adopted this Statement, together with a compilation of such additions and deletions, is available from the MTC].

The signatory state has included on the list of "Protected Activities" those in-state activities that are either required protection under P.L. 86-272; or, if not so required, that the signatory state, in its discretion, has permitted protection. The mere inclusion of an activity on the listing of "Protected Activities", therefore, is not a statement or admission by the signatory state that said activity is required any protection under the Public Law.

A. Unprotected Activities:

The following in-state activities (assuming they are not of a de minimis level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under the Public Law:

1. Making repairs or providing maintenance or service to the property sold or to be sold.

2. Collecting current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.

3. Investigating credit worthiness.

4. Installation or supervision of installation at or after shipment or delivery.

5. Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.

6. Providing any kind of technical assistance or service including, but not limited to, engineering assistance or design service, when one of the purposes thereof is other than the facilitation of the solicitation of orders.

7. Investigating, handling, or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.

8. Approving or accepting orders.

9. Repossessing property.

10. Securing deposits on sales.

11. Picking up or replacing damaged or returned property.

12. Hiring, training, or supervising personnel, other than personnel involved only in solicitation.

13. Using agency stock checks or any other instrument or process by which sales are made within this state by sales personnel.

14. Maintaining a sample or display room in excess of two weeks (14 days) at any one location within the state during the tax year.

15. Carrying samples for sale, exchange or distribution in any manner for consideration or other value.

16. Owning, leasing, using or maintaining any of the following facilities or property in- state:

a. Repair shop.

b. Parts department.

c. Any kind of office other than an in-home office as described as permitted under IV.A.18 and IV.B.2.

d. Warehouse.

e. Meeting place for directors, officers, or employees.

f. Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.

g. Telephone answering service that is publicly attributed to the company or to employees or agent(s) of the company in their representative status.

h. Mobile stores, i.e., vehicles with drivers who are sales personnel making sales from the vehicles.

i. Real property or fixtures to real property of any kind.

17. Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.

18. Maintaining, by any employee or other representative, an office or place of business of any kind (other than an in- home office located within the residence of the employee or representative that (i) is not publicly attributed to the company or to the employee or representative of the company in an employee or representative capacity, and (ii) so long as the use of such office is limited to soliciting and receiving orders from customers; for transmitting such orders outside the state for acceptance or rejection by the company; or for such other activities that are protected under Public Law 86-272 or under paragraph IV.B. of this Statement).

A telephone listing or other public listing within the state for the company or for an employee or representative of the company in such capacity or other indications through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state shall normally be determined as the company maintaining within this state an office or place of business attributable to the company or to its employee or representative in a representative capacity . However, the normal distribution and use of business cards and stationery identifying the employee's or representative's name, address, telephone and fax numbers and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.

The maintenance of any office or other place of business in this state that does not strictly qualify as an "in-home" office as described above shall, by itself, cause the loss of protection under this Statement.

For the purpose of this subsection it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining such in-home office.

19. Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchisor or licensor to its franchisee or licensee within the state.

20. Shipping or delivering goods into this state by means of private vehicle, rail, water, air or other carrier, irrespective of whether a shipment or delivery fee or other charge is imposed, directly or indirectly, upon the purchaser.

21. Conducting any activity not listed in paragraph IV.B. below which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

B. Protected Activities:

The following in-state activities will not cause the loss of protection for otherwise protected sales:

1. Soliciting orders for sales by any type of advertising.

2. Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office as described in IV.A.18. above.

3. Carrying samples and promotional materials only for display or distribution without charge or other consideration.

4. Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration.

5. Providing automobiles to sales personnel for their use in conducting protected activities.

6. Passing orders, inquiries and complaints on to the home office.

7. Missionary sales activities; i.e., the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune.

8. Coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order.

9. Checking of customers' inventories without a charge therefor (for re-order, but not for other purposes such as quality control).

10. Maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year.

11. Recruiting, training or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.

12. Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

13. Owning, leasing, using or maintaining personal property for use in the employee or representative's "in-home" office or automobile that is solely limited to the conducting of protected activities. Therefore, the use of personal property such as a cellular telephone, facsimile machine, duplicating equipment, personal computer and computer software that is limited to the carrying on of protected solicitation and activity entirely ancillary to such solicitation or permitted by this Statement under paragraph IV.B. shall not, by itself, remove the protection under this Statement.

V. INDEPENDENT CONTRACTORS

P.L. 86-272 provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the company or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without the company's loss of immunity:

1. Soliciting sales.

2. Making sales.

3. Maintaining an office.

Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those provided under P.L. 86-272 and this Statement.

Maintenance of a stock of goods in the state by the independent contractor under consignment or any other type of arrangement with the company, except for purposes of display and solicitation, shall remove the protection.

VI. APPLICATION OF DESTINATION STATE LAW IN CASE OF CONFLICT

When it appears that two or more signatory states have included or will include the same receipts from a sale in their respective sales factor numerators, at the written request of the company, said states will in good faith confer with one another to determine which state should be assigned said receipts. Such conference shall identify what law, regulation or written guideline, if any, has been adopted in the state of destination with respect to the issue. The state of destination shall be that location at which the purchaser or its designee actually receives the property, regardless of f.o.b. point or other conditions of sale.

In determining which state is to receive the assignment of the receipts at issue, preference shall be given to any clearly applicable law, regulation or written guideline that has been adopted in state of destination. However, except in the case of the definition of what constitutes "tangible personal property", this state is not required by this Statement to follow any other state's law, regulation or written guideline should this state determine that to do so (i) would conflict with its own laws, regulations, or written guidelines and (ii) would not clearly reflect the income- producing activity of the company within this state.

Notwithstanding any provision set forth in this Statement to the contrary, as between this state and any other signatory state, this state agrees to apply the definition of "tangible personal property" that exists in the state of destination to determine the application of P.L. 86-272 and issues of throwback, if any. Should the state of destination not have any applicable definition of such term so that it could be reasonably determined whether the property at issue constitutes "tangible personal property", then each signatory state may treat such property in any manner that would clearly reflect the income-producing activity of the company within said state.

VII. MISCELLANEOUS PRACTICES

A. Application of Statement to Foreign Commerce.

Public Law 86-272 specifically applies, by its terms, to "interstate commerce" and does not directly apply to foreign commerce. The states are free, however, to apply the same standards set forth in the Public Law and in this Statement to business activities in foreign commerce to ensure that foreign and interstate commerce are treated on the same basis. Such an application also avoids the necessity of expensive and difficult efforts in the identification and application of the varied jurisdictional laws and rules existing in foreign countries.

This state will apply the provisions of Public Law 86-272 and of this Statement to business activities conducted in foreign commerce. Therefore, whether business activities are conducted by (i) a foreign or domestic company selling tangible personal property into a country outside of the United States from a point within this state or by (ii) either company selling such property into this state from a point outside of the United States, the principles under this Statement apply equally to determine whether the sales transactions are protected and the company immune from taxation in either this state or in the foreign country, as the case might be, and whether, if applicable, this state will apply its throwback provisions.

B. Application to Corporation Incorporated in State or to Person Resident or Domiciled in State.

The protection afforded by P.L. 86-272 and the provisions of this Statement do not apply to any corporation incorporated within this state or to any person who is a resident of or domiciled in this state.

C. Registration or Qualification to Do Business.

A company that registers or otherwise formally qualifies to do business within this state does not, by that fact alone, lose its protection under P.L. 86-272. Where, separate from or ancillary to such registration or qualification, the company receives and seeks to use or protect any additional benefit or protection from this state through activity not otherwise protected under P.L. 86-272 or this Statement, such protection shall be removed.

D. Loss of Protection for Conducting Unprotected Activity During Part of Tax Year.

The protection afforded under P.L. 86-272 and the provisions of this Statement shall be determined on a tax year by tax year basis. Therefore, if at any time during a tax year the company conducts activities that are not protected under P.L 86-272 or this Statement, no sales in this state or income earned by the company attributed to this state during any part of said tax year shall be protected from taxation under said Public Law or this Statement.

E. Application of the Joyce Rule.

In determining whether the activities of any company have been conducted within this state beyond the protection of P.L. 86-272 or paragraph IV.B. of this Statement, the principle established in *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal. (11/23/66), commonly known as the "Joyce Rule", shall apply. Therefore, only those in-state activities that are conducted by or on behalf of said company shall be considered for this purpose. Activities that are conducted by any other person or business entity, whether or not said person or business entity is affiliated with said company, shall not be considered attributable to said company, unless such other person or business entity was acting in a representative capacity on behalf of said company.

ADDENDUM:

PUBLIC LAW 86-272

Section 381. Imposition of net income tax.

(a) Minimum Standards.

No state or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) Domestic corporations; persons domiciled in or residents of a State.

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to ----

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident, of such State.

(c) Sales or solicitation of orders for sales by independent contractors.

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property. (d) Definitions.

For purposes of this section ----

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principle and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

Section 382. Assessment of net income taxes; limitations; collection.

(a) No State, or political subdivision thereof, shall have power to assess, after September 14, 1959, any net income tax which was imposed by such State or political subdivision, as the case may be, for any taxable year ending on or before such date, on the income derived within such State by any person from interstate commerce, if the imposition of such tax for a taxable year ending after such date is prohibited by section 381 of this title.

(b) the provisions of subsection (a) of this section shall not be construed ----

(1) to invalidate the collection, on or before September 14, 1959, of any net income tax imposed for a taxable year ending on or before such date, or

(2) to prohibit the collection, after September 14, 1959, of any net income tax which was assessed on or before such date for a taxable year ending on or before such date.

Section 383. Definition.

For purpose of this chapter, the term "net income tax" means any tax imposed on, or measured by net income.

Section 384. Separability of provisions.

If any provision of this chapter or the application of such provision to any person or circumstance is held invalid, the remainder of this chapter or the application of such provision to persons or circumstances other than those to which it is held invalid, shall not be affected thereby.

California Franchise Tax Board Listing of Activities by Public Law 86-272

(1) maintaining any of the following in California:

(a) a sales office maintained by employees rather than independent contractors;

(b) a showroom that is more than temporary;

(c) a (live) telephone answering service;

(d) a warehouse or any other facility for warehousing goods for shipment outside California;

(e) inventory or consigned stocks of goods from which orders are filled;

(f) a repair shop;

(g) a parts department;

(h) a purchasing office;

(i) an employment office; or

(j) a meeting place for directors;

(2) owning advertising material in California such as television films or supervising the production of such films;

(3) owning or renting real or tangible personal property in California other than delivery equipment or salespersons' vehicles;

(4) retrieving damaged or returned merchandise or repossessing products in California;

(5) executing or supervising contracts in California;

(6) approving credit or collecting accounts in California;

(7) handling complaints, approving orders and securing deposits on sales in California;

(8) supervising personnel, including investigating or appointing agents or distributors, in California;

(9) installing products in California, including supervising or inspecting installed products;

(10) providing engineering services in California;

(11) conducting training courses or lectures in California; or

(12) performing warranty repairs in California.

Appendix B. Changes to the Official Commentary on Article 5 of the OECD Model Income Tax Convention

Add the following heading and paragraphs 42.1 to 42.10 immediately after paragraph 42 of the Commentary on Article 5

"Electronic commerce

42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet website, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that website is concerned. On the other hand, the server on which the website is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

42.3 The distinction between a website and the server on which the website is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the website. For example, it is common for the website through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the website, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its website should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the website is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a website has the server at its own disposal, for example it owns (or leases) and operates the server on which the website is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through

such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include: - providing a communications link – much like a telephone line – between suppliers and customers; - advertising of goods or services; - relaying information through a mirror server for security and efficiency purposes; - gathering market data for the enterprise; - supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting websites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an "e-tailer") that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the websites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent

establishments of the enterprises that carry on electronic commerce through websites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the websites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the websites of many different enterprises. It is also clear that since the website through which an enterprise carries on its business is not itself a " person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the website being an agent of the enterprise for purposes of that paragraph.