NEWS

IRS Studying E-Commerce Tax Problems

Mention the Internet and electronic commerce and many see a brave new world to explore. For the tax administrator, that world evokes fear because electronic commerce weakens or eliminates many of the tools currently used to ensure tax compliance. The tax administrator worries that the electronic world will make his job harder or even impossible and will result in the death of direct taxes. Recent research by the IRS and anecdotal evidence have only increased that fear.

The IRS Upstate New York (Buffalo) District is in the final phase of a study on the impact of electronic commerce on the compliance of small business taxpayers. For purposes of the study, small business taxpayers are entities with less than $5 million in assets. The study identified approximately 18,000 commercial Web sites (.com sites) operating in the following market segments: retail/wholesale, computer hardware/software, financial services, Internet service providers, “gray market” activities such as pornography and gambling, and business services.

Approximately 1,600 of the businesses in the sample were selected for additional study. Four hundred and twenty-nine sites in the sample were selected for field examinations. Although a final report on the tax compliance — that is, filing, payment, and reporting compliance — of the businesses is not due until January, the preliminary results are sobering.

Who Is the Taxpayer?

The beneficial owners of 9.5 percent of the 1,600 Web sites selected for additional study could not be identified. Since a tenuous connection exists between a domain name and the beneficial owner of a Web site, it can be difficult to identify the taxpayer responsible for the site. It is significantly more difficult to identify a taxpayer in the electronic world than in the “normal” population, according to an IRS source.

One solution may be to require persons who register a Web site to provide a taxpayer identification number; that may be of limited use, however, if the owner of the site is a foreigner or is a nominee for a third party. Also, it is currently possible to create a Web site without formally registering, according to an IRS source.

Five percent of the Web sites in the study sample became inactive within 60 days of initial identification. The IRS is unsure if the sites became inactive as a result of business failure or if the businesses moved to another site. Whatever the case, the Web is littered with abandoned and unused sites.

To better understand what is going on with the Internet and its impact on tax compliance, the IRS is considering a “longitudinal study” of electronic commerce entities. The goal would be to study the life cycle and evolution of a sample of commercial Web sites. The study would place particular emphasis on compliance regarding tax payments and the filing of required returns.

Compliance Problems Identified

Audits of 260 of the 429 sites selected for field examination have been completed. So far, changes to the taxable income of 27 percent (70) of the taxpayers were required, with additional tax owed. The extra tax assessed was across the board, with some taxpayers having losses and others owing a few hundred thousand dollars in taxes. Also, 7 percent of the cases resulted in securing one or more delinquent tax returns. Until the study is completed, says an IRS source, it would be difficult to make meaningful revenue estimates.

Of the audited taxpayers so far, 65 percent improperly wrote off costs associated with the development of their Web site. The development costs should have been amortized.

Additional problems are being identified in the excise tax area. For example, taxpayers are evading taxes by purchasing expensive fishing equipment from overseas suppliers that is mailed to the United States. Another concern is how to assess the excise taxes on gambling that occurs on the Web.

Although the excise taxes currently involved are not large, the problem of collecting excise taxes in the electronic world illustrates the difficulty caused by the disappearing middleman. Often a U.S. manufacturer or a wholesaler would be responsible for collecting excise taxes. Similarly, a U.S. retailer would be responsible for collecting sales taxes.

Over time, that problem can be mitigated by arranging for information sharing between the United States and foreign countries or by requiring withholding or information reporting by shippers or sellers on the basis of the destination of the merchandise. But making this solution work will take time and experience.

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Another tax administration study under way is examining the problem of encryption — specifically, two concerns. First, with multinationals that have internal communications networks, it will be more difficult to access records necessary to understand a transaction and make the appropriate tax adjustments. Second, taxpayers will be able to undertake transactions with tax significance that the IRS will be unable to detect. For example, if a taxpayer transfers funds offshore using a secure system, the IRS will not be aware of the transaction.

A further concern is the use of encrypted information to arrange for the transfer of money that may be deposited in an offshore bank. The IRS is concerned about taxpayers in a mobile society establishing offshore bank accounts and using them to hide income. With encryption and bank secrecy, it will be virtually impossible for the IRS to discover the unreported income.

Further Studies Planned

Because it does not yet know a great deal about the problems posed by Internet commerce, the IRS is hoping to undertake four additional studies in the future. The first will examine the use of digital technologies as a tool for masking the identity and location of a business. It would include an assessment of the new Internet Corporation for Assigned Names and Numbers, or ICANN, a nonprofit organization that is involved in the registration of Web site names. The study would look at ICANN Web site registration procedures on taxpayer identification, the identification problems associated with Web sites operating below second level domain names — that is, buried Web sites — and the manipulation of a tax jurisdiction through a false flag.

The false flag problem will be especially challenging. A taxpayer may have a Web site in Bermuda for the sale of merchandise, but the company, which is located in the United States, downloads the orders from Bermuda and sends the goods to the U.S. purchaser. The IRS may not be able to associate the Bermuda site with the U.S. company, which can evade various federal, state, and local taxes. Alternatively, a Bahamian corporation may rent part of its Web site to a third party. For a fee, the Bahamian company will forward the orders to the U.S. client.

The second study would look at electronic payment systems over open networks and include an assessment of the potential role of electronic payment systems to reduce the costs and risk for taxpayers to move business income to and from a tax haven. Currently, there is no central reporting of electronic payment transfers, and limited and dispersed records are kept on those types of inbound and outbound payments.

Another study of the business practices of electronic commerce facilitators would include an assessment of using electronic facilitators as an information reporting source or a place to withhold taxes.

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Finally, the IRS wants to study the business practices and structures of Internet service providers (ISPs). Nearly 10 percent of the ISP sites that the IRS has examined failed to file a tax return.

Through the studies the IRS hopes to get a sense of whether electronic commerce is creating new compliance problems or making existing problems worse. However, if it’s creating problems, it may also provide new opportunities to solve them. For example, the IRS received millions of information reporting documents on paper regarding interest and dividend payments in the 1960s. Because of the costs of transcription, only a fraction were used to cross-check returns. After a law change required the data to be submitted on magnetic media, almost all of it was transcribed, which led to the collection of billions of dollars in additional taxes. Perhaps data received in electronic form as a byproduct of electronic commerce would also create new cost-effective opportunities to match transaction data against taxpayer records.

Taxpayer Service

Although fearful of the Web’s potential for creating tax evasion opportunities, the IRS is not blind to its potential as a tax administration tool and is launching several initiatives to help taxpayers and its own compliance staff understand Internet tax issues.

First, the agency is planning to produce an Internet guide for small businesses that will serve as a companion piece to the “Tax Guide for Small Business” (Pub. 334) and could include interactive question-and-answer sessions. The IRS proposes to make the guide available to businesses that have recently registered a domain name with one of the ICANN-approved registration services.
Second, the IRS is planning to hold an interactive seminar for new technology-oriented businesses. The hour-long meeting would be on the Web, with the assumption that a larger number of companies from different geographic regions could attend using their office computers.

Third, the agency is preparing an Internet guide for its employees that will serve as a multifunctional primer for customer service and enforcement employees on the technologies and tools of the Internet. The guide is being written under a mandate from an electronic commerce subgroup set up by the Organization of Economic Cooperation and Development, and will represent a distillation of the expertise of the IRS, U.K. Inland Revenue, and the Australian Taxation Office. It should be available in draft form next year.

Finally, the Buffalo District is planning a market segment specialization program guide on tax issues facing a company involved in electronic commerce. The draft should be completed by the end of March, according to an IRS source.

— George Gutman

Treasury Official Promises Action on Corporate Shelters

Eric Solomon, Treasury’s incoming deputy assistant secretary for tax policy, tried to convince participants at an October 15 session of a Practising Law Institute seminar on mergers and acquisitions that they should care about the corporate tax shelter problem. Corporate tax shelters breed disrespect for the system and require Congress to gunk up the code with specific fixes, he told his audience. He assured them the administration would continue to pursue all avenues of attack against tax shelters—not just by seeking legislation, but also by dealing with shelters through individual guidance, audit, and litigation.

Forthcoming Guidance

Turning to a subject that his audience was definitely interested in, Solomon gave a rundown of forthcoming guidance. The next batch of section 355(e) regulations will define “acquisition” and deal with questions involving public trading and employee options, two subjects on which practitioners have been vocal. The so-called Bausch & Lomb regulation (proposed regulation section 1.368-2(d)(4)), which explains that prior share ownership does not automatically violate the “solely for voting stock” requirement for C reorganizations, will become final. But there is still a debate raging within the government whether disregarded single-member entities should be permitted to participate in tax-free section 368 reorganizations.

The final version of temporary regulation section 1.368-1T, the continuity of shareholder interest regulation, will address prereorganization redemptions, extraordinary distributions, and share repurchase programs. Extraordinary distributions, which count against continuity, are a special problem for regulated investment companies, Solomon noted. Speaking of which, the administration also plans to issue guidance implementing Notice 88-19, 1988-1 C.B. 486, which deals with General Utilities repeal avoidance on conversion to a regulated investment company. The regulations will be directed toward events that result in the ownership of C corporation assets by a RIC or a real estate investment trust with a basis determined by reference to the C corporation’s carryover basis. There will be transitional guidance on nonqualified preferred stock, and section 1504(d) guidance to address changes in Canadian banking law. Also, revenue procedures providing guidelines for seeking a corporate

Fifth Annual Woodworth Lecture

H arry L. Gutman will deliver the 5th annual Laurence Neal Woodworth Memorial Lecture in United States Tax Law and Policy in Washington, December 3, 1999. The lecture, which is sponsored by the Claude W. Pettit College of Law of Ohio Northern University, is scheduled to be held at 11:00 a.m. in Room B-318 of the Rayburn House Office Building.

The subject of Mr. Gutman’s lecture is “Reflections on the Process of Enacting and Administering the Tax Law.”

Harry L. Gutman is a partner with KPMG in Washington. He is a former Chief of Staff of the Joint Committee on Taxation.

Laurence Woodworth served on the staff of the JCT for more than 50 years, beginning in 1944; he was chief of staff from 1964 to 1976. He then served as Assistant Secretary of the Treasury for Tax Policy.

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