Commentary: Exploring the Challenges of Electronic Commerce Taxation Through the Experience of Financial Instruments

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I. INTRODUCTION

I was delighted to learn of the topic that Charley Kingson had selected to present for the first Tillinghast Lecture. The international tax issues surrounding intangibles, electronic commerce, and communications technologies, in particular the questions of source-based taxation, strike at the heart of change and uncertainty in international tax. Such a problem is well suited for consideration by the audience for this evening’s lecture.

Not surprisingly, a problem that cannot be resolved within Charley’s lecture most certainly is not to be solved in the Commentary that follows. What I would like to do is highlight a few points and identify useful avenues of comparison and analysis, as well as raise several concerns.

My main point, which I will try to clarify and elaborate, is that as we begin to evaluate the regime developed for source-based taxation and adapt it to the taxation of the electronic commerce and intangible transfers¹ taking place today, I strongly urge making the most of a related, and in some cases parallel, analysis that is currently under way with respect to the international taxation of financial instruments and financial services entities. In the midst of the information and technology revolution, much attention of tax lawyers and scholars has been focused on financial instruments,² perhaps largely to the exclu-

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¹ The use here of the phrases “electronic commerce” and “information technologies” (and related terms) is intended to be broad and to encompass the range of business activities that involve computers, electronic communications, and information distribution.

tion of the broader range of new information technologies that also raise tax questions. However—and here I may be somewhat biased—I believe that much of the work done with financial instruments shares the same foundations, and that the study of electronic commerce taxation would benefit from the experience with financial instruments. We should identify the key features common to both financial instruments and electronic commerce and then review the pertinent tax analyses of financial instruments. The effort should pay off by providing a more solid base from which to begin the exploration of electronic commerce taxation.

II. THE PROBLEM

In order to benefit from the analyses already undertaken for financial instruments, it is helpful to re-examine the tax problem on which this lecture focuses. First, to the extent the focus is the source-based taxation of information technologies, which of the following is the better model for the problem? Is it:

(1) The previous business world was very physical and Congress designed source rules to handle it, but now the world is much less physical and the old rules do not work. Or

(2) The previous world was governed by source rules, which, though not perfect, were generally acceptable because of the de facto limits imposed on taxpayer behavior by transaction costs and limited alternatives. Now that money is earned through less tangible activities, the weaknesses of the old rules have been exacerbated to the point where they no longer adequately function.  

One might ask, “Does it matter which model?” or alternatively, “Isn’t it too obvious to be important?” I believe that the answer is yes, it matters which model, and that one should be explicit because it provides a clearer sense of what is happening and why. If one believes (2) is the better model, as Charley and I do, then knowing that may make us more comfortable contemplating a broad range of changes to the rules, because, in fact, these rules have never been perfect. That is, in considering the source-based taxation of electronic commerce, one starts with source rules developed at a time when earning income

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4 Id. at 644–58.
was a more physical activity. At that time, the rules were tolerable, but not flawless. The major difference is that those "flaws" matter more in the taxation of electronic commerce.

In looking at this picture, Charley raises two questions: (1) Do the old rules make sense, even looking at the past? and (2) What do we do now with changing facts? To answer both questions, we need to ask what we expect from the source rules, what steps we take to tax at source, and what we fear most.

Unfortunately, even the basic point, the "why" of source-based taxation, is not absolutely clear, and the proper role and scope of source-as compared to residence-based jurisdiction continues to be debated.

But, as a preliminary matter, one can describe the why of source-based taxation as a possible combination of factors, including: (1) the recognition of the source country's claim to such income because it provided the environment in which income was earned, (2) the observation that source-based taxation can be harder to avoid than residence-based taxation, (3) the appeal of a tax on foreigners, and (4) the balancing of taxing power between developed and developing nations.

In actually imposing a source-based tax, the United States uses a multi-step process: (1) categorize the income, (2) apply the source rule for that income category to determine whether it is foreign or domestic source, and (3) determine whether or not the income is taxed even if it is U.S. source, and if taxed, by what method.

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6 Earlier cases struggled to classify an item of income in order to determine its source. See, e.g., Karrer v. United States, 152 F. Supp. 66 (Ct. Cl. 1957) (question whether income was from services or royalties); Korfund Co. v. Commissioner, 1 T.C. 1180 (1943) (source of income from noncompetition agreement); see also John J. Cross III, Taxation of Intellectual Property in International Transactions, 8 Va. Tax Rev. 553 (1989).

7 See Kingson, note 3, at 642.

8 See Kingson, note 3, at 658-62.


10 See, e.g., Avi-Yonah, note 9, at 1336; Green, note 9, at 29-32.

11 See IRC §§ 861-865.

12 Some U.S. source income is taxed on a gross basis through a withholding mechanism. IRC §§ 871(a), 881(a). Other U.S. source income (earned by a U.S. trade or business or permanent establishment of the foreign person) is taxed on a net basis at graduated rates.
The process of categorization depends on the ability of the tax law to distinguish among income types—often a difficult task, even when the taxpayer is not trying to be clever. Looking at the past, the source rules exhibited their failings, as taxpayers and the government struggled over the proper category for each income item.\textsuperscript{13} Regardless of the precise purpose for and motive behind source-based taxation, for it to work with any efficiency, the categorization process must be fairly self-evident, at least if different categories lead to different rules. As Charley's example regarding royalties and sales illustrates, the challenge in using these categories is not new.\textsuperscript{14} What is new is the amount of revenue and the volume of business generated by activities for which there are very hazy applications of existing categories.\textsuperscript{15} Moreover, even after categorizing the income item, one must agonize over the tax treatment under trade or business and permanent establishment standards, raising additional troublesome questions regarding what constitutes adequate contact for net basis taxation in a less physical business world. As more total dollars, as well as a higher proportion of total income generated, are from electronic commerce and communications,\textsuperscript{16} one cannot ignore the subject and probably cannot afford to give up the revenue potentially lost through rules whose application is uncertain in the face of substantial change.

So, given some sense of the task, and of the kind of tools usually used to accomplish it, why not charge ahead with pen and paper (or perhaps more appropriately, laptop) and draft some regulations and rulings? What is the concern? The answer is several things: mobile income, tax rules that are effectively elective, stifling an important industry, double taxation, and treaty problems.\textsuperscript{17} And these concerns are not unfounded.

While a factory cannot be moved over the weekend, if the business is intangibles, it can move rather easily.\textsuperscript{18} Furthermore, the concern is

\textsuperscript{13} See note 6.

\textsuperscript{14} See Kingson, note 3, at 645.

\textsuperscript{15} See Tax Issues, note 5, at G-6.


\textsuperscript{17} See, e.g., Tax Issues, note 5, at G-5 (noting the permanent establishment and treaty benefits issues raised by electronic commerce, the enforcement concerns, and the need for collaboration); Practitioner Urges Caution in Taxation of Internet Business, Daily Tax Rep. (BNA), Sept. 4, 1996, at G-6 [hereinafter Caution] (IBM representative acknowledging governments' concern that electronic commerce might erode the tax base, but observing that businesses may face double taxation in the absence of international agreement over tax rules and that Internet-based businesses are very mobile and can leave an unfavorable jurisdiction).

\textsuperscript{18} See Caution, note 17, at G-6.
not abstract. Businesses do think and act with their degree of mobility in mind and taxing jurisdictions are attentive to such realities when seeking to retain or lure industry. A recent domestic example from Massachusetts shows the dance quite clearly. The mutual fund industry, which is substantially based in Massachusetts, sought significant tax concessions from the state. The mutual fund companies, including Fidelity Investments, the nation's largest mutual fund company, asserted that they were a portable industry, ready to move. They asserted they were not only ready to move, but actually planning to move to take advantage of recently passed tax laws in several other states, including Rhode Island that were designed to lure mutual funds from Massachusetts. The result: Massachusetts made tax concessions and the industry is still in Massachusetts. Certainly, less mobile businesses also have obtained tax concessions from states, but the example is powerful and easily can be transferred to the global stage.

For example, the Prime Minister of Malaysia recently announced the details of a government incentive plan to draw foreign investors to the country's proposed "multi-media super corridor," which would include expensive telecommunications links and a fiber-optic network. Among the proposed tax incentives is a five- to ten-year corporate

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19 See Charles Stein, Fund Firms' Tax Relief Gets Green Light, Boston Globe, July 31, 1996, at D1 (quoting a mutual fund executive's statement that Massachusetts "is the birthplace of the mutual fund industry"); see also Jerry Ackerman, Mutual Funds Take to Beacon Hill in Push for Tax Relief, Boston Globe, May 15, 1996, at D1 (17% of those employed in the mutual fund business nationwide work for Massachusetts companies).

20 See id. at D1 (describing the state tax break sought in 1996 by the mutual fund industry in Massachusetts).

21 See id. (quoting one of the bill's chief sponsors, State Senator Tolman, "This is a very portable industry. . . . They have shown the ability to move elsewhere if we do not act.").


23 See Stein, note 19, at D1 (noting that the tax bill was the result of a "competitive threat" because several states, including Rhode Island and Connecticut, "recently passed tax laws designed to lure mutual fund companies from Massachusetts"); see also Charles M. Sennott, State's Efforts for Fidelity Latest Lure to Protect Jobs, Boston Globe, June 19, 1996, at B1 ("Fidelity spokeswoman Ann Crowley was blunt in assessing what is at stake: 'Massachusetts would have to act now if it would like to see the mutual fund industry continue to grow and add new jobs in this state'.").

24 See, e.g., Fidelity Shows Fidelity, Boston Globe, Sept. 16, 1996, at A14 (describing Fidelity Investments decision to add 1,000 jobs in Massachusetts as an "important down payment" on its obligation under the "tax-for-jobs trade-off").

tax exemption.26 One hundred Japanese companies have confirmed their participation, and apparently Microsoft has expressed an interest as well.27

Some of the business activities encompassed within the idea of electronic commerce and information technologies may find themselves especially mobile and their necessary connection to any particular jurisdiction minimal.28 But this observation about tenuous connections (that they can enhance mobility), also leads to a quite different concern over the possibilities for double taxation. Just within the United States, the dollar value of the cyberspace market, combined with the states' antiquated source rules and the states' incentive to develop creative (and profitable) source rules, has led to concern that an Internet seller could face more than 100% taxation through multiple state taxes.29 When the taxpayer is not a manufacturing plant sitting in the middle of one taxing jurisdiction, a greater variety of possible source connections can be identified by each jurisdiction, raising the likelihood of double taxation.30

But even accepting source-based taxation and an ability to categorize electronic commerce satisfactorily and thus to identify a source rule, we must decide what degree of connection is necessary for what kind of taxation, for example, gross basis or net basis. That question forces us to evaluate application of the trade or business31 and permanent establishment standards.32 Do the traditional rules typically require a certain type of physical connection? Why? Is another measure better able to signal electronic commerce's level of connection to a particular jurisdiction?

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26 Id.
27 Id.
28 For example, businesses with minimal physical plant needs, or for which the production of goods or services need not be geographically near the end-user, may have enhanced mobility. See Tax Issues, note 5, at G-6 (discussing how online businesses can spring up and disappear overnight).
29 See States Likely to Take More Aggressive Internet Tax Positions, Daily Tax Rep. (BNA), Sept. 6, 1996, at H-1 (describing concerns that, in an effort to increase revenues, states might take a more aggressive approach towards the taxation of Internet transactions, and that Internet sellers might face more than 100% tax on their income due to states using differing methodologies).
30 See Tax Issues, note 5, at G-6, G-7 (discussing how a number of states are too aggressive in claiming jurisdiction to tax Internet access, services, and online transactions).
31 IRC § 864(b) (defining trade or business), § 871(b) (requiring net basis taxation of nonresident alien individual's income effectively connected with U.S. trade or business), § 882 (requiring net basis taxation of foreign corporation's income effectively connected with its U.S. trade or business).
With so much potential revenue at stake, it is important not to turn the industry into one that bears virtually no tax anywhere. Conversely, if many jurisdictions try to claim a source connection, for example, to Internet sales income, the potential for multiple levels of taxation is especially serious. Clearly, tax authorities need to move with care.

III. A PARALLEL TO FINANCIAL INSTRUMENTS

So far, I have identified a range of transactions, electronic commerce, and related information activities, that governments may want to tax on a source basis, but the categories are weak and the rules for deciding how to tax are not clearly compelling. At this point, I believe the similarities between the tax issues raised by financial instruments and those raised by electronic commerce and information technologies are sufficiently similar that the tremendous energy devoted to the former in the past 10 years should be of some assistance in the efforts to explore the latter.

What are these similarities? At the core of financial instruments are many of the same factors that make the electronic commerce and communication income issues generally difficult: mobility of the activity, difficulty identifying the activity, difficulty locating the activity, rapidly changing transactions and activities, and importance of multijurisdictional coordination.

There is a similarity as well in the results of the analysis. As mentioned earlier, the use of categories in source-based taxation was always weak, but a combination of transaction costs and finite substitutability allowed them to operate with fair success. This was apparent not only with royalties and sales, but also on the financial side, with stock and debt. The debt/equity line has always been contested, but has grown more so with the development of financial instruments that can isolate, divide, and recombine pieces of risk and return with greater precision. Even if the potential categories for electronic commerce and communication activities are not as flexible, and lack the manipulability of mathematical equivalences based on put-call parity, alternative and confusing characterizations nonetheless exist.

Another way to view the difficulty posed by electronic commerce to the tax system, and correspondingly, the parallel to financial instru-

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33 It is important to note this underlying assumption because residence-based taxation of electronic commerce would not be as difficult as source-based taxation.


35 See, e.g., Warren, Innovation, note 2, at 465-70.
For electronic transfers, this may mean posing a hypothetical like the one discussed at the ABA Tax Section meeting in Washington this past May, which considered the taxation of a foreign Internet service provider (with its main server located in the United States and a back up secondary server in a third country) that provided services to a U.S. manufacturer. This case study raised questions about permanent establishment, trade or business and source rules, but failed to result in consensus.37

The second problem, and it relates to the first in several ways, is how to handle multinationals with complex intangible activity. On the financial instruments side, this is a question about how to tax financial services entities, which requires understanding both the actual services and “products,” and the role of each branch, division, or subsidiary in the development, use, and sale of financial products.38 With respect to electronic commerce and communications income, it means not only understanding what, for example, Internet service providers do, but also how they do it—what the various functions are, where they are performed, and by whom.

In addition, a common reaction to financial instruments—that the details are too complicated to follow—is also endemic to the world of electronic commerce and communications. Yet, the details are important. Designing good tax rules requires a solid understanding of the economics of the activities being taxed. Microsoft’s decision to give control of its new software technology to an industry group in order to attract software developers to its system, emphasized for me the complex interactions among product development, sales, service, and profit.39 These connections are important to grasp. While I do not believe that, if the tax community became computer wizards and financial geniuses, the tax questions would vanish, it is important to

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38 See, e.g., Charles T. Plambeck, The Tax Implications of Global Trading, 48 Tax Notes 1143 (Aug. 27, 1990); Reich, note 2, at 3; Samuels & Brown, note 2, at 529.

39 See Bart Ziegler & Don Clark, Microsoft Gives Technology Away to Beat Rival, Wall St. J., Oct. 2, 1996, at B1, B7 (explaining that Microsoft and its competitor Netscape, which have developed incompatible technologies for linking Web pages and other programs on computers, are battling to become the software industry standard).
understand the transactions as clearly as possible (even if you could not have dreamed them up on your own). Then, one can understand the core of the activity, hold the current tax rules up for scrutiny, and think about how the goals and rules interact.

Not only are there similarities between financial instruments and electronic transfers, but in some cases, they come together. IRS Commissioner Margaret Richardson has stated, “Some foreign banks are now using the Internet to solicit new customers with promises of complete anonymity and a haven from all taxes.” The Commissioner also noted a Web advertisement offering a book that discussed “Banking in Silence,” and another that enticed clients with promises of a tax-free environment and the ability to “communicate with the bank anytime from anywhere via the Internet.”

None of the connections that I have emphasized between the electronic commerce and communication area and the financial instruments business should be surprising. What revolutionized the financial industry was a combination of factors, including innovations in computer and information technologies, that enabled businesses to restructure and finely tune their financial management as they more easily analyzed and shifted risk, communicated information, located counter parties, updated and transferred data, and created new packages of risks and returns. Thus, much derives from the information and technology revolution, which, I would agree with Charley, has dramatically altered the ways in which people interact, communicate, conduct business. And to the extent that cross-border tax issues predominate, it makes sense to turn to the literature of financial instruments—not for answers (because there are not a lot) but for ideas, examples, and the elimination of some alternatives. Financial instruments sparked pursuit of many questions first, possibly because these instruments are high profile, but also possibly because (as I recently heard a tax counsel from an investment bank suggest, and it sounds plausible) financial institutions were already global to a significant degree, and when the “information” revolution struck, they were in place to take it, and all the issues, to a global level.

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41 Id.
42 See generally Plambeck et al., note 36, at 660 (observing that derivative financial instruments developed due to a number of factors including technological advances); Samuels & Brown, note 2, at 529-30 (noting that “the principal trends affecting the recent global expansion of the securities business have been economic, technological, and regulatory,” and that “technological advances have also contributed to the development of complex hedging and trading strategies for international securities firms and their clients.”)
43 Kingson, note 3, at 642.
IV. Making Use of the Parallel

Someone might well respond at this point by saying, “Very nice, you have highlighted some parallels, but how does that aid the analysis of the multijurisdictional taxation of electronic commerce and information industries?” I think there are some basic uses one can make of the comparison:

1) As noted above, financial instruments have shown many tax categories to be even weaker than they were believed to be in the past. They have pushed hard at the boundaries as well as put more revenue and income into the most problematic categories. As a result, we have been forced to explore questions about economic substance, and sometimes found even that standard to be confusing and unsatisfactory, at least if many of the existing categories remain the same. For example, the economic substance of a complex financial transaction could be determined by disaggregation—breaking the transaction down into smaller pieces that have an established tax treatment. But if, as is often the case with put-call parity, there is not just one way to disaggregate and if the different component transactions under disaggregation receive different tax treatment, then the disaggregation exercise has not advanced the analysis.

In addition, the rapid pace of technological change as it relates to both financial instruments and electronic commerce means that any categorization cannot be too descriptive or literal because the picture of the world that was accurate last year is most likely inaccurate today. As the government has found with financial instruments, playing a game of regulatory catch up is not particularly satisfying. Nonetheless, we may be able to isolate the core that permits identification of some activity as financial instruments and another as electronic commerce and use that to redefine a system of categories perhaps more closely linked to function.

2) The struggle with existing financial instrument categories has led to another level of questions that also must be considered before taxation of electronic commerce can be reviewed satisfactorily:
   a) How much re-evaluation of the tax system are we willing to engage in? How far towards starting with a clean slate are we capable of going?
   b) What are the reasons for the different tax rules for the different categories? How logical are the existing results, even when the placement of an item of income in a given category is clear? That is, even if

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44 See Section II.
45 Warren, Innovation, note 2, at 470-73 (noting that, in designing different financial contracts, taxpayers are able to elect various tax treatments and engage in tax arbitrage).
46 See id. at 467.
a certain activity should be considered services, is the rule then accorded services a sensible one? As Charley’s discussion of the new sourcing of foreign sales income indicated, there is tremendous pressure to incorporate a variety of economic, industry, employment, political, and revenue concerns in the tax rules.47

c) How much international cooperation would be necessary to meet our goals? With regard to financial instruments, various categories of arbitrage are possible, and if they are to be limited, some joint international effort would be required. What collaborative opportunities exist among taxing jurisdictions?

3) The current taxation and understanding of financial instruments and financial services entities has been furthered through the use of the Advanced Pricing Agreement Program (APA). The methods and results reached in banking and global trading APAs might provide some guidance with respect to the question of electronic commerce and communication activity by the industry providers, the issues of trade or business and permanent establishment, and multijurisdictional income allocation. Perhaps APAs on electronic commerce issues could provide significant information about the underlying nature of the activities. For these allocations, a key question would be what role physical presence should play.

An interesting question to consider here, and one which Charley hints at,48 is whether the kinds of information maintained and used by the taxpayers themselves to monitor their activities would be helpful, similar to the APA process of explaining to the government your understanding of your business operations. Of course, not all issues could be resolved in such a way, but the taxpayers have had a strong incentive to figure some of this out. Certainly, you do not stay in any business very long unless you understand what you are doing, how you make money, what your inputs are, and how you collect a return.

4) Finally, although someone approaching the subject with a scholarly perspective can consider all of these questions at the fullest level, and perhaps identify exactly which approach would be preferable if starting with a clean slate and operating without political or other constraints, it is almost certain that the precise path of reform that the rules ultimately will take will be different from that idealized result. So, at the same time, we need to think about the kinds of compromises that have some measure of logic, internal coherence, and integrity. For example, in the financial instruments area, although the debt/equity line may have very tenuous underpinnings, many discus-

47 Kingson, note 3, at 661 (arguing to divide transfers of intangibles into categories based on business function).
48 Kingson, note 3, at 662.
sions assume that the distinction will continue for tax purposes, and therefore pursue the question of what to do (if anything) about the different withholding rules applicable to dividends and interest, as well as the question of what is the appropriate classification and tax treatment of synthetic payments. 49

V. LIMITS ON THE PARALLEL

All of the above having been said, I must respond, however, to the implicit questions: “What are the limits to a comparison with financial instruments?” “What are the negatives?”

1) There are not a lot of answers coming out of financial instruments work. Despite the tremendous energy devoted to the taxation of financial instruments, there are many questions without answers, and dilemmas without easy solutions. But, even where there are as yet no answers, the understanding of what is going on with financial instruments, and of the likely impact of various rules, is improving. Moreover, looking at the analysis of financial instruments is more than just picking a random tax topic and saying we are bound to learn something through a comparison. It is the examination of an area with, in part, a common genesis—the rapid development of computer and communication technologies. Other similarities also tie the two together: the intangible nature of the product, the international scope of the market, the portability of both product and production, and the reliance on an arbitrage of value as an integral part of the industry's profitability. And it is these common features that pose the challenges to developing good source rules.

2) The parallel is not exact. Much of the concern over financial instruments has focused on timing and has sought to combat the potential arbitrage opportunities in a realization-based system. 50 Financial instruments also have generated significant attention because of their ability to replicate a wide range of cash flows with varying tax treatments. 51 For electronic transfers and communications issues, it is less a question of financial equivalence, and more one of the limits, needs, and capabilities of communication and computer technologies.

Despite these caveats, I believe that not only would the analysis of electronic commerce benefit from the work already undertaken for financial instruments, but perhaps the continuing analysis of financial


50 See, e.g., Shuldiner, note 2, at 250-65 (discussing timing problems in a realization-based system); Warren, Innovation, note 2, at 470-73 (discussing potential of tax arbitrage).

instruments would benefit from the attention now directed towards electronic commerce.

VI. Conclusion

I wanted to mention, in conclusion, that when I finished reading Charley's address and had outlined my comments, I sat back and thought about what I really viewed as the next step. I concluded that what would be ideal would be to identify the major areas of the communications revolution and, in detail, try to work out a coherent picture of what they looked like, how they operated now and were likely to operate in the future, what the underlying economics were, how existing tax rules would apply in the different cases, the problems with the results, the reasons for the problems, and the range of possible solutions, and then combine all of that with a second, and substantially parallel, look at similar issues (primarily cross-border) for financial instruments. Having envisioned this monumental endeavor, I turned to my backlog of daily tax publications, only to discover that the International Fiscal Association's Scientific Committee, chaired by none other than David Tillinghast, had announced that it is sponsoring a two-part research project that will examine "the impact of modern communications systems on traditional source taxation concepts and issues relating to financial products."\textsuperscript{52} This is a perfect opportunity to take parallel tracks of tax research and analysis and share and coordinate the observations and insights as the work is being done. I could not imagine a more timely project under finer supervision.

\textsuperscript{52} IFA to Sponsor Communications Systems, Innovative Financial Products Project, Daily Tax Rep. (BNA), Sept. 6, 1996 at D6.