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An Ideal E-Commerce Consumption Tax in A Global Economy

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ABSTRACT

Consumption taxation of e-commerce in a global economy is especially difficult because most jurisdictions currently use the destination model. Under the destination model of consumption taxation, the jurisdiction in which the purchaser resides imposes the consumption tax. Because virtually all consumption taxes are collected and paid by sellers, a destination jurisdiction faces both legal and practical problems in forcing a distance seller in another jurisdiction to collect and pay the applicable consumption tax. E-commerce, especially e-commerce in digital goods and services, is practically immune from consumption taxation where the seller is located outside the jurisdiction of the country of the buyer. So, for example, the United Kingdom will find it impossible to collect its 17.5% value added tax on digital goods, such as computer software, sold by a seller located in California USA to a consumer living in the UK.

This author proposes that the destination model be abandoned and that taxing jurisdictions agree to share the consumption tax base between the origination and the destination jurisdiction. So, in the case of a British consumer buying software from an American company in California, the UK and California would split the consumption tax. Initial taxability would be determined by the destination jurisdiction. The overall rate of tax, in order to make the tax neutral and therefore fair, would be determined by the destination jurisdiction as well. The origination jurisdiction could receive up to ½ the tax it would have imposed or ½ imposed by the destination state, whichever is less. This ceiling protects the tax base of the destination jurisdiction.

Because interaction of multinational and multistate tax systems could create crippling complexity,

the proposal requires a uniform product coding system that each taxing jurisdiction will use to determine taxability and the rate of tax. In addition, each jurisdiction will maintain a registration system that will permit tax-exempt sales, especially those involving business-to-business transactions or purchases by governments or charities. To make the system simple and efficient for sellers, a uniform software will be developed for use by independent third party payment intermediaries, such as credit card companies and banks, who will take over the collection and reporting function for a fee sufficient to make their participation profitable. Sellers will have no audit exposure for sales that they make under the system. All jurisdictions will want to participate in order to acquire their share of the revenue set aside for origination jurisdictions.

INTRODUCTION

The power to tax is the power to destroy, or so goes the saying made famous by Justice John Marshall during the formative years of the United States Supreme Court. Those firms now engaging in electronic commerce ("e-commerce") fear that taxation may destroy them. In the end, it will not be the taxes themselves that will harm e-commerce so much as the cost of complying with a myriad and multitude of national and subnational consumption taxes. Attempting to put together a workable multi-national approach to taxing e-commerce that balances the revenue needs of governments against the legitimate desire of e-commerce businesses to compete in an open and free market is a worthwhile exercise.

For the next few years, e-commerce interests may be able to pit governments against each other and succeed in preserving their current tax holiday from many forms of consumption taxes. In the end, however, e-commerce will have to shoulder its share of the tax burden as do other forms of economic activity.

E-COMMERCE WITHIN THE CURRENT TAX REGIME

Most countries impose a myriad of taxes, and most of these taxes apply to e-commerce activity. For example, let us look at a hypothetical e-commerce business, EROCK.com, which produces and sells original rock music. EROCK.com, located in England, specializes in a new form of global rock music that sells well world-wide, especially to those individuals plugged into the Internet. EROCK.com has signed a half dozen rock groups and expects to become a music media giant over the next decade. EROCK.com sells all of its music over the Internet at a cost that is about one-third of a traditional music CD. EROCK.com has thirty employees, all of whom live and work in England.

For the time being, EROCK.com's sole source of revenue is its sale of music over the Internet to a customer base spread out all over the world. EROCK.com is subject to the same array of UK taxes as any other business. If it owns real property, it will have to pay council taxes to the local council. In addition, EROCK.com must pay tax on its company income, value added tax on its in-UK and in-EU sales, and payroll taxes on wages paid to its employees. On its non-EU sales, EROCK.com need not pay any consumption taxes to the countries in which the final consumer resides.

The example of EROCK.com helps to illustrate that the de facto exemption enjoyed by e-commerce is not as broad as most people may believe. However, exemption from paying consumption taxes provides e-commerce with an unjustified competitive advantage and deprives governments of needed revenue. Consumption taxes are a major source of revenue for most governments. If a substantial percentage of this revenue were lost to e-commerce sales, then many governments would face a fiscal crisis or the need to raise other taxes.

CONSUMPTION TAXES

Consumption taxes are an important source of revenue for most governments around the world. These taxes come in two basic forms: special and general. A special consumption tax, such as those excise taxes imposed on liquor, cigarettes, petrol, or air travel, is applied to a certain product that justifies a specific tax rate and an unique tax regime. In contrast, general consumption taxes are applied on a broad range of products and services, including those sold through e-commerce. These taxes follow either the European model of the value added tax (VAT) or the United States model known as the retail sales tax (RST).

Valued Added Tax--VAT

The VAT is a tax imposed on each business during each stage of production of a product or service. The ultimate consumer, however, actually bears the burden of the tax because it is included in the price of the product or service purchased. To eliminate pyramiding of the tax, each business in the chain of production claims a credit against its VAT equal to the VAT charged and invoiced on all items going into the product. Through this invoice/credit mechanism, a business is responsible only for that part of the VAT attributable to the value that it adds in its stage of production.

For multinational transactions within the EU, the administration of the VAT has become difficult. The VAT is a consumption tax intended to be borne by the ultimate consumer of the product, with the tax revenue going to the country in which the purchase and consumption take place. However, making proper adjustment is difficult because large amounts of VAT may have been collected and paid in one country during initial stages of production. Upon final sale in another EU country, all this collected and paid tax must be credited, which creates some accounting nightmares. On an interim basis, the EU allows a selling business to sell a product to a business in another EU country free of VAT, but the purchasing business must pay VAT upon acquisition of the product. This system works well in theory because it shifts the tax and revenue to the destination country and the point of consumption. Technical difficulties arise, however, because the seller must be properly registered and because the purchaser may also be reselling to another business in a different country within the EU.

For business-to-consumer sales where the business and the consumer are in two different EU countries, the VAT is charged and collected in the country where the sale begins if the seller's sales into the specific country are below a threshold. When the annual sales of the seller exceed the threshold, then the seller must register in the destination country and begin collecting at that country's rate and pay the collected VAT to that country's tax officials.

For sales into or out of the EU, the rules are fairly simple, Outbound sales are free of VAT, and the seller receives a credit for all VAT paid up to that point. Inbound sales are subject to the VAT, and the purchaser is responsible for the collection and payment of the VAT, which for consumer goods involves collection by the delivering company or the Post Office.

The VAT in other countries operates in a manner similar to the EU model. Exports are sold free of VAT and imports are subject to VAT upon importation. The VAT rates for various countries are: Argentina 21%, Brazil 18.5%, China 17%, Korea 10%, Mexico 15%, Norway 23%, South Africa 14%, Switzerland 7.5%, and Taiwan 5%.

Retail Sales Tax--RST

Most common within the United States, the RST is a tax on products sold at retail. The RST is a local tax imposed by individual states. There is no national RST. All but five (Alaska, Delaware, Montana, New Hampshire, and Oregon) of the fifty states have a RST. Because all sales other than those at retail to the ultimate consumer are exempt from the tax, a complicated rebate and credit system is unnecessary. This does not mean that the RST is free of administrative complexity. Within each state, the primary problem with the RST occurs with defining non-retail sales and providing exemptions for these sales. Substantial record keeping is necessary. And many businesses, because they are the final consumer of a variety of goods and services that are not later resold at retail, bare the burden of the tax. As a result, some pyramiding of the tax does occur.

Another substantial problem with the RST within the United States is the treatment of interstate sales. For more than 30 years, one state cannot force an out-of-state seller to collect and pay that state's sales tax unless that seller maintains a physical presence (plant, sales force, or office) within the taxing state. Mail order and catalog sales are not sufficient to establish physical presence within the taxing state. As a result, out-of-state mail order and catalog sellers can and do sell goods without imposing, collecting, or paying the RST of the state into which the sale is made.

States do have the legal authority to impose the RST on the consumer, and all states with a RST have imposed this tax on consumers, calling it the "compensating use tax". However, states have been unsuccessful in enforcing the compensating use tax, which consumers in the United States widely ignore. The level of non-compliance with the compensating use tax is so high that the average consumer believes that no such tax, with the corresponding liability for payment, exists.

This gigantic loophole for interstate sales has been a problem in the United States well before the advent of e-commerce. It has robbed states of substantial tax revenues over the years. With the projected growth of e-commerce and the de facto exemption that e-commerce will enjoy from the RST, substantial fiscal harm looms ahead for states.

Other countries with the RST, or a consumption tax that is very similar, do not face the same distance sales problems that have arisen in the United States over the last 30 years. Countries with the RST or a similar consumption tax include: Australia 22%, Canada 7%, Japan 5%, New Zealand 12.5%, and Peru 18%.

E-COMMERCE AND CONSUMPTION TAXES

Within the EU, the current VAT is well equipped to deal with e-commerce in physical or digital goods. For intra-EU sales from one country to another, business-to-business sales shift the VAT to the destination country through use of the invoice/credit mechanism. For similar sales directly from a business to a consumer, the VAT applies either by the origination country or the destination country depending on the size of the annual sales by the business into the destination country. A certain amount of rate disparity may arise because the VAT rate varies from a high of 25% in Denmark and Sweden to a low of 15% in Luxembourg. Businesses wishing to insure the lower VAT rate of a destination country can use this lower rate merely by registering with the tax authorities in the destination country.

For exports out of the EU, all sales are free of VAT. The seller receives a VAT rebate or credit on the amount of VAT on inputs that has been invoiced up to the point of export. Accordingly, the form of the sale as physical or digital goods is irrelevant on export sales.

For imports, VAT, along with any customs duties, is due at the time of importation into an EU country from a non-EU country. For imports, the form of the goods is critical. When the goods are physical, they traverse a country's boundary and expose themselves physically to tax officials at the point of importation. The only physical way around the customs border is smuggling. In the case of digital goods delivered via the Internet, the customs border does not physically exist. As a result, a consumer within the EU can purchase digital goods from a non-EU vendor free of VAT.

Casting our eye back to EROCK.com, we can see how the VAT works for delivery of digital goods. For sales within England, EROCK.com must charge a UK VAT of 17.5% on all such sales. For sales to consumers in other EU countries, EROCK.com charges either the UK rate of VAT or the rate of the other country, depending on the amount of its sales into the particular destination country. These intra-EU distance selling rules allow each EU country to set its annual threshold at either 35,000 euros or 100,000 euros. Belgium, Denmark, Finland, Greece, Ireland, Italy, Portugal, Spain, and

Sweden have all adopted the lower 35,000 euros threshold, whereas the other EU countries have opted for the higher threshold of 100,000 euros.

If we assume that EROCK.com will be very successful, then its sales of digital music will exceed the thresholds in all the EU countries and will force EROCK.com to register for VAT in all fifteen EU countries. The end effect will be that EROCK.com's sales of rock music over the Internet to consumers within the EU will be subject to the VAT rate of the country of the consumer. But for EROCK.com's compliance problem of dealing with the tax authorities of fifteen different EU countries whose tax forms will be in thirteen different languages, the consumption tax results are correct as a matter of tax policy. The rate of tax is determined by the country of consumption. This means that all consumers within a specific EU country pay the same rate of tax on the product whether delivered in digital form over the Internet or in a physical form as a CD or whether delivered from within the country of consumption or from another EU member country. Accordingly, the tax is neutral and consumers buy the goods they want based on considerations other than tax rates.

For EROCK.com sales outside the EU, no VAT applies and none needs to be charged or collected. The imposition of another non-EU country's VAT or RST is problematic. Assuming EROCK.com has no physical presence or assets in these other countries, it is difficult to see how these countries can force EROCK.com to collect and pay their consumption taxes. So, for example, if EROCK.com sells its music to consumers in California, the state of California, which would impose a retail sales tax of 7.25% if EROCK.com were physically located there and also making sales to customers within the state, would be unable to impose or collect its RST from EROCK.com. The EU has no intention of imposing a collection and payment duty on EU vendors exporting to non-EU countries. California's compensating use tax does apply to the transaction. But California, like the other 44 states with a RST, is unable to collect the tax from the consumer.

Within the United States, the current law prohibits states from imposing their consumption taxes on remote sellers located outside the state. This means that California cannot force out-of-state sellers to charge and collect the California retail sales tax unless that seller has a "nexus" with California. For these purposes, "nexus" means doing business within California through the presence of a plant, office, or sales force. For practical purposes, this means that mail order, catalog, and Internet sellers of goods are beyond the reach of California's RST so long as the seller's only contact with California is sending goods there and receiving payments from customers. These rules apply to a seller located in a different state than California.

For the delivery of goods from outside the United States, customs may be imposed by and payable to the national government. However, individual states cannot impose their RST on foreign sellers because the United States Constitution bars taxes on imports unless the federal Congress authorizes such taxation.

In the case of digital goods, these United States rules show a pattern of consumption tax that is somewhat different from the EU's treatment of EROCK.com. To illustrate the difference, let us take another hypothetical company called NEWAGE.com , which produces new age music and sells it exclusively over the Internet to customers located around the world. Let us further assume that NEWAGE.com has twenty employees with office and production facilities in Portland, Oregon, a state in the United States having no RST. NEWAGE.com has no physical presence within any state other than Oregon and no country other than the United States.

Because NEWAGE.com is located within Oregon, all of its sales to Oregon customers are free of a RST. In addition, all of NEWAGE.com's sales to customers in other states within the United States are free of the RST of those states because NEWAGE.com has no physical presence in those states. And finally, all of its sales to customers in other countries are free of RST or VAT, as the case may be.

Let's assume that NEWAGE.com makes sales to customers within the UK. These sales are free of VAT, not legally, but practically, because the UK has no way of forcing NEWAGE.com to comply with its VAT laws and no way of forcing the UK consumer to pay the customs and the VAT on the purchase of the music. As between NEWAGE.com and EROCK.com, we see that NEWAGE.com can sell all its music world-wide without charging any consumption taxes. EROCK.com, by comparison, can sell its product free of consumption taxes everywhere except within the EU. Assuming that the EU is an important part of its market, EROCK.com is at a competitive disadvantage when compared to other on-line rock music sellers located outside the EU. These circumstances may very well induce companies like EROCK.com to locate outside the EU, a result that is bad for the UK because of the loss of economic growth (jobs, income, and capital formation).

THE FUNDAMENTAL NATURE OF THE PROBLEM

Consumption taxes were designed based on the underlying assumption that the seller and the buyer are located within the same taxing jurisdiction. To promote administrability, these taxes also place the collection and payment burden on the seller even though the economic burden is supposed to fall on the buyer. Unfortunately, large numbers of taxable sales begin in one country and finish in another. Where the origination of the transaction begins in one taxing jurisdiction and ends in another, the imposition of the correct tax is problematic. When confronted with this question, the VAT and RST systems have concluded that the tax system and tax rate of the destination jurisdiction should apply. Placing the taxable event within the destination jurisdiction makes good sense on a theoretical level if we intend the consumer to bear the economic burden of the tax. If consumption is the appropriate subject of taxation, then the country in which goods are received is presumably the country of consumption and ought to receive the tax revenue generated by the consumption tax.

The VAT and RST have followed this "destination" model in determining the "correct" tax consequences that should flow from a sale of goods that begin in one country and end in another. On a theoretical level, the "destination" model is not so obviously correct. Both the origination country and the destination country have an interest in the tax revenue generated by sales of goods and services to consumers. If we view taxes as the price paid for having orderly and stable societies, markets, and governments, then both the origination state and the destination state play a critical role in the "consumption" of the good produced. It is the labor and capital market of the origination country that permits production and marketing of the product and the consumer market of the destination country that provides a market for the seller. Obviously, both of these countries benefit from each other's markets and should be prepared to share the tax revenue generated from consumption taxes.

Once a consumption tax using the destination model is imposed on a bi-national or a multi-national transaction, compliance becomes a major problem because the origination country has the practical ability to force compliance, but it is the destination country that gets the revenue. Obviously, the origination country has no real interest in using its scarce governmental resources to police another country's tax system. In fact, countries benefit from not undertaking compliance efforts on behalf of another country. The origination country saves money by not spending any money on enforcement and actually gains other tax revenues (property, payroll, and income taxes) if the business within its borders enjoys a competitive tax advantage in the markets of other countries.

Modern day equivalents of this dynamic are the French hypermarkets located along the English Channel where British consumers travel for substantial savings on liquor, cigarettes, and other tax-favored products. It is the tax disparity between the UK and France that has created the flourishing hypermarkets and transchannel transportation industries. The effect of this tax disparity is the loss of jobs and the revenues within the UK and the creation of jobs and the generation of additional tax revenue for France.

A PROPOSED SOLUTION

Any proposed solution to the problem should be neutral and administrable. Neutrality occurs when a tax system operates in such a way that comparable transactions are taxed at the same rate within a particular taxing jurisdiction. So, for example, music purchased by a consumer should bear a consumption tax of 0% in Oregon USA, 7.25% in California USA, 16% in Spain, 17.5% in the United Kingdom, and 25% in Sweden no matter where the music is produced or no matter what country it is sold from. This level of neutrality means that all sellers into a specific market face a level playing field at least with respect to the imposition of consumption taxes.

Administrability requires that a tax be one which a taxpayer can comply with easily and without undue cost. Unfortunately, global sellers such as EROCK.com and NEWAGE.com face a maze of tax systems and rules described in the arcane tax verbiage of the world's many different languages. Even the EU VAT, which the EU has been working on for thirty years to make administrable, remains a compliance nightmare because fifteen different countries have fifteen different VAT systems that the EU Council and the EU Commission have been endeavoring to harmonize.

The same is true for the RST in the United States. Forty-six jurisdictions (forty-five states and the District of Columbia) have retail sales taxes. Each is unique, has its own rules, its own forms, and its own compliance requirements. In the United States, multi-state sellers face less of a nightmare than EU multi-country sellers because no tax registration is required in a particular state of the United States merely because of sales into that state. But those multi-state businesses with a physical presence in a particular state must deal with that particular state's individual consumption taxes.

Compliance with the tax systems of multiple tax jurisdictions is one problem. Another is the prospect of multiple audits. Taxpayers around the world know that tax audits are a very expensive proposition. Professional fees paid to those who represent a business at a tax audit are always substantial. In addition, the business must deal with contingent tax liabilities for so long as the tax authority legally has the ability to determine and collect deficiencies in tax. Contingent tax liabilities, once determined and collected, can turn a profitable business into a bankrupt one.

Taxing jurisdictions prefer tax systems in which voluntary taxpayer compliance is high. Taxpayer compliance tends to be highest when the tax liability can be determined easily and at a modest cost. Also, taxpayers are less likely to cheat if they know that other businesses are not enjoying an unjustified competitive advantage because of a de facto tax exemption.

BASIC PROPOSAL

A model consumption tax on multistate and mutinational sales of goods and services should have these characteristics:

1. Shared Tax Base. The origination country and the destination country should share the consumption tax base. By sharing revenue, the destination country gives the origination country an interest in insuring that the consumption tax is collected and paid. The rate of tax or the exemption from tax should be determined by the destination country. This approach gives deference to the destination country and insures tax neutrality. The origination country should receive an amount of tax equal to the lesser of ½ of its VAT or RST rate or ½ of the VAT or RST of the destination country. This gives primacy to the tax base of the destination country. To encourage participation by origination states or origination countries with no applicable consumption taxes, the plan should provide an option for these jurisdictions to impose an export tax in an amount that is the lesser of 3% or ½ of the destination jurisdiction's consumption tax.

2. Registration System for Businesses, Governments, and Charities. To avoid pyramiding of consumption taxes, a business should be allowed to register in each country in which it actively conducts business through one or more physical establishments. Sales to registered businesses would be exempt from consumption taxes on the theory that the goods are being used as inputs for

subsequent taxable sales. The technical rules of exemption would be a matter of the domestic law of the destination jurisdiction, although the EU may develop special rules to insure harmonization. Sales to governments and charities would be exempt to the extent that the destination jurisdiction determined, as a matter of national or state tax policy, that they should enjoy tax exemption on purchases.

3. Universal Product Coding System. A universal product coding system should be developed that each taxing jurisdiction would use to determine those products subject to tax. The destination jurisdiction would determine which products are taxable and which are not. This coding system would also enable taxing jurisdictions to vary the rate of tax for different products or to make certain products exempt from tax.

4. Third Party Collection and Payment. All participating countries would rely on third parties to collect and pay the tax. These third parties would likely be credit card companies and banking institutions that would receive a fee for their administration of the system. Each of the participating countries could require credit card companies and banks to assume collection and payment responsibilities as a condition of doing business within the relevant country.

5. Universal Software to Determine Taxability. A universal software would be developed to determine the consumption tax due on each sale. This system would require information showing: a) the product being sold; b) the taxing jurisdiction of the purchaser; c) the registered status of the purchaser; and d) the taxing jurisdiction of the place of origin. Both e-commerce sellers and third party collectors would have to use this software.

6. Audit Insurance. Sellers would cease to be subject to any audits as long as they sold within the system and properly applied the product coding system. This immunity from audit occurs because sellers are no longer responsible for the collection and payment of the tax.

7. Audit Function. The primary audit function would fall on the destination country. It is the destination country that is most interested in compliance. The primary concern will be businesses and other entities that claim exemption when not entitled to it. The second area of concern will be consumers who claim to reside in low or no tax jurisdictions but actually reside somewhere else. Some method for dealing with this potential abuse should be devised to deter cyberspace smuggling.

8. Privacy. Because so many taxing jurisdictions will be involved, safeguards should exist for protecting the privacy of businesses and consumers. The third parties involved in collection and payment should be restricted in the use of the information that they acquire.

9. Adoption. A method to promote universal adoption should be used. Because non-participating states will lose tax revenue, they will likely join the measure through the adoption of domestic legislation. The system should operate on the same basis within national and extra-national entities such as the EU and NAFTA. So, these rules would apply to state-to-state sales within the United States, to country-to-country sales within the EU, and country-to-country sales where neither country is a member of a super-national entity such as the EU or NAFTA.

10. Income Redistribution. The system should allow for the creation of a fund to promote computer use and Internet access to those countries with lower per capita income. In addition, low income countries should be given the option to retain a slightly higher share of revenue if ear-marked for: a) public health; b) public education; or c) infra-structure improvements.

ILLUSTRATIVE EXAMPLES

In the following examples, we shall assume that 1) all the countries and relevant states have adopted the measure described above, 2) universal product codes have been developed, 3) each country or state has developed a registration system to determine exemption from consumption taxes, 4) a universal software program has been developed for use by e-commerce sellers and third-party payment intermediaries, 5) this software contains data showing the rate of tax for each jurisdiction for each coded product, the residence and registration status of the seller, and the residence of the buyer, and 6) the third-party intermediary will receive 5% of the tax to compensate it for its collection, payment, and information reporting duty.

1. EROCK.com. Looking back at EROCK.com (a UK company/UK 17.5% VAT), we shall assume that the company makes Internet sales of music to customers in Sweden (25% VAT), Spain (16% VAT), Oregon USA (0% RST), and California USA (7.25% RST). We shall further assume that each customer purchased 100 euros worth of music with a credit card issued by a company using the collection and payment software. Finally, we shall assume that music is subject to the consumption tax of the relevant jurisdiction. The overall rate of tax is determined by the destination state or country. The UK's share of each of these taxes is equal to ½ of the destination country or state's rate or ½ of its own rate, whichever is less.

* Sweden. The sale to the Swedish consumer will cost 125 euros (100 price plus 25 Swedish VAT). On the purchase, the credit card company adds a 25 euro tax to the transaction. The credit card company collects 125 euros, with 100 payable to EROCK.com (less the credit card transaction fee), 8.75 euros to the UK (less the 5% collection fee), and 16.25 euros to Sweden (less the 5% collection fee).

* Spain. The sale to a consumer in Spain will cost 116 euros (100 price plus 16 Spanish VAT). In this case, however, the UK will receive ½ of Spain's VAT because the UK VAT rate is higher than Spain's. This limit shows that the destination country has the primary claim to the tax revenue and should not lose revenue to the higher tax jurisdiction. Or viewed in another way, at least ½ of Spain's VAT tax base should be preserved no matter how high the tax rate is in the origination state. So, EROCK.com receives the same 100 euros (less the credit card transaction fee), the UK receives 8 euros (less the 5% tax collection fee), and Spain receives 8 euros (less the 5% tax collection fee)

* Oregon USA. The sale to the consumer in Oregon will cost 100 euros. The 0% tax in Oregon, because it is the destination jurisdiction, controls, and no tax is added to the purchase price. EROCK.com still receives the 100 euros (less the credit card transaction fee). In this case the UK receives no tax revenue, nor does Oregon, which makes sense because Oregon imposes no consumption tax.

* California USA. The sale to the consumer in California will cost 107.25 euros (100 price plus 7.25 of California RST). EROCK.com receives its 100 euros (less the credit card transaction fee). In this case, as in the case with Spain, the 7.25 of RST is divided equally between the UK and California because the UK VAT rate of 17.5% is higher than the California RST rate of 7.25%. So the UK and California each receives 3.625 euros (less the 5% tax collection fee).

2. An EROCK.com sale to a registered business in Spain. We shall assume the same circumstances as in 1) above. In addition, we shall assume that EROCK.com sells a large number of its songs to a Spanish company, e-musica mundial, which intends to translate the lyrics into Spanish for sale over the Internet within Spain and to Spanish speaking markets in North and South America. We shall assume that e-musica mundial is a registered business within Spain. E-musica mundial pays 500,000 euros to EROCK.com for the redistribution rights of 100 songs. E-musica mundial paid the 500,000 euros through a bank that is a recognized third-party intermediary under this tax collection system. E-musica mundial supplies its Spanish registration number to the bank. After translating the lyrics from English into Spanish, e-musica mundial sells large amounts of its music into its intended markets. We shall assume that one such purchase was within Spain for 100 euros and another was to a consumer in Mexico for 100 euros. Mexico has a VAT with a rate of 15%.

* EROCK.com sale to e-musica mundial. On the sale of the songs from EROCK.com to e-musica mundial for 500,000 euros, there is no added VAT because this is a business-to-business sale and because e-musica mundial is registered in Spain. When e-musica mundial makes payment through the bank and supplies its registration number, the computer software shows that e-musica mundial is registered and that it is permitted to purchase products without imposition of the UK or Spanish VAT. To insure that e-musica mundial and other registered businesses comply with Spanish VAT rules, Spain will be supplied information on these sales by the third-party payment intermediaries. Because tax-free sales require a certain level of record-keeping and information reporting by the third-party intermediaries, the bank should receive some compensation for the extra costs it incurs. While e-musica mundial is subject to potential audits by Spain, EROCK.com is not because it is selling to a registered buyer and is entitled to rely on the claimed status of the buyer.

* e-musica mundial sale within Spain. On this sale, the normal domestic VAT rules will apply, and e-musica mundial pays its VAT under the current system. Because the third-party payment system is so efficient, Spain, and all other countries with consumption taxes, should consider adopting the third-party collection and payment system for domestic sales.

* e-musica mundial sales to a consumer in Mexico. On this sales, the cost of the music to the consumer is 115 euros (100 for the music and 15 for the Mexico VAT). The 15 euros in VAT is divided equally between Spain and Mexico with each country receiving 7.50 euros (less 5% for the tax collection fee). The VAT is equally divided because Spain's VAT rate is more than Mexico's.

3. NEWAGE.com. We shall assume that NEWAGE.com, the Oregon USA company described earlier is also having success selling its music in a digital format over the Internet. NEWAGE.com sells its music to consumers worldwide. We shall assume that Oregon has adopted the option of imposing a tax on exports in order to capture its share of consumption taxes. The purpose of this option is to induce jurisdictions with no consumption tax to participate in the overall system. By participating, Oregon has an incentive to have its e-commerce merchants work within the system. The merchants, because Oregon has no consumption tax of its own, do not expose themselves to any additional financial liability. Instead, the businesses will cooperate in using the universal software and the universal coding system. If we assume that NEWAGE.com sells $100 worth of music to consumers in Montana USA, California USA, and Spain, then we see these results.

* Montana USA. Montana is one of the few states within the United States that does not have a RST. As a result, the sale to a consumer in Montana will be subject to no RST. The consumer pays $100, and NEWAGE.com receives $100 (less the credit card transaction fee).

* California USA. The price of the music for the California purchaser is $107.25 ($100 price plus $7.25 of RST). Because Oregon has exercised the option to receive the 3% amount, $3 (less the 5% tax collection fee) will go to Oregon. California receives the remainder: $4.25 (less the 5% tax collection fee).

* Spain. The price of the music for the consumer in Spain is $116 ($100 price plus $16 in VAT). Oregon receives its 3%, or $3 (less the 5% tax collection fee), and Spain receive $13 (less the 5% tax collection fee).

OBSERVATIONS

The above examples illustrate that a split revenue system can work quite well. By splitting revenue, both jurisdictions have an interest in seeing that the system works. Even those countries that may view themselves as tax havens are likely to participate in order to acquire the 3% in revenue that will be available on most sales. Neutrality is preserved within jurisdictions because the consumption tax rate does not vary based on the origin of sale. The EU should find the proposal attractive because it solves the problem of designating the point of sale within the EU and also preserves most of the

VAT tax base for sales from outside the EU. Because VAT rates within the EU are among the highest in the world, the EU is extremely vulnerable to non-EU digital sellers hoping to take advantage of a borderless cyberspace and the de facto tax exemption it provides for consumption taxes. This proposal virtually eliminates that vulnerability of the EU market.

The United States e-commerce business community will likely object to this proposal. Ordinarily, the basis for their complaint would be the cost of compliance. This complaint, however, has no basis because vendors incur no extra cost for compliance (other than participating in product coding, which should involve minimal costs). Any registration under the system for exemption for business-to-business sales will be quite similar to the types of registration already required within most of the states with a RST and, therefore, should involve only minimal compliance costs. Exposure to audit will not change. Companies will have audit exposure only in those states in which they have a physical presence, which is the audit exposure they currently face.

The real reason for opposition to this proposal from the e-commerce business community within the United States will be the realization and understanding that the proposal, by making sure that all sales bear the local rate of consumption tax, will remove the tax-favored status currently enjoyed by these businesses. They know that the exemption from consumption taxes provides a powerful competitive edge. They would like to retain that competitive edge. If they cannot preserve the edge forever, any delay is economically advantageous. Given a choice between equivalent goods, a consumer will obviously take advantage of a 15% to 25% price difference attributable to an exemption from the VAT. Local sellers of goods are entitled to expect a tax neutral environment in which to sell their goods and services.

Most of the state and local governments within the United States will support this proposal because it solves the current problem of catalog and mail order sales. In addition, it solves the problem of growing e-commerce. State and local governments receive about one third of all their revenue from the RST. Any substantial reduction in that tax base will create fiscal problems for these governments. The scope of the problem is currently masked by the buoyant United States economy whose growth has provided for almost commensurate growth in RST revenues. If e-commerce grows at the rate most experts predict, then RST revenues eventually will begin declining even if the American economy continues its robust growth.

The United States Congress is likely to be negative or lukewarm to the proposal. The proposal does not directly affect federal revenues in any way because there is no national sales tax. As a result, the Congress does not acquire any new revenues or prevent the loss of existing revenue sources. Many in Congress will realize that the United States will be better able to maintain its current competitive advantage in e-commerce because sales originating within the United States will have a substantial advantage over local sales in high tax jurisdictions like the EU. In fact, many non-US e-commerce sellers may establish themselves in the United States because it currently is something of a consumption tax haven, unlike the EU where all intra-EU e-commerce sales are subject to the VAT of either the origination or the destination country. So far, the US Congress has supported a moratorium on the taxation of e-commerce, and many voices currently within Congress have called for a permanent ban. Given the constitutional structure within the United States, the passage of federal legislation to support this proposal may be very difficult. Forty percent of the United States Senate can block any legislation. And a presidential veto could effectively stop any legislation because a two-thirds majority from both the Senate and the House of Representatives is required to nullify the president's veto. Inaction at the federal level within the United States will preserve the tax-free condition of the status quo.

From a tax policy point of view, the proposal is actually quite ideal. It is neutral, and it is simple for all the taxpayers. The simplicity comes primarily from the use of computer software, which will make many of the functions as automatic as possible. With computer software, the number of rates and exemptions is largely irrelevant. The product code classification, which will be the most difficult task, will actually be relatively simple because the mass marketing and selling of goods tend to make these products fall into fairly definite categories. Some international organization will be necessary for this coding. A commercial company may serve this purpose well.

Financial intermediaries might be wary about the proposal because it shifts collection, payment, and information reporting responsibility to them. If paid a profitable amount, however, these intermediaries will likely take these tasks on quite eagerly. They are already well equipped to deal with high volumes of financial data and have the expertise to implement such a system efficiently.

The software itself should not be too difficult to develop. The more difficult task will be the interpretation of local tax laws to determine how they will work within the system. This can be solved, however, by giving each jurisdiction the responsibility for determining which products are subject to tax and which are not under the product coding system.

All in all, then, this proposal should receive serious consideration from world governments that are concerned about the erosion of their consumption tax base caused by the growth of e-commerce.

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