

AUGUSTINPARTNERS LLC

U.S. STEUERBERATUNG

300 EAST 42ND STREET
16TH FLOOR
NEW YORK, NY 10017
FON (212) 593-9900
FAX (212) 593-9997
www.augustinpartners.com

U.S. Taxation of Internet Sales

Regardless of industry or marketplace, foreign business interests planning to do business in the U.S. must become familiar with the U.S. rules governing the taxation of foreign taxpayers in the U.S. Emphasizing this need, the growing role of e-commerce as a means of doing business is prompting a continuing examination of how traditional U.S. tax policies and principles should apply to sales transactions conducted over the Internet. Mindful that all foreign businesses should seek the advice of experienced U.S. tax advisors before entering into any U.S. business venture, the following paragraphs focus on the broadly applicable areas of concern in connection with the U.S. taxation of Internet sales *from the perspective of the seller.*

U.S. Federal and State Income Taxation

The *Internet Tax Nondiscrimination Act* signed into law by President Bush on December 3, 2004, reinstates the legislative ban on any new federal or state taxes on specified electronic commerce transactions and Internet access fees *through November 1, 2007.* Originally enacted in 1998, the law bars the states from enacting any new discriminatory taxes on electronic commerce and forbids the taxing of charges for a service that enables users to access content, information, electronic mail, or other services over the Internet. For this purpose, the term "electronic commerce" broadly includes any transaction conducted over the Internet or through Internet access including the sale, lease, license, offer, or delivery of property, goods, services, or information. The moratorium applies regardless of whether the tax is imposed on the provider or on the buyer of Internet access and regardless of the terminology used to describe the tax.

The moratorium however, does not apply to taxes already in place on the date the law was originally enacted. Therefore, despite the moratorium on taxing Internet access charges and specified electronic commerce transactions noted above, income earned *through actual sales transactions conducted over the Internet are still subject to income taxes in the U.S. under existing U.S. principles of taxation.*

Presently, the IRS approach to e-commerce is to treat the Internet in the same manner as more traditional tax settings. To this end, many current tax policies and ideals can still help guide the taxpayer. For example, if a foreign business entity has otherwise

created a *permanent establishment* in the U.S. as defined under U.S. law and/or applicable treaty protocols, then such transactions will likely be subject to U.S. federal and state income tax (similar to U.S. citizens and residents). Typically, permanent establishment constitutes a fixed place of business through which the business of an enterprise is wholly or partly carried on. Furthermore, if it is determined that such activities result in a permanent establishment subject to tax in the U.S., the need for U.S. federal and state income tax returns and other filings will also need to be addressed.

(Note: There continues to be a debate over the question of whether a server located in the U.S. constitutes a permanent establishment for a foreign seller. Although such a conclusion seems reasonable, the question has not yet been addressed in the U.S. courts or by legislation.)

State and Local Sales Taxes Levied on Internet Sales

Equally as important, Internet sellers may also be subject to state and local *sales taxes* depending upon the facts involved and the particular state(s) in question. With rates generally ranging from 3 to 8 percent of a sales transaction, sales taxes may be levied by various state or local jurisdictions on each individual Internet sales transaction. In general, a sales tax is any tax, which is applied to the sale of tangible personal property or services, at the retail, wholesale, or manufacturing level. The term “sales tax” however, embraces a large variety of levies in force in the U.S. and depending upon the jurisdiction, it includes such taxes labeled as a “retail sales tax”, “gross receipts tax,” or “gross income tax.”

In general, Internet-based retailers must follow the same basic rules for collecting and paying over the sales tax as those operating out of malls, storefronts, or mail-order operations. For example, one fundamental principle that is almost universal in determining whether a state may levy a sales tax on sales conducted over the Internet is whether the *seller* has a sufficient connection or *nexus* to the particular state *and* whether the *customer or buyer* is a *resident* of that state.

For this purpose, “nexus” generally means a *physical presence* in a state such as through ownership or lease of business property, locating employees within a state, participation in trade shows, or using agents to solicit sales within a state. (This list is not intended to be all-inclusive.) For example, if an Internet retailer leases warehouse space in New York State and its customer, a resident of New York State, orders clothing through the retailer’s website, the retailer will be required to collect the sales taxes in New York State. However, if the customer were a resident of California, the retailer would not be required to charge the customer New York sales taxes. If on the other hand, the retailer also had a physical presence or nexus in California, the retailer would also be liable to collect California sales tax on any sales to California residents.

Many web-based businesses sell *digital products* that can be downloaded directly from the Internet. Based upon the current level of technology, these digital products are generally limited to software, recorded music, and electronic books. However, as the market and sales volume for these products continues to expand, so will the states' desire to add them to the list of specifically taxable transactions. Currently, most state tax laws and regulations are silent with regards to "sales" of digital products. Only a handful of states have specific rulings on the taxability of downloaded software, and no states have rules relating to sales of digital products as a class. This however, will not prevent any particular state from taxing such activities upon audit, and will likely be an evolving area of the law in many states over the next several years.

An important point to remember is that *each state has its own rules, which should be reviewed prior to deciding whether a particular transaction causes a tax in that state.* Many states have also become increasingly aggressive in defining what activities and/or presence in the state are sufficient to cause a nexus for taxation, although the laws of each state generally provide for specific exemptions from the sales tax such as sales of products purchased for resale, etc. Once again, it is generally recommended that all Internet sellers consult with their tax advisors for any particular state's rules in this area.

Processing of Customers' Credit Card Payments Online

In order to accept and process credit card purchases online, businesses must first select a payment processing service. Regardless of jurisdiction, a merchant account must be established with a bank in order to accept credit cards online or payments to the company's account. For this service, the company will be required to pay a processing fee for each transaction, as well as a setup fee and/or a monthly account maintenance fee.

When using a credit card processing service, an important issue for the seller is when he will actually have access to the cash from the sale. Although the time-lag between the date of the sale and the actual receipt of cash may vary depending upon the bank, the general rule is between 24 to 48 hours for sales within the U.S. and up to 72 hours for international transactions, according to one leading New York City based international bank. However, with some banks there may also be an "initial" delay of one or two weeks between the date of the sale and the date credited to the bank account of the seller until "the bank becomes familiar with the client." After that, the general rule discussed above should apply. Sellers should therefore negotiate this matter up front before engaging a payment processing service.

In order to better understand exactly how a credit card purchase is processed over the Internet, the following is an example of an Internet sale processing cycle:

- First, the purchaser would place an order online using the company's web site;
- Second, the company would securely transfer order information to the payment processing service over the Internet using a secure, encrypted messaging protocol. The payment processing service would receive the order information and perform the requested services;
- Third, the payment processing service would format the order and send it through its payment gateway to the processor;
- Fourth, the transaction is then routed to the issuing bank to request authorization;
- Fifth, the transaction is either authorized or declined by the issuing bank or card;
- Sixth, the payment processing service returns the message to the company; and
- Seventh, the issuing bank approves the transfer of money to the acquiring bank and the acquiring bank credits the merchant's account.