Taxation of The Internet—A Work In Progress That Doesn't Yet Work

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Over the last several years, "e-business" has developed from a virtually non-existent concept to a multi-billion dollar industry with no limits in sight. Many thousands of entrepreneurs each year create new World Wide Web sites to market and sell goods and services. Not surprisingly, taxing authorities worldwide agree that any sales and profits from such activities should be taxed by someone somewhere. However, no one has yet figured out a viable method of creating or implementing an effective means of determining or collecting such taxes, and the result has been desperation and disagreements of a scale not seen in the tax law area for quite some time. The U.S. Treasury issued a "White Paper" which thoroughly reviewed the U.S. legal theories that could be applied to tax Internet activities, and basically concluded by indicating that the U.S. government was not sure what to do and asked for help on how to solve this mystery. Congress essentially punted by imposing a moratorium on certain Internet-related taxes and not addressing other basic U.S. tax concepts. U.S. states to date have not been able to effectively impose and collect sales taxes on revenue generated by Internet transactions.

Let's look at two different examples. An Internet casino is established in a friendly jurisdiction (at least at that time) such as Antigua through an Antigua company. All of the casino's employees and its computer and telephone equipment are located in that country. Anyone with Internet access anywhere in the world can log on and play for real money by supplying their credit card number. If a portion of the casino's customers are located in the U.S., technically, at first glance, the Antigua company could be viewed as "engaged in a U.S. trade or business," with its taxable income allocable to the U.S. players being subject to U.S. income tax.

In another case, a Cayman Islands corporation, CayCo, sells its own brand of men's shirts made outside of the United States, and sells them to worldwide customers over its Internet site. CayCo also has a small "information booth" in a South Beach boutique, where it does not sell the shirts, but has an "independent representative" available there to answer any questions about how the shirts can be ordered by credit card. Virtually all of CayCo's actual customers are U.S. persons. CayCo's main computer server is located and maintained in Boca Raton, but its other operations beyond the server and the information booth are all in the Cayman Islands.

In the first example, all of the Antigua company's business activities arguably take place outside of the United States. Although the related U.S. tax law is far from clear, it could be claimed that the company only performs services or sells products outside of the United States. A 1942 U.S. tax case, *Piedras Negras,* involved a Mexican radio station with a powerful signal that could be heard by U.S. listeners. In that case, the court held that even though the station had a U.S. audience, it had no actual U.S. physical presence or business activities, and thus its income from U.S. advertisers was not subject to U.S. income tax. Under this line of reasoning, the fact that Americans can tap into the Internet and play video poker on the Antigua company's "virtual casino" would not be relevant, so long as the Antigua entity is completely "offshore."

As for CayCo's activities, the law is even less clear. The South Beach information booth and the Florida-based server may help demonstrate that CayCo has a sufficient U.S. presence to subject it to U.S. income tax, although its overall situation would have to be analyzed in much greater detail before determining any potential exposure. In addition, the State of Florida might attempt to collect Florida sales tax on CayCo's sales, at least those which result from inquiries at the information booth or purchases by Florida customers.

As a bottom-line, the state and federal tax law in this area remains in a state of flux, and no final determinations are expected in the near future, as politicians and bureaucrats continue to debate the issues in question. One proposal has been the creation of a sophisticated computer program that will record all Internet transactions of a particular web site and divvy up each taxing jurisdiction's share, but no such software has yet made an appearance. In any event, professional tax advice should be consulted prior to the establishment of any offshore or U.S.-based Internet service or sales business, as relatively minor differences in activities, computer and employee locations, and other variations may ultimately produce quite different results.