

# CAN WIDENING THE SCOPE OF INFORMATION REPORTING TO INCLUDE INCOME DERIVED FROM ONLINE SALES HELP TO NARROW THE EXPANDING TAX GAP?

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## I. INTRODUCTION

Over the past decade, the Internet has become an integral part of our society, and its expansion has led to a surge in e-commerce.<sup>1</sup> E-commerce, defined as “any business transaction completed over a computer network, including . . . the sale of goods or services,”<sup>2</sup> has similarly become integral to our society. The popularity of e-commerce is reflected in the observation

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1. See Pamela Swidler, Note, *The Beginning of the End to a Tax-Free Internet: Developing an E-Commerce Clause*, 28 CARDOZO L. REV. 541, 542, 546–48 (2006) (noting the recent surge in e-commerce and arguing that the Supreme Court ruling in *Quill v. North Dakota*, 504 U.S. 298 (1992), that a physical nexus is required to tax interstate commerce, is dated and inapplicable in the context of Internet commerce). According to a U.S. Census Bureau study, “Rapid growth in e-retail has been the norm. From 2001 to 2006, retail e-sales increased at an average annual growth rate of 25.4 percent, compared with 4.8 percent for total retail sales.” U.S. CENSUS BUREAU, 2006 E-COMMERCE MULTI-SECTOR REPORT 3 (2008), available at <http://www.census.gov/eos/www/2006/2006reportfinal.pdf>. Note that the estimates provided by the U.S. Census Bureau study only include sales from online marketplaces where the marketplaces take title to the goods sold and do not include arrangements for purchase or sale of goods owned by others. U.S. Census Bureau, E-Stats—Measuring the Electronic Economy, Frequently Asked Questions, <http://www.census.gov/eos/www/faq.html> (last visited Dec. 26, 2009).

2. IRS.gov, Electronic Business & Electronic Commerce, <http://irs.gov/businesses/small/industries/article/0,,id=209249,00.html> (last visited Dec. 26, 2009).

that most consumers consider online retail to be “a primary benefit of the Internet.”<sup>3</sup> The Internet has dramatically enhanced the ease and convenience of engaging in e-commerce in the United States and worldwide. Purchasing items ranging from textbooks to antique lamps to luxury handbags is now only a mouse click away. Items can be purchased remotely from “click and mortar businesses”<sup>4</sup>—retail businesses with both a physical and Internet presence—and small online businesses alike.

Online selling platforms,<sup>5</sup> such as eBay, Amazon, and Google Checkout, have facilitated the growth of sales by small businesses, sole proprietors, and casual sellers. For instance, eBay, “the world’s largest online marketplace,”<sup>6</sup> has contributed to the evolution of e-commerce by bringing sellers and buyers together in a virtual marketplace, offering a variety of both new and used items. With more than 724,000 Americans reporting that they derived their primary or secondary source of income from eBay sales in 2005,<sup>7</sup> tax law must be modernized to facilitate effective taxation of Internet commerce. In particular, income tax law must be updated to incorporate income generated by e-commerce and ensure that this income is properly reflected on the tax returns of online sellers and appropriately taxed.<sup>8</sup>

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3. Press Release, Suzy Bausch & Michelle McGiboney, Nielsen Online, News Release: Nearly 80 Percent of U.S. Adult Online Consumers Made Internet Purchase in Previous Six Months (Nov. 12, 2008), available at [http://www.nielsen-online.com/pr/pr\\_081112.pdf](http://www.nielsen-online.com/pr/pr_081112.pdf) (reporting a statement by Nachi Lolla, Research Director, Commerce, Nielsen Online).

4. IRS.gov, Retail Industry ATG—Chapter 3: Examination Techniques for Specific Industries (Electronic Business, Online Retail), <http://www.irs.gov/businesses/small/article/0,,id=141491,00.html> (last visited July 15, 2009).

5. Although many websites, such as eBay, are commonly referred to as auction websites, eBay’s user agreement explicitly states that eBay is “not a traditional auctioneer. Instead, [its] sites are venues to allow anyone to offer, sell, and buy just about anything, at anytime, from anywhere, in a variety of pricing formats and locations, such as Stores, fixed price formats, and auction-style formats.” eBay, Your User Agreement, <http://pages.ebay.com/help/policies/user-agreement.html> (last visited Dec. 26, 2009). Thus, throughout this Note, the terms “online trading platform” and “online selling platform” are used to refer to eBay, Amazon, and Google Checkout.

6. eBay, Who We Are: E-Commerce, <http://www.ebayinc.com/who> (last visited Dec. 26, 2009).

7. CHANDRA BHANSALI ET AL., INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE: SMALL BUSINESS/SELF-EMPLOYED SUBGROUP REPORT 1 (2006), available at [http://www.irs.gov/pub/irs-utl/2006\\_irpac\\_public\\_meeting.pdf](http://www.irs.gov/pub/irs-utl/2006_irpac_public_meeting.pdf). According to a survey conducted by eBay of its users, “[E]Bay estimates that more than 430,000 people generate most of their incomes selling goods—in 43,000 different categories—through the site, which at any one time lists about 29 million items, from cars to cuff links, world-wide.” Nick Wingfield, *Boss Talk: Auctioneer to the World—Projecting Continued Growth, eBay’s Whitman Says Site Innovates by Heeding Users*, WALL ST. J., Aug. 5, 2004, at B1.

8. When existing tax laws were developed, their relation to virtual worlds had not yet been contemplated. Leandra Lederman, *eBay’s Second Life: When Should Virtual Earnings Bear Real Taxes?*, 118 YALE L.J. POCKET PART 136, 137 (2009).

Although the Internal Revenue Service (“IRS”) has explicitly stated that “[a]ll income from auctions, traditional or online . . . is generally taxable unless certain exceptions are met,”<sup>9</sup> it is widely known that there is not complete compliance by online sellers; nonreporting and underreporting of income is a major issue stemming from e-commerce.<sup>10</sup> However, both the extent to which taxpayers fail to comply with their obligations to report income derived from online sales, and the extent to which underreporting is intentional, remain unclear.<sup>11</sup> Devising and implementing tax legislation that facilitates tax compliance by online sellers is an important undertaking given the common misperception among taxpayers that the Internet is a “‘tax-free’ zone.”<sup>12</sup> Since it is “comparatively easy and cheap to set up an eBay business,” taxpayer confusion about reporting obligations may be more prevalent among online sellers than among traditional “brick-and-mortar” stores.<sup>13</sup> The limited amount of tax guidance for online sellers may explain their relatively greater noncompliance.<sup>14</sup>

The “explosion”<sup>15</sup> of e-commerce in the last decade raised important tax policy implications that must be addressed to narrow the expanding “tax gap.” The tax gap, which measures the extent to which taxpayers fail to file their federal tax returns and to pay the correct tax on time,<sup>16</sup> is the

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9. IRS.gov, Reporting Auction Income and the Tax Gap, <http://www.irs.gov/newsroom/article/0,,id=174478,00.html> (last visited Dec. 26, 2009).

10. Although the number of eBay users who pay taxes on earnings derived from online sales is unknown, “experts suspect the percentage is low.” Verne Kopytoff, *IRS Urged to Go After EBay Sellers: Tax Experts Say Online Auctions Should Report Users’ Gross Sales*, S.F. CHRON., Feb. 24, 2007, at A1. According to Leandra Lederman, “Many eBay sellers likely underreport their income for income tax purposes, whether because of ignorance of the law or simply because, absent information reporting, noncompliance is not obvious.” Lederman, *supra* note 8, at 139.

11. See OFFICE OF TAX POLICY, U.S. DEP’T OF TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 8 (2006), available at <http://www.ustreas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf>.

12. Swidler, *supra* note 1, at 541.

13. Martin Vaughan, *Online Sellers Face New IRS Rules*, WALL ST. J., July 30, 2008, at D3.

14. Filing taxes has been thought to be so complicated for casual sellers that Intuit Corporation, maker of the tax assistance software TurboTax, has created a separate software program just for these taxpayers. Kathy M. Kristof, *Taxes Get Complicated for Sellers on Internet*, L.A. TIMES, Apr. 2, 2006, at C3.

15. Trevor J. Mohr, Note, *From the Garage to the Information Superhighway: Tax Consequences for Individual EBay Users and IRS Policy Toward the Online Marketplace*, 14 WIDENER L. REV. 297, 298 (2008). “The Internet auction is exploding as an international platform for individual buyers and sellers.” Susan Albring, Lillian F. Mills & Marlene Plumlee, *Beanie Baby Billions? Unpaid Taxes on Internet Auctions*, 87 TAX NOTES 1153, 1154 (2000).

16. IRS.gov, New IRS Study Provides Preliminary Tax Gap Estimate, <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> (last visited Dec. 26, 2009). See also IRS.gov, Understanding the Tax Gap, [www.irs.gov/newsroom/article/0,,id=137246,00.html](http://www.irs.gov/newsroom/article/0,,id=137246,00.html) (last visited Dec. 26, 2009).

result of three major tax obligation violations: underreporting, underpayment, and nonfiling.<sup>17</sup> The growth of Internet commerce, an area plagued by the asymmetry of information inherent in a self-reporting tax system,<sup>18</sup> has contributed to the expansion of the tax gap. At the federal level, underreporting of income from online sales on websites such as eBay arguably contributes significantly to the widening of the tax gap.<sup>19</sup>

Similarly, e-commerce has been found to have a significant impact on state taxes,<sup>20</sup> although this is not captured in the estimate of the federal income tax gap. At the state level, jurisdictional issues involved in interstate commerce result in the inability of states to collect sales tax on purchases made on the Internet. Because online sellers may not directly apply sales tax to transactions that occur interstate,<sup>21</sup> and instead buyers are supposed to report interstate purchases in the form of use taxes but many fail to do so,<sup>22</sup> online sales transactions are often not taxed, resulting in billions of dollars of lost revenue for states.<sup>23</sup>

This Note focuses on the widening tax gap that stems from underreporting and nonfiling of income on federal income tax returns by

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17. U.S. DEP'T OF TREASURY, UPDATE ON REDUCING THE FEDERAL TAX GAP AND IMPROVING VOLUNTARY COMPLIANCE 3 (2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf); IRS.gov, Understanding the Tax Gap, *supra* note 16. The Department of Treasury defines these terms in the following way: "under-reporting" is "not reporting one's full tax liability on a timely-filed return"; "underpayment" is "not timely paying the full amount of tax reported on a timely-filed return"; and "nonfiling" is "not filing required returns on time and not paying the full amount of tax that should have been shown on the required return." U.S. DEP'T OF TREASURY, *supra*, at iii.

18. See Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1735 (2010) ("A core problem for enforcement of tax law is asymmetric information. . . . [T]he taxpayer knows the facts regarding the relevant transactions he or she engaged in during the tax year . . . . The government is forced to obtain that information after the fact, either from the taxpayer or from third parties." (footnote omitted)).

19. Mohr, *supra* note 15, at 297.

20. See Swidler, *supra* note 1, at 548–51. Although acknowledging that studies conducted to estimate the loss from uncollected state sales taxes stemming from e-commerce are controversial, Swidler cited several studies that have attempted to estimate the amount of lost sales tax revenue "due to the shift in consumer buying habits to remote sellers online." *Id.* For instance, one study "[b]ased on a weighted national sales tax of 6.4% and projected Internet growth" estimated the loss to be approximately \$3.5 billion. *Id.* at 549. A 2001 study cited by Swidler estimated a \$14 billion loss in 2003, "attributable only to e-commerce transactions that would have otherwise taken place in a brick and mortar store." *Id.* at 550.

21. See U.S. CONST. art. I, § 8, cl. 3; *Quill Corp. v. North Dakota*, 504 U.S. 298, 302–03, 315–19 (1992).

22. See Leslie J. Carter, Comment, *Blowing the Whistle on Avoiding Use Taxes in Online Purchases*, 2008 U. CHI. LEGAL F. 453, 454, 470–73 (analyzing the "circumstances under which purchasers of goods over the internet may use state false claims acts to bring successful claims alleging [sales and use] tax violations against online retailers").

23. See Swidler, *supra* note 1, at 548–51.

online sellers who engage in e-commerce on websites like eBay, Amazon, and Google Checkout.<sup>24</sup> A few researchers have similarly explored the issue of the income tax consequences of online sales. For instance, Susan Albring, Lillian Mills, and Marlene Plumlee<sup>25</sup> conducted a study estimating the magnitude of the tax gap attributable to unreported capital gains taxes on eBay auctions of collectible items.<sup>26</sup> They conclude that taxpayer education and increased enforcement may be necessary to address tax evasion by online sellers.<sup>27</sup> Richard Malamud, also exploring taxation of income derived from online sales, concludes that regulations pertaining to § 6045 of the Internal Revenue Code (“the Code”) on requirements of brokers to file information returns should be amended and expanded to apply to income earned from sales on eBay.<sup>28</sup> Recognizing that a majority of the tax gap is attributable to the failure of self-employed individual filers to report significant taxable income,<sup>29</sup> Trevor Mohr suggests that the IRS should develop a better understanding of transactions conducted on eBay and expert advice in developing new regulations for Internet commerce.<sup>30</sup>

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24. Existing scholarship on taxation of e-commerce primarily focuses on lost sales and use tax revenue for state and local governments resulting from the failure of online merchants to collect these taxes from out-of-state buyers. *See, e.g.*, Megan E. Groves, *Tolling the Information Superhighway: State Sales and Use Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 619, 620, 636 (2000) (evaluating the procedure by which states may seek to apply sales and use taxes to purchases made online and proposing that Congress enact a “practical nexus standard for the Commerce Clause” to be applied to taxation of e-commerce); Isaac J. Morris, *Creating an Online Internet Tax: A Complex Construction?*, 2 NW. J. TECH. & INTELL. PROP. 291, 293 (2004) (critiquing the necessity of imposing a physical presence requirement for Internet sales taxes and advocating for a “straightforward [legislative] solution[]” that rests on an analysis of a seller’s purposeful availment in a taxing jurisdiction); Swidler, *supra* note 1, at 547; Carter, *supra* note 22, at 453–54, 488. Recent case law involving taxation of Internet sales also deals with levying state sales taxes. *See, e.g.*, Amazon.com LLC v. N.Y. State Dep’t of Taxation & Fin., 877 N.Y.S.2d 842, 846, 849, 851 (Sup. Ct. 2009) (upholding a New York statute that required “collection of New York taxes from New Yorkers by out-of-state sellers that contractually agree to pay commissions to New York residents for referring potential customers to them” and finding it did not violate the Commerce Clause).

25. At the time of their publication, Susan Albring was a Ph.D. candidate and Lillian F. Mills and Marlene Plumlee were assistant professors. Albring et al., *supra* note 15, at 1153.

26. *Id.*

27. *Id.* at 1158.

28. *See* Richard Malamud, *How the IRS Can Close the Online Auction Tax Gap*, 106 TAX NOTES 110, 110, 112–13, 115 (2005) (arguing that “[f]airness dictates that the IRS crack down on those who don’t report their income, especially if that can be done easily by amending outdated regulations so that gross income of many businesses would be reported to the IRS”).

29. Mohr, *supra* note 15, at 299. Mohr explains that “[m]any users are intentionally failing to comply with IRS reporting requirements, and the present regulations may not control usage or force individual taxpayer compliance.” *Id.*

30. *See id.* at 310. Mohr suggests that the IRS can apply the same approach it used in analyzing § 183 of the Code, pertaining to income derived from activities not engaged in for profit such as hobbies, in developing tax law for horse breeding to alter the Code to increase reporting of e-commerce income. *See id.* at 308–11. As discussed in Part III below, § 183 does not permit deductions where an

In particular, he concludes that part of the solution will consist of revising the Code to require filing Forms 1099 and W-9<sup>31</sup> for sellers conducting sales on eBay and regulating entities like eBay.<sup>32</sup>

This Note draws upon the scholarship in this area to evaluate whether a new provision included in the Housing and Economic Recovery Act of 2008 (“the Act”), signed in July 2008, will help narrow the tax gap resulting from underreported and unreported income derived from online sales.<sup>33</sup> Section 3091 of the Act,<sup>34</sup> codified at § 6050W of the Code, requires payment settlement entities and third-party settlement organizations, who make payments to participating payees in settlement of reportable payment transactions, to annually report to the IRS the gross amount of such reportable transactions and the taxpayer identification number (“TIN”) of participating payees.<sup>35</sup> Characterized as part of “Congress’s latest attempts to close the tax gap,” the requirements under § 6050W are “expected to reduce noncompliance related to income underreporting by taxpayers with gross income from payment card and/or

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individual engages in an activity not for profit. Subsection (d) of § 183, defining when an activity is presumed to be engaged in for profit, carves out special terms for the presumption pertaining to breeding, training, showing, or racing horses. I.R.C. § 183(d) (2006). Mohr explains that the “presumption’s specific mention of horse breeding was enacted pursuant to specifically researched tax theory that supported applying section 183 to the activity while also offering taxpayers an incentive to invest” and to prevent harsher treatment of farmers engaged in the activity of horse breeding. Mohr, *supra* note 15, at 309–10. He suggests that the IRS should similarly further its understanding of the nature of eBay transactions to ensure that regulations affecting e-commerce increase taxpayer compliance without interfering with the industry and “offer better tax consequences to users who are hindered by the current Code application.” *Id.* at 310.

31. An IRS Form 1099 is a type of information return that must be filed with the IRS, reporting certain kinds of business transactions. IRS.gov, A Guide to Information Returns, <http://www.irs.gov/efile/article/0,,id=98114,00.html> (last visited Dec. 26, 2009). A Form 1099-B, for example, is an information return that must be filed by a broker or barter exchange for each person for whom the broker has sold or exchanged stocks or bonds or for each person “who exchanged property or services through a barter exchange.” IRS, DEP’T OF TREASURY, 2009 INSTRUCTIONS FOR FORM 1099-B, at 1 (2009), available at <http://www.irs.gov/pub/irs-pdf/i1099b.pdf>. See also *infra* text accompanying note 117. An IRS Form W-9 is a form used “to request the taxpayer identification number (“TIN”) of a U.S. person.” IRS, DEP’T OF TREASURY, INSTRUCTIONS FOR REQUESTER OF FORM W-9, at 1 (2007), available at <http://www.irs.gov/pub/irs-pdf/iw9.pdf>. Form W-9 is used by people required to file information returns with the IRS to ensure that they get the payee’s correct information. *Id.* For individuals, the TIN is often their social security number. *Id.* at 1–2.

32. Mohr, *supra* note 15, at 321–22.

33. An article by Leandra Lederman, providing a framework for evaluating information reporting proposals, evaluates the efficiency of three reporting proposals and concludes that the new information reporting provision examined in this Note “holds some, though somewhat limited, promise.” Lederman, *supra* note 18, at 1752.

34. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, sec. 3091(a), § 6050W, 122 Stat. 2654, 2908–11.

35. See *id.*

third-party network transactions.”<sup>36</sup> The provision is estimated to raise approximately \$9.5 billion in tax revenue over ten years.<sup>37</sup>

Although this particular provision has not yet received much attention from scholars or the press,<sup>38</sup> compliance with its requirements poses potentially significant cost implications for the business models of small businesses<sup>39</sup> and online trading platforms. Even though the provision will not begin applying to tax returns until calendar year 2011,<sup>40</sup> it is imperative that reporting entities begin to incorporate the provision in their tax planning. One commentator has expressed that the affected parties “will need to invest significant time and resources to make the necessary changes to existing systems in order to comply.”<sup>41</sup> For instance, obtaining proper names and TINs from merchants and transmitting them to the IRS for validation could end up being a “long and tedious process”—a process that reporting entities should begin to contemplate and plan accordingly now.<sup>42</sup>

This Note explores how several benefits derived from the new information reporting requirement for e-commerce transactions outweigh the potentially increased costs involved in its implementation. The new information reporting provision is a promising addition to the Code, serving as a potentially valuable tool in addressing the issue of noncompliance among online sellers. This Note explains that while there are numerous individuals casually selling goods on websites like eBay, information reporting required by this new section of the Code is properly

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36. D. Joe Gill, *New Information Reporting Requirements for Payment Card and Third-Party Network Transactions*, 2009 TAX ADVISER 150, available at <http://www.aicpa.org/pubs/taxadv/mar2009/taxclinic.pdf#nameddest=6>.

37. See JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATED BUDGET EFFECTS OF THE TAX PROVISIONS CONTAINED IN H.R. 3221, THE “HOUSING AND ECONOMIC RECOVERY ACT OF 2008,” SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008, at 3 (Comm. Print 2008), available at <http://www.jct.gov/publications.html?func=startdown&id=1275>. It should be noted that given that this provision applies to any payment settlement entity, such as a credit card company, some percentage of this figure likely reflects unreported income from other credit card transactions not involving e-commerce transactions.

38. See Gill, *supra* note 36. Gill observes that § 6050W “has not received a lot of attention” and suggested that it could end up “biting” those who “have placed it at the bottom of their to-do list or, worse, failed to notice it altogether.” *Id.*

39. See Andrea Coombes, *Keeping Tabs: Thanks to New Housing Bill, Credit-Card Transactions to Be Reported to IRS*, MARKETWATCH.COM, Aug. 21, 2008, <http://www.marketwatch.com/news/story/firms-fume-over-new-irs/story.aspx?guid=%7BCA36D1AD-6888-44CD-AB93-0C15FC297DDC%7D&print=true&dist=printMidSection>.

40. See Housing and Economic Recovery Act of 2008 § 3091(e), 122 Stat. at 2911.

41. STEVEN FRIEDMAN, KPMG, CREDIT CARD ISSUERS AMONG THOSE AFFECTED BY NEW REPORTING REQUIREMENT 5 (2008), available at [http://us.kpmg.com/microsite/taxnewsflash/2008/Aug/6050\\_Reporting.pdf](http://us.kpmg.com/microsite/taxnewsflash/2008/Aug/6050_Reporting.pdf).

42. *Id.*

confined to requiring reports only for individuals who derive a significant amount of income from online sales.<sup>43</sup> Limiting information reporting in this manner maintains consistency with important tax principles of equity and administrative ease, as discussed throughout this Note.

Part II of this Note presents an overview of the e-commerce landscape in the United States. Part III outlines the Code sections applicable to analyzing taxation of income derived from Internet sales. Part IV discusses the concept of the tax gap, illustrates the magnitude of the problem, and explains how information reporting may help decrease the expansion of this gap. Part V discusses the guiding principles for tax policy and considers how these principles may influence the appropriate approach to taxation of income generated from Internet sales. Part VI describes the history of proposals and recommendations put forth by various agencies to address the underreporting and nonfiling of e-commerce income and outlines what appears to be the result of this history: § 6050W of the Code. Part VII explores the implications of this new reporting provision for online trading platforms, online sellers, and the IRS. Lastly, Part VIII offers suggestions for Treasury regulations and guidance aimed at assisting affected parties in carrying out the new reporting obligation.

## II. THE LAY OF THE E-COMMERCE LAND

The “explosive growth”<sup>44</sup> of the Internet has increased the ease with which businesses can be formed and engage in commerce. E-commerce enables sellers from any location to sell goods or services to any other location without maintaining an actual physical store. As one researcher has observed, “Many sole proprietors have found using Internet auction sites so advantageous and cost-effective that they have closed their physical storefronts and reopened their businesses in the virtual world.”<sup>45</sup> For instance, given the ease and low-cost entry of establishing a business selling items on eBay, many eBay sellers start out selling goods purchased

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43. See the Housing and Economic Recovery Act of 2008, sec. 3091(a), § 6050W(e), 122 Stat. at 2910, which provides an exception for de minimis payments by third-party settlement organizations. A third-party network will only need to file an information return for online sellers who exceed a threshold \$20,000 of gross receipts and an aggregate of two hundred transactions. *Id.*

44. BHANSALI ET AL., *supra* note 7, at 1.

45. Mohr, *supra* note 15, at 297. See also Tanya Mohn, *The Mouse in the Antiques Shop*, N.Y. TIMES, Sept. 5, 2004, at 14WC (quoting an antiques shop dealer who observed that “[eB]ay is certainly the reason that so many smaller shops have closed”). Moreover, some small businesses have found that an online presence on websites like eBay has served as a powerful marketing tool, driving traffic into their actual store locations. See Gwen Moran, *Small Business: Bricks & Clicks*, U.S. NEWS & WORLD REP., Nov. 2, 2005, [http://www.usnews.com/usnews/biztech/articles/051102/2bricksclicks\\_print.htm](http://www.usnews.com/usnews/biztech/articles/051102/2bricksclicks_print.htm).

at a bargain.<sup>46</sup> Several transactions later, these casual sellers end up functioning as profit-seeking businesses, finding themselves subject to the requirements of the new information reporting provision in § 6050W of the Code,<sup>47</sup> as described in detail in Part VI.B.

Three major online platforms—eBay, Amazon, and Google Checkout—have emerged as forums for small businesses, sole proprietors, and casual sellers to sell new and used items to consumers “outside the scope of physical realms, where typical commercial activities take place.”<sup>48</sup> These online platforms are a popular medium of e-commerce used by many buyers and sellers.<sup>49</sup> According to one study, eBay comprises approximately 14 percent of e-commerce.<sup>50</sup> Although it is unclear whether and to what extent the currently troubled economy and related buying slowdown will negatively affect e-commerce, these online selling platforms continue to represent an important component of e-commerce and have the potential to thrive if e-commerce continues to grow.<sup>51</sup> In fact, online shopping appears to remain strong despite the currently weak economy.<sup>52</sup>

#### A. THE ONLINE MARKETPLACES

The popularity of the eBay platform has increased tremendously since it “opened its virtual bidding floor in 1995.”<sup>53</sup> On any given day, there are more than 140 million listings for items on eBay.<sup>54</sup> From 2007 to 2008 the number of active users using eBay grew from approximately 83.2 million to 86.3 million.<sup>55</sup> eBay users range from casual sellers to entrepreneurs

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46. See Vaughan, *supra* note 13 (“The transition from casual seller to profit-seeking business can seem almost spontaneous.”).

47. See *id.*

48. Mohr, *supra* note 15, at 298.

49. In a quarterly study performed by Nielsen Online, eBay and Amazon were ranked as the first and second top online retailers (ranked by unique audience). Press Release, Bausch & McGiboney, *supra* note 3, at 2.

50. *Id.*

51. See Kristina Dell, *eBay Bids for Revitalization*, TIME, Dec. 11, 2008, at G1.

52. A Nielsen Online press release from the 2008 holiday season noted that “Nielsen Online, a service of the Nielsen Company, reported . . . that Web traffic from home and work to the Holiday eShopping Index increased 10 percent year over year on Black Friday,” representing growth “from 28.8 million unique visitors in 2007 to 31.7 million unique visitors in 2008.” Press Release, Michelle McGiboney, Nielsen Online, News Release: Despite Challenging Economy, Black Friday Traffic to Online Shopping Sites Grows 10 Percent Year over Year (Dec. 1, 2008), available at [http://www.nielsen-online.com/pr/pr\\_081201.pdf](http://www.nielsen-online.com/pr/pr_081201.pdf).

53. See Mohr, *supra* note 15, at 302.

54. eBay, Inc., Annual Report (Form 10-K), at 2 (Feb. 20, 2009) [hereinafter *eBay Annual Report*].

55. *Id.* (defining an “active user” as “any user who bid on, bought or listed an item during the

whose quarterly sales can yield more than half a million dollars.<sup>56</sup> By the end of 2008, eBay users worldwide had established around 516,000 virtual “storefronts,” which enable sellers to post all of their listings on one customized page.<sup>57</sup> According to eBay, its marketplace “platforms are more effective, relative to available alternatives, at addressing markets of scarce new goods, new items that are no longer in-season, end-of-life products and used and vintage items.”<sup>58</sup> In recent periods, eBay’s growth has stemmed from its “fixed-price listing format,” rather than its traditional auction format,<sup>59</sup> but eBay is nonetheless providing an online marketplace for users to sell goods to buyers located anywhere. Its payment segment, PayPal, enables buyers and sellers to “easily and quickly send and receive payments online.”<sup>60</sup>

The Amazon Services division of Amazon.com offers users a selling platform similar to that provided by eBay. On Amazon Marketplace, sellers of all types can complete transactions with customers in a single checkout process.<sup>61</sup> In fact, casual sellers who expect to have less than forty orders per month can sign up for a program that has no monthly fee but rather a “per product sold fee” of only \$0.99.<sup>62</sup> Like eBay, Amazon also enables sellers to sell casually or to open a “branded, custom online store” through a program called “Webstore.”<sup>63</sup> Amazon’s Participation Agreement notifies its users that Amazon is not involved in the actual transaction between third-party sellers and buyers, but rather serves as a platform for the transaction and provides payment services.<sup>64</sup> Amazon notes that its Payment Service division is not the purchaser of the seller’s goods and

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preceding 12-month period”).

56. See Vaughan, *supra* note 13 (“Like many eBay sellers, Sarah Davis didn’t set out to be a business owner. But somewhere between her first online sale and last quarter’s \$560,000 in sales of second-hand luxury handbags, it dawned on her that she had become one.”).

57. eBay Annual Report, *supra* note 54, at 3.

58. *Id.* at 2.

59. *See id.*

60. *Id.* at 6.

61. Amazon.com, Inc., Annual Report (Form 10-K), at 3–4 (Jan. 30, 2009) [hereinafter Amazon.com Annual Report].

62. Amazon.com, Selling on Amazon—Frequently Asked Questions, <https://www.amazon.com/gp/seller-account/mm-product-page.html?topic=200274800> (last visited Dec. 26, 2009). In these transactions, Amazon is “not the seller of record” and instead earns “fixed fees, revenue share fees, per-unit activity fees, or some combination thereof.” Amazon.com Annual Report, *supra* note 61, at 3.

63. See Amazon.com, Help: Selling on Amazon.com, <http://www.amazon.com/gp/help/customer/display.html?nodeId=1161232> (last visited Dec. 8, 2009).

64. Amazon.com, Participation Agreement, <http://www.amazon.com/gp/help/customer/display.html?ie=UTF8&nodeId=1161302> (last visited Dec. 26, 2009).

merely facilitates the processing of the transaction.<sup>65</sup>

Google Checkout, the newest of the three major online platforms, was launched in 2006.<sup>66</sup> It is a service provided by Google to users, advertisers, and participating merchants intended to “make online shopping faster, more convenient, and more secure.”<sup>67</sup> Google Checkout offers an “online shopping payment processing system for both consumers and merchants.”<sup>68</sup> As noted in the Google Checkout Terms of Service, Google Payment Corporation, a wholly owned subsidiary of Google that operates the Google Checkout service,<sup>69</sup> provides third-party services to facilitate payment transactions between the buyer and the seller.<sup>70</sup>

## B. ONLINE SELLERS

Online sellers who engage in e-commerce on sites like eBay are required by law to report online income,<sup>71</sup> but for several reasons—ranging from ignorance of the law concerning their reporting obligations to intentional evasion of taxpayer duties—many of these sellers underreport or completely fail to report this income.<sup>72</sup> The extent to which intentional misreporting occurs relative to unintentional misreporting is unknown given that it is impossible to ascertain a taxpayer’s intention from a tax return. Nonetheless, the undeclared sales transactions facilitated by websites like eBay, Amazon, and Google Checkout have been identified as contributing to the widening tax gap,<sup>73</sup> although the exact amount of noncompliance has not been determined.<sup>74</sup>

The results of the 2000 study performed by Albring, Mills, and

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65. *Id.*

66. See Saul Hansell, *Google Aims to Speed the Online Checkout Line*, N.Y. TIMES, June 29, 2006, at C1.

67. Google, Inc., Annual Report (Form 10-K), at 6 (Dec. 31, 2008), available at [http://investor.google.com/documents/2008\\_google\\_annual\\_report.html](http://investor.google.com/documents/2008_google_annual_report.html).

68. *Id.* at 69.

69. See Google, Google Checkout Privacy Policy, <https://checkout.google.com/files/privacy.html> (last visited Dec. 15, 2009).

70. See Google, Google Payment Corp. Terms of Service <https://checkout.google.com/termsOfService?type=seller> (last visited Dec. 26, 2009).

71. See *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (calling “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion,” part of one’s taxable gross income).

72. See Lederman, *supra* note 8, at 139.

73. See Kopytoff, *supra* note 10.

74. Mohr, *supra* note 15, at 299–300 (“There is a lack of factual statistics quantifying how much eBay users actually contribute to the problem, and neither the IRS or Congress has made any significant progress in addressing it.”).

Plumlee suggest that unreported e-commerce income contributes a considerable amount to the widening tax gap.<sup>75</sup> This study attempted to estimate the uncollected capital gains tax stemming from sales of collectibles on eBay by casual individual sellers.<sup>76</sup> Noting that “[s]ome dealers in collectibles may treat their sales as a business and report the profits,” which would be subject to ordinary income tax rates,<sup>77</sup> the researchers focused their study on the unreported profits of individuals.<sup>78</sup> The researchers collected eBay data for twenty-four “random hours from the rolling [thirty]-day historical record of completed auctions” and extrapolated to “annual unreported sales.”<sup>79</sup> They estimated the bases for these collectible items by assuming the following: “(1) an ad hoc basis of \$5 per auction, based on Beanie Baby retail prices; (2) basis equals 50 percent of selling price; and (3) bases range from 10 percent to 90 percent of selling price.”<sup>80</sup> Applying these bases estimates and the assumption that no sales were reported on sellers’ tax returns, they concluded that “hundreds of millions of dollars from eBay collectibles alone” were uncollected.<sup>81</sup> Acknowledging that “numerous measurement issues . . . make precise estimates difficult,” the researchers concluded that the “order of magnitude based on reasonable assumptions is striking.”<sup>82</sup>

### C. ASYMMETRIC INFORMATION

The “nature of the network”—the Internet—as a rapidly evolving borderless global forum consisting of a multitude of anonymous users<sup>83</sup> contributes to one of the core problems of enforcing tax laws with respect to e-commerce: asymmetric information.<sup>84</sup> Online sellers can easily register to sell goods on websites by providing very little information to the online

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75. See Albring et al., *supra* note 15, at 1153–54.

76. See *id.* at 1153, 1155. The researchers excluded from their data collection the trading of goods categorized as “antiques, art, great collections, and jewelry/gemstones” because these categories “appeared more likely to involve businesses or registered dealers.” *Id.* at 1155. The researchers, whose “curiosity was piqued by the Beanie Bay phenomenon,” used a final sample consisting of data on the trading of “plush toys, Pokémon toys, action figures, stamps, coins, sports memorabilia, sports cards, advertising, holiday memorabilia, comic books, lunch boxes, and trading cards.” *Id.*

77. *Id.* at 1153 n.2.

78. See *id.* at 1155. If the individual sellers were engaged in a trade or business, their profits would be subject to ordinary income as discussed in Part III.

79. *Id.* at 1153.

80. *Id.* at 1155.

81. *Id.* at 1153.

82. *Id.* at 1158.

83. See Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet Is Changing Tax Laws*, 34 CONN. L. REV. 333, 337–48 (2002).

84. Lederman, *supra* note 18, at 1735.

platforms. For instance, eBay's registration form asks only for the seller's name, address, telephone number, email address, and date of birth.<sup>85</sup> Moreover, as one researcher found, by performing a search of the Internet using the search engine Google, none of the online trading platforms notified sellers that a Form 1099<sup>86</sup> would be filed with the IRS, nor did they request that the sellers provide their TINs.<sup>87</sup> Thus, prior to the effective date of § 6050W of the Code, there was no mechanism in place to track the transactions of online sellers eligible for income taxation.

The asymmetry problem relating to e-commerce income is no different from the asymmetry problem that arises concerning other kinds of income where the taxpayer is the primary source of knowledge about his or her income. As Leandra Lederman explains, "One aspect" of the asymmetry problem is that the "taxpayer knows the facts regarding the relevant transactions he or she engaged in during the tax year—or at least has ready access to that information" but does not necessarily volunteer this information on his or her annual tax return.<sup>88</sup> Information asymmetry is reflected in the observation that honesty is fostered where the taxpayer knows that the government has information about the taxpayer's activities.<sup>89</sup> One researcher has concluded that "social science and empirical studies confirm that income visibility is an important determinant of tax compliance."<sup>90</sup> As Lederman explains, "This dynamic highlights a different information asymmetry: the government knows more about its enforcement activities than taxpayers do."<sup>91</sup>

Information reporting, as discussed in Part IV, is a means by which the IRS can solve both of the forms of asymmetries described above<sup>92</sup> and may prove helpful when confronting the problems of underreporting by sellers in the online marketplace. A statement issued by the IRS regarding aims to improve voluntary compliance reports that "compliance is highest where parties other than the taxpayer are required to file information reports and withhold taxes from payments made."<sup>93</sup> A recent survey

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85. See eBay, eBay Register, <https://scgi.ebay.com/ws/eBayISAPI.dll?RegisterEnterInfo> (last visited Dec. 26, 2009).

86. See *supra* note 31 (explaining Form 1099). See also *infra* text accompanying note 117.

87. Malamud, *supra* note 28, at 111.

88. Lederman, *supra* note 18, at 1735.

89. See *id.* at 3.

90. Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 40 LOY. U. CHI. L.J. 483, 485 (2009).

91. Lederman, *supra* note 18, at 1735 (footnote omitted).

92. See *id.*

93. U.S. DEP'T OF TREASURY, *supra* note 17, at 6.

conducted by the IRS Oversight Board found that 40 percent of respondents stated that third-party reporting of income to the IRS had a “great deal of influence” on whether they report and pay their taxes honestly.<sup>94</sup>

Although seemingly an “obstacle to deflating the tax gap,”<sup>95</sup> online selling platforms can help alleviate asymmetric information problems and provide information valuable to increasing taxpayer compliance and the narrowing of the gap, as discussed below in Part VII. According to one source, “Auction sites such as eBay make it possible for thousands of transactions which might otherwise occur in isolated front yards, parking lots, and town squares”—transactions which the IRS does not have the resources to monitor—to “flow through” websites that may have the capacity to track this data.<sup>96</sup> By adding information reporting requirements to the Code that require entities such as eBay’s PayPal to provide the IRS with information regarding taxable transactions taking place on the web, the data that online selling platforms likely already collect in their ordinary course of business can be leveraged in minimizing the tax gap.

### III. SECTIONS OF THE INTERNAL REVENUE CODE APPLICABLE TO TAXATION OF E-COMMERCE INCOME

Under § 1 of the Code, the federal income tax is applied to “taxable income,”<sup>97</sup> which generally means “gross income” minus deductions.<sup>98</sup> “Gross income” is broadly defined in § 61 of the Code as meaning “all income from whatever source derived, including (but not limited to) the following items: (1) [c]ompensation for services, including fees, commissions, fringe benefits, and similar items; (2) [g]ross income derived from business; (3) [g]ains derived from dealings in property;” and so forth.<sup>99</sup> The breadth of this definition is reflected in the IRS factsheet providing guidance on reporting auction income and the tax gap, which states that “[a]ll income from auctions, traditional or online, and consignment sales is generally taxable unless certain exceptions are

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94. 2008 IRS OVERSIGHT BD. TAXPAYER ATTITUDE SURVEY 5, available at [http://www.treas.gov/irsob/reports/2009/IRSOB\\_2008-TAS.pdf](http://www.treas.gov/irsob/reports/2009/IRSOB_2008-TAS.pdf). The IRS Oversight Board has conducted this survey annually since 2002 as a means of better understanding taxpayers’ attitudes toward compliance and tax preparers, expectations for customer service, and willingness to provide additional funding for IRS service and enforcement programs. *Id.* at 1.

95. Mohr, *supra* note 15, at 304.

96. *Id.* at 304–05.

97. See I.R.C. § 1 (2006).

98. See *id.* § 63.

99. *Id.* § 61.

met.”<sup>100</sup> The operative word in the IRS factsheet is “income.” As noted in a list of tax tips for e-business and e-commerce available on the IRS website, if a seller’s “online sales are the Internet equivalent of an occasional garage or yard sale,” the seller is generally not required to report the sale if the seller did not receive more than he or she originally paid for the item sold.<sup>101</sup> The IRS, however, distinguishes the “online garage sale” from what it considers a “home-based online business,” explaining that “[i]f [an] online garage sale turned into a business and/or [the seller has] recurring sales and [is] purchasing items for resale with the intention of making a profit; [the seller] may have started an online business.”<sup>102</sup>

The IRS is likely to be interested in increasing compliance among taxpayers who obtain a substantial amount of income from online sales, as reflected in the de minimis exception of § 6050W of the Code described below in Part VI.B. Income resulting from sales of personal property “akin to an occasional garage sale or yard sale is generally not required to be reported”<sup>103</sup> because, in most cases, the original basis is greater than the sale price. Under § 1001 of the Code, which states that a “gain from the sale or other disposition of property [is] the excess of the amount realized” over the taxpayer’s adjusted basis, there are no tax consequences for items held for personal use and later sold for less than their original purchase price.<sup>104</sup> Where the casual or occasional online seller evolves into a small business with numerous transactions involving the purchase of items for resale, however, it may be classified as an online auction business.<sup>105</sup>

Classified as either business income or capital gains, gains from e-commerce must be reported by online sellers on their annual income tax returns.<sup>106</sup> A reportable gain consists of income net of the original cost, known as the “basis” of the item sold.<sup>107</sup> According to an IRS publication for use in preparing 2008 returns, “Income from sales at auctions, including online auctions, may be business income.”<sup>108</sup> It also may be capital gains,

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100. IRS.gov, Reporting Auction Income and the Tax Gap, *supra* note 9.

101. IRS.gov, Tax Tips—E-Business & E-Commerce, <http://www.irs.gov/businesses/small/industries/article/0,,id=209314,00.html> (last visited Dec. 26, 2009).

102. *Id.*

103. IRS.gov, Reporting Auction Income and the Tax Gap, *supra* note 9.

104. *See* I.R.C. § 1001(a).

105. IRS.gov, Reporting Auction Income and the Tax Gap, *supra* note 9.

106. IRS.gov, Tax Tips—E-Business & E-Commerce, *supra* note 101.

107. *See* IRS.gov, Reporting Auction Income and the Tax Gap, *supra* note 9. As discussed below, determining the correct “basis” can be a complicated issue. For instance, the Code provides that a person who inherits an item receives a stepped-up basis—whereas, if an individual receives personal property as a gift, he or she receives the gift giver’s basis.

108. IRS, PUBL’N 525, TAXABLE AND NONTAXABLE INCOME 16 (2009), *available at*

which are gains from the sale of a capital asset. Capital assets are distinguished from property such as inventory, which businesses hold primarily for sale to customers in the ordinary course of business. Where an online seller is operating a “viable online business,” and therein seeks to earn a profit, the seller may be entitled to deduct business expenses.<sup>109</sup>

Under § 162 of the Code, online sellers who are engaged in a trade or business can deduct ordinary and necessary expenses incurred in carrying on their trade or business.<sup>110</sup> The IRS defines an “ordinary” expense as one that is “common and accepted in a trade or business” and a “necessary” expense as one that is “helpful and appropriate for a trade or business.”<sup>111</sup> In order for an online seller to deduct business expenses under § 162, the seller must have the requisite intent to profit.<sup>112</sup>

Generally, a taxpayer cannot recognize a loss on the sale of personal property because the taxpayer must be engaged in a trade or business to deduct expenses under § 162 and losses are deducted where the expenses are greater than the gross income.<sup>113</sup> Expenses cannot be deducted under § 162 where a taxpayer fails to prove intent to profit, which may be characteristic of a situation where the taxpayer is a casual seller. For instance, suppose a law student purchased a torts textbook for \$135 during his or her first year of law school. This amount represents the student’s basis in the item. At the beginning of the student’s second year of law school, he or she sells the book on Half.com, eBay’s fixed price media marketplace,<sup>114</sup> for \$70. The law student cannot recognize a \$65 loss on this sale without showing that he or she is engaged in the business of selling used law school textbooks and intends to profit from this activity.

Information reporting is already required by several sections of the Code.<sup>115</sup> For instance, under § 6041 of the Code, “[a]ll persons engaged in

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<http://www.irs.gov/pub/irs-pdf/p525.pdf>.

109. See IRS.gov, Tax Tips—E-Business & E-Commerce, *supra* note 101.

110. See I.R.C. § 162(a) (2006). Moreover, under § 212 of the Code, a taxpayer can deduct “the ordinary and necessary expenses paid or incurred . . . for the production or collection of income.” *Id.* § 212(1). For online sellers, this deduction would be applicable to the fees paid to the online trading platforms for posting items on the site.

111. IRS.gov, Reporting Auction Income and the Tax Gap, *supra* note 9.

112. See I.R.C. §§ 162(a), 183(a).

113. See IRS, PUBL’N 334, TAX GUIDE FOR SMALL BUSINESS 31 (2008), available at <http://www.irs.gov/pub/irs-pdf/p334.pdf>.

114. See eBay Annual Report, *supra* note 54, at 1.

115. There are more than twenty-five situations in which third-party information returns are required. *E.g.*, I.R.C. §§ 6051–6053. As noted by the Joint Committee on Taxation in discussing the new § 6050W of the Code, “Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing

a trade or business and making payment in the course of such trade or business . . . , of \$600 or more in any taxable year, . . . shall render a true and accurate return to the Secretary,” including information such as the amount of gains, profits, and income and the name and address of the recipient of the payment.<sup>116</sup> Generally, a Form 1099-MISC must be filed with the IRS (and delivered to the recipient of payment) for, among several things, any person receiving payments of \$600 or more for services performed for a trade or business, including a sole proprietor, and for sales of \$5000 or more of consumer goods “to a buyer for resale anywhere other than a permanent retail establishment.”<sup>117</sup>

Under § 6045 of the Code, an entity conducting business as a “broker” is also required to submit information returns containing information such as the name and address of each “customer” and its “gross proceeds.”<sup>118</sup> Section 6045(c) defines “broker” as including a dealer, a barter exchange, and “any other person who (for a consideration) regularly acts as a middleman with respect to property or services.”<sup>119</sup> As discussed in Part VI, proposals have been made to expand the definition of “broker” under § 6045 as a means of applying the information reporting requirement to sales on websites like eBay.<sup>120</sup>

#### IV. THE TAX GAP

Developed by the IRS as a means of “gaug[ing] taxpayers’ compliance with their federal tax obligations,” the tax gap “measures the extent to which taxpayers” fail to file their taxes in a timely manner, if at all.<sup>121</sup> In a self-reporting tax system, gaining an understanding of the tax gap and its components—underreporting, underpayment, and nonfiling—is critical to enabling the legislature to make better tax policy decisions and allocate tax administration resources.<sup>122</sup> The tax gap is indicative of a

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their income tax returns and to help the [IRS] determine whether such returns are correct and complete.” JOINT COMM. ON TAXATION, 110TH CONG., TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE “HOUSING AND ASSISTANCE TAX ACT OF 2008” AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008, at 60 (Comm. Print 2008), available at <http://www.house.gov/jct/x-63-08.pdf>.

116. I.R.C. § 6041(a).

117. IRS, U.S. DEP’T OF TREASURY, 2009 INSTRUCTIONS FOR FORM 1099-MISC 1 (2009), available at <http://www.irs.gov/pub/irs-pdf/i1099misc.pdf>.

118. I.R.C. § 6045(a).

119. *Id.* § 6045(c).

120. See *infra* text accompanying notes 192–98.

121. IRS.gov, Understanding the Tax Gap, *supra* note 16.

122. *Id.*

serious problem; it reflects the amount of revenue that the government needs in order to perform its functions but is unable to collect from taxpayers. The tax gap also represents inequities between taxpayers who comply with their tax obligations and taxpayers who do not.<sup>123</sup> These inequities may exacerbate the problem because, as discussed below in Part VII, there is a degree to which noncompliance generates further noncompliance.<sup>124</sup>

The expansion of the tax gap is evident in empirical estimates gathered by the IRS. In 1981, the gross income tax gap was an estimated \$76 billion, and in 1992, it was estimated to be approximately \$127 billion.<sup>125</sup> In 2001, the IRS's latest estimate of the tax gap,<sup>126</sup> the tax gap was estimated to be in the range of \$312 billion to \$353 billion for all types of taxes.<sup>127</sup> The 2001 estimate reflects a voluntary compliance rate of 83.7 percent, which is consistent with the 80–85 percent range of the compliance rate over the past two decades.<sup>128</sup> Underreporting of income tax and other taxes comprises approximately 83 percent of the gross tax gap,<sup>129</sup> with understatement of income, improper deductions, overstated business expenses, and incorrectly claimed credits as significant components of underreporting.<sup>130</sup> Approximately 57 percent of the overall tax gap is

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123. See *The IRS and the Tax Gap: Hearing Before the H. Comm. on the Budget*, 110th Cong. 22 (2007) [hereinafter *The IRS and the Tax Gap*] (statement of Nina E. Olson, National Taxpayer Advocate), available at [http://www.irs.gov/pub/irs-utl/nta\\_housebudget\\_testimony\\_021607.pdf](http://www.irs.gov/pub/irs-utl/nta_housebudget_testimony_021607.pdf); *infra* text accompanying notes 199–200.

124. See *infra* note 200 and accompanying text.

125. U.S. GAO, REPORT TO THE HONORABLE JOHN W. OLVER, HOUSE OF REPRESENTATIVES, TAX GAP: MANY ACTIONS TAKEN, BUT A COHESIVE COMPLIANCE STRATEGY NEEDED 3 (1994), available at <http://archive.gao.gov/t2pbat3/151585.pdf>.

126. U.S. GAO, REPORT TO THE COMMITTEE ON FINANCE, U.S. SENATE, TAX GAP: IRS COULD DO MORE TO PROMOTE COMPLIANCE BY THIRD PARTIES WITH MISCELLANEOUS INCOME REPORTING REQUIREMENTS 1 n.2 (2009).

127. IRS.gov, Understanding the Tax Gap, *supra* note 16. Although the IRS expects to collect an additional \$55 billion of this figure from IRS enforcement and compliance efforts such as audits, it is still a dramatic increase as compared to the prior decade. See *id.* This figure reflects the most recent tax gap estimate published by the IRS at the time this Note was written. See U.S. GAO, *supra* note 126, at 1 n.2. This figure does not include taxes that should have been paid on illegal income. IRS.gov, Understanding the Tax Gap, *supra* note 16.

128. *Ways to Reduce the Tax Gap: Hearing Before the S. Finance Comm.*, 110th Cong. (2007) [hereinafter *Ways to Reduce the Tax Gap*] (testimony of Eric Solomon, Treasury Assistant Secretary for Tax Policy), available at <http://www.treas.gov/press/releases/hp360.htm>.

129. *Closing the Tax Gap: Hearing Before the H. Comm. on Small Business*, 110th Cong. (2007) [hereinafter *Closing the Tax Gap*] (statement of Mark Everson, IRS Comm'r). The IRS estimates that underpayment contributes to nearly 10 percent and nonfiling constitutes nearly 8 percent of the gross tax gap. U.S. DEP'T OF TREASURY, *supra* note 17, at 3.

130. See U.S. DEP'T OF TREASURY, *supra* note 17, app.

attributed to individual income tax underreporting.<sup>131</sup>

Particularly relevant to underreporting of income by online sellers is a finding by a Treasury Department study that a significant contributor to the size of the tax gap is the failure of some merchants to “accurately report their gross income, including income derived from payment card transactions.”<sup>132</sup> Moreover, noncompliance by sole proprietors has been found to significantly contribute to the expansion of the tax gap. In July 2007, the Government Accountability Office (“GAO”) issued a report that noted that the IRS estimates that \$68 billion of the tax gap for 2001 was attributable to “sole proprietors,” defined as owners of “unincorporated businesses by themselves.”<sup>133</sup>

Recognizing the growing popularity of engaging in business via e-commerce, the IRS has directed research efforts toward “addressing reporting compliance among small businesses that are doing business over the Internet.”<sup>134</sup> An audit report published by the Small Business/Self-Employed Division of the IRS discussed an IRS study performed in 2000 that “analyzed the tax compliance risks associated with electronic commerce.”<sup>135</sup> Although the study was not exclusively based on data pertaining to income derived from transactions using online trading platforms,<sup>136</sup> it provides insight into the portion of the tax gap that is attributable to the broader category of e-commerce. The study found that the 426 commercial websites the researchers analyzed generated a \$6.2 million tax gap in 1997, mostly “due to the understatement of taxable

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131. *Closing the Tax Gap*, *supra* note 129 (statement of Mark Everson, IRS Comm’r).

132. 2007 U.S. DEP’T OF TREASURY GEN. EXPLANATIONS OF ADMIN.’S FISCAL YEAR REVENUE PROPOSALS 117 [hereinafter 2007 REVENUE PROPOSALS].

133. U.S. GAO, REPORT TO THE COMMITTEE ON FINANCE, U.S. SENATE, TAX GAP: A STRATEGY FOR REDUCING THE GAP SHOULD INCLUDE OPTIONS FOR ADDRESSING SOLE PROPRIETOR NONCOMPLIANCE 3–4 (2007). The GAO “is known as ‘the investigative arm of Congress’ and ‘the congressional watchdog,’” supporting “Congress in meeting its constitutional responsibilities and help[ing] improve the performance and accountability of the federal government for the benefit of the American people.” GAO, Welcome to GAO, <http://www.gao.gov/> (last visited Dec. 26, 2009). According to the GAO, “Sole proprietors constitute about 72 percent of all businesses in the United States but are small; they have only 4.8 percent of all business receipts.” U.S. GAO, *supra*, at 5. Sole proprietors include a broad range of businesses—from service providers like doctors to sellers of goods like car dealers—and may be engaged in these activities on a full-time or part-time basis. *Id.*

134. U.S. DEP’T OF TREASURY, THE INTERNAL REVENUE SERVICE IS MAKING PROGRESS IN ADDRESSING COMPLIANCE AMONG SMALL BUSINESSES ENGAGED IN ELECTRONIC COMMERCE (2004) (memorandum from Gordon C. Milbourn III, Acting Deputy Inspector General for Audit), *available at* <http://www.treasury.gov/tigta/auditreports/2005reports/200530010fr.pdf>.

135. *Id.* at 1.

136. *Id.* (noting that “[t]he study included retail and wholesale businesses, financial services, business services, Internet service providers, computer sales/services businesses, and adult entertainment businesses”).

income.”<sup>137</sup> Additionally, “10 percent of the selected commercial website owners failed to file their 1997 tax returns and 12 percent could not be identified, so their filing status is unknown.”<sup>138</sup> The estimated tax gap stemming from small businesses that conduct business over the Internet has increased dramatically: in March 2004, the Small Business/Self-Employed Division estimated that it “may be as high as \$1 billion.”<sup>139</sup>

The Office of Tax Policy of the Treasury Department has identified three main challenges involved in efforts aimed at reducing the tax gap: increasing voluntary compliance, reducing opportunities for evasion, and simplifying the administration of the tax laws.<sup>140</sup> In its discussion of reducing evasion opportunities, the Office of Tax Policy stated that reliable third-party data is critical to enabling the IRS to detect errors in reporting and that the IRS still lacks this reliable “information on certain types of income, most notably income earned by the self-employed.”<sup>141</sup> As one researcher has explained, “Opportunity provides one important reason for noncompliance among self-employed and small business taxpayers.”<sup>142</sup>

Preliminary findings by the IRS indicate that, “[o]verall, compliance is highest where there is third-party reporting and/or withholding,”<sup>143</sup> such as wage, salary, and tip compensation reported by employers through W-2 forms. Such informational returns are found to be a “proven way” of increasing compliance and assisting the IRS in discovering noncompliance.<sup>144</sup> To the extent that information reporting helps identify noncompliant taxpayers who can then be contacted directly, information reporting enables IRS resources to be more efficiently allocated.<sup>145</sup>

Policies aimed at narrowing the tax gap must account for the fact that legislative proposals approaching tax compliance “do not come close to eliminating the tax gap.”<sup>146</sup> Complete closure of the tax gap would “require universal audits followed by draconian collection practices, imposing

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137. *Id.*

138. *Id.*

139. *Id.*

140. OFFICE OF TAX POLICY, *supra* note 11, at 8.

141. *Id.* at 9.

142. Morse, *supra* note 90, at 485.

143. IRS.gov, Understanding the Tax Gap, *supra* note 16.

144. U.S. GAO, *supra* note 125, at 5.

145. *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap: Hearing Before the H. Comm. on the Budget, 110th Cong. 12 (2007)* [hereinafter *Tax Compliance*] (statement of Michael Brostek, Director, Tax Issues, Strategic Issues, U.S. GAO).

146. *Ways to Reduce the Tax Gap, supra* note 128 (testimony of Eric Solomon, Treasury Assistant Secretary for Tax Policy).

prohibitive costs and burdens on taxpayers as well as the IRS.”<sup>147</sup> Weighing the benefits of a tax law against its costs, and taking into account all potential costs, is an important step in evaluating tax policy aimed at decreasing the tax gap. Although complete closure may not be feasible, tax compliance can be significantly improved to reduce the continually growing tax gap. According to Lederman, to the extent the tax gap “can be narrowed at a cost that is low in comparison to the additional funds collected, the government can use the funds to reduce the deficit, lower other taxes, or to reduce debt financing of bailouts and other spending.”<sup>148</sup>

## V. GUIDING PRINCIPLES FOR TAX POLICY

In developing tax policy aimed at increasing reporting of income derived from e-commerce transactions, consideration of existing tax policies and principles is critical to maintaining both neutrality between the various forms of engaging in commerce and consistency in tax laws. This part outlines traditional tax policy principles and how these principles should be applied to taxation of e-commerce income and provides a brief overview of how other countries have approached the problems of income tax avoidance associated with e-commerce transactions.

### A. U.S. TAX POLICY

Focusing on the policy goals of equity, efficiency, and transparency is important in writing tax laws, as IRS National Taxpayer Advocate Nina E. Olson expressed in a written statement before the House of Representatives.<sup>149</sup> Applying the same tax principles that are generally applied to the taxation of all forms of business activity is an important part of formulating tax laws to be applied to Internet commerce. Doing so ensures that the first principle—equity—is maintained, which is important since there appears to be no justifiable reason for treating e-commerce any differently from traditional forms of retailing.

The notion of maintaining fundamental tax principles in developing tax law for Internet commerce has also been promoted by Arthur J.

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147. *Id.*

148. Lederman, *supra* note 18, at 1734–35 (footnotes omitted).

149. *The IRS and the Tax Gap*, *supra* note 123, at 3 (statement of Nina E. Olson, National Taxpayer Advocate). See also Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 709 (2007) (“When the appropriateness of a tax proposal or provision is evaluated as a policy matter, the concerns usually referenced are efficiency, equity and ‘simplicity’ or ‘administrability.’”).

Cockfield, who researched how the Internet is changing tax laws.<sup>150</sup> Cockfield asserts that tax reform efforts must “recognize the importance of protecting ‘real world’ or traditional norms that existed prior to the advent of the Internet.”<sup>151</sup> With this notion in mind, he puts forth a legal model that “align[s] legal rules with the nature of the network, without overly intruding on cyberspace values.”<sup>152</sup> In his analysis, Cockfield describes three guiding principles that are fundamental “to ensur[ing] that a tax system can effectively collect tax revenues to pay for public goods”: (1) maintaining tax neutrality; (2) promoting administrative simplicity; and (3) applying and maintaining traditional tax laws.<sup>153</sup>

The first tax policy principle that Cockfield identifies is consistent with the principle of equity that National Taxpayer Advocate Olson notes is important to developing tax policy; tax laws should exhibit neutrality between traditional commercial activities and Internet activities.<sup>154</sup> Cockfield cites a Treasury report that stresses the importance of a “tax system treat[ing] economically similar income equally, regardless of whether earned through electronic means or through more conventional channels of commerce.”<sup>155</sup> For instance, taxation of items sold at a Saturday garage sale is often not monitored or enforced. Thus, the equity principle would suggest that the same general laxity toward taxation of sales where dollar amounts are small should be applied to the intermittent sales by casual online sellers. The forum—whether a front lawn or an online trading platform—should not dictate a different tax treatment of the same transaction.

Additionally, Cockfield asserts that taxation involving Internet sales “should neither distort nor hinder commerce. No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions.”<sup>156</sup> Implementing tax policy that does not impede the growth of e-commerce has been cited as an

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150. See Cockfield, *supra* note 83, at 333–34, 350.

151. *Id.* at 350.

152. *Id.* at 334.

153. *Id.* at 351–52.

154. *The IRS and the Tax Gap*, *supra* note 123 (statement of Nina E. Olson, National Taxpayer Advocate).

155. Cockfield, *supra* note 83, at 351 (quoting OFFICE OF TAX POLICY, U.S. DEP’T OF TREASURY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE 19 (1996), available at <http://www.treas.gov/offices/tax-policy/library/internet.pdf>).

156. *Id.* (quoting WHITE HOUSE, A FRAMEWORK FOR GLOBAL ELECTRONIC COMMERCE 5 (1997), available at <http://s3.amazonaws.com/lcp/cibercultura/myfiles/A-Framework-for-Global-Electronic-Commerce-Al-Gore.pdf>).

important consideration by many scholars.<sup>157</sup> Otherwise, tax law could discourage online sales and stunt the growth of an increasingly important means of commerce for many merchants and consumers.

Secondly, the promotion of administrative simplicity should be a key consideration in developing tax laws. As Cockfield explains, “[T]he laws should not create overly burdensome compliance costs for businesses and should be relatively easy to enforce by tax authorities.”<sup>158</sup> As discussed in Part VII, the benefits of a proposed information reporting requirement should be evaluated in light of the costs that it entails. Moreover, as also described in Part VI, an analysis of the costs involved for both taxpayers and the IRS is an important consideration. According to Lederman,<sup>159</sup> “[A]dministrability of a tax is key to its effectiveness”; she emphasizes that without effective implementation, the best tax policy in the world is useless.<sup>160</sup>

Thirdly, Cockfield also advocates for application of the set of tax rules traditionally applied to businesses, suggesting that they would “generally suffice to deal with [the] emerging challenges” presented by the growth of Internet commerce.<sup>161</sup> Although he notes that these fundamental laws and principles are often problematic in several circumstances, he asserts that they “reflect consensus among governments concerning how economic activity should be taxed.”<sup>162</sup> He further suggests that “radical change to these traditional principles would not likely attract the level of cooperation required to deal with emerging challenges.”<sup>163</sup>

In sum, the principles of neutrality or equity, administrative simplicity, and maintaining tradition will provide a strong foundation for establishing an approach to taxing e-commerce income. One of the challenges faced by the IRS and legislators lies in striking the appropriate balance between these principles because, as Cockfield discusses, they often run into conflict with each other when applied to economic activity that takes place on the Internet.<sup>164</sup> One example of the tension inherent in

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157. See, e.g., *id.* at 362 (“Legal rules should be properly aligned with the nature of the network and act to preserve traditional norms without destabilizing cyberspace.”).

158. *Id.* at 351.

159. Leandra Lederman is the William W. Oliver Professor of Tax Law at Indiana University Maurer School of Law–Bloomington. See Lederman, *supra* note 18, at 1733.

160. Lederman, *supra* note 149, at 709 (citing Richard M. Bird, *Administrative Dimensions of Tax Reform*, 10 ASIAN-PAC. TAX BULL. 134, 134 (2004)).

161. Cockfield, *supra* note 83, at 351.

162. *Id.*

163. *Id.* at 351–52.

164. See *id.* at 352.

applying these guiding principles is attempting to balance equity in the application of tax laws and achieving this equity in a manner that does not impose substantial administrative burdens on the IRS. For instance, suppose that an occasional eBay seller makes \$1000 gross profit in a given tax year. Suppose eBay—or its payment entity, PayPal, as is likely to be the case under § 6050W<sup>165</sup>—is required to file an informational return with the IRS reporting the eBay seller's \$1000 gross profit. Suppose that the eBay seller's neighbor also earns \$1000 gross profit, but is less Internet-savvy (or more Internet-wary) and earned this profit from transactions at a garage sale on his or her front lawn on a Saturday afternoon. In this situation, the equity principle would dictate the filing of an information return for both individuals, as the forum for their transactions should not dictate the tax treatment of the income they earned. Although the equity principle would be satisfied by requiring an information return in both circumstances, the administrative simplicity principle is potentially undermined if filing information returns in both circumstances would entail monitoring of the respective forums: monitoring an online trading platform that presumably keeps databases of transaction records is likely far less burdensome than sending IRS agents to drive around suburban neighborhoods in search of garage sales.

#### B. INTERNATIONAL APPROACHES TO TAXATION OF E-COMMERCE INCOME

Given that the expansion of e-commerce is a global phenomenon, an examination of the treatment of income derived from Internet sales in other countries may be useful in evaluating whether this new reporting requirement can be an effective means of addressing noncompliance by taxpayers engaged in e-commerce. Foreign nations that have faced similar problems of underreporting of income from online transactions have “taken promising steps in understanding and combating” the problems involving taxation of e-commerce.<sup>166</sup> This section provides a brief overview of the approaches taken by countries seeking to tax income generated from online sales.

In the United Kingdom, for instance, the general rule is that income received from online sales becomes subject to taxation when the items sold were initially purchased by the seller with the intention of eventually being

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165. As discussed below in Part VII, and in the text accompanying note 279, the IRPAC stated in its comments responding to IRS Notice 2009-19, in which the IRS requested comments regarding § 6050W, the common belief is that “third party networks” as described in § 6050W include entities such as PayPal.

166. Mohr, *supra* note 15, at 313.

sold.<sup>167</sup> Her Majesty's Revenue and Customs ("HMRC"), the U.K. equivalent of the IRS, launched a program to discover high-volume online sellers who post and sell items on eBay and fail to declare the related income.<sup>168</sup> This "crackdown" on taxation of e-commerce income was specifically geared at targeting online "traders."<sup>169</sup>

In Canada, where eBay sellers are also required to report their online sales income,<sup>170</sup> the Minister of National Revenue has the power to compel disclosure of confidential taxpayer information, such as the names and sales information of eBay "PowerSellers,"<sup>171</sup> to verify that they are complying with their tax obligations.<sup>172</sup> In a recent judgment involving eBay, the Canadian Federal Court of Appeal concluded that the Minister is not required to prove that he is conducting a "serious and genuine" inquiry into one or more specific individuals" but that he "must only satisfy a judge that the information or documents sought are required to verify compliance with the Act."<sup>173</sup> In July 2009, the Minister of National Revenue and Minister of State Jean-Pierre Blackburn informed Canadian eBay sellers that the Canada Revenue Agency, the government agency that administers the tax laws for Canada and most of its provinces and territories,<sup>174</sup> would begin auditing eBay sellers at the end of summer 2009.<sup>175</sup> In a statement to the media, Blackburn stated, "I strongly encourage eBay sellers, and for that matter, any taxpayer who has not already done so, to correct their tax

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167. Emma Thelwell, *The Tax Sleuths Are Logging On to Bust the Online Traders: The Revenue Wants Its Cut of the Virtual Economy*, DAILY TELEGRAPH (London), Jan. 6, 2007, at 4.

168. See Mohr, *supra* note 15, at 313 n.98.

169. See Rosemary Gallagher, *If You Make Net Profits, You're in the Taxman's Web*, SCOTSMAN, Feb. 3, 2007, available at <http://sport.scotsman.com/ebay/If-you-make-net-profits.3343506.jp>.

170. Kristen A. Parillo, *Tax Authorities to Begin Auditing eBay Sellers*, TAX NOTES INT'L (Can.), Aug. 4, 2009.

171. According to eBay, a "PowerSeller" is a seller who ranks among the most successful sellers on the website. See eBay Annual Report, *supra* note 54, at 4. To qualify as a "PowerSeller," members must meet a set of requirements, which includes "uphold[ing] the eBay community values, including honesty, timeliness and mutual respect"; meeting a minimum of \$1000 in sales or one hundred items per month, for three consecutive months, and a minimum of \$12,000 or 1200 items for the prior twelve months; being an active member for ninety days; and having an account in good financial standing. eBay, *Why Should You Feel Confident Buying from a PowerSeller?*, <http://stores.ebay.com/replaceaphone-com-store-auctions/why-you-can-buy-with-confidence.html> (last visited Dec. 26, 2009).

172. See John Sorensen, Stevan Novoselac & Corrinne Lobe, *The Long Arm of the Minister of National Revenue Grows Another Foot—Disclosure in eBay Canada*, MONDAQ, Jan. 19, 2009.

173. *Id.*

174. Canada Revenue Agency, *About the Canada Revenue Agency (CRA)*, <http://www.cra-arc.gc.ca/gncy/menu-eng.html> (last visited Dec. 26, 2009). The CRA also administers "social and economic benefit and incentive programs delivered through the tax system." *Id.*

175. See Press Release, Can. Revenue Agency, News Release: "EBay Sellers Must Declare All Income for Tax Purposes," States Minister Blackburn (July 30, 2009), available at <http://www.cra-arc.gc.ca/nwsrm/rlss/2009/m07/nr090730-eng.html>.

affairs as soon as possible to avoid penalties or prosecution.”<sup>176</sup>

The Irish tax authority, the Revenue, is similarly investigating PowerSellers who generate profits from trading on eBay.<sup>177</sup> The Revenue is expected to focus on major sellers and to ask eBay to provide the details of their transactions to cross-check them against the tax returns these sellers file to determine whether the money earned has actually been declared.<sup>178</sup>

In sum, as these examples from other countries illustrate, there is a growing trend toward capturing lost tax revenue stemming from underreporting or nonfiling by sellers on online trading platforms like eBay. Although there is no empirical data demonstrating the effectiveness of these measures, these examples affirm that income generated from online sales is a significant source of revenue that the government should take pragmatic steps to collect in order to reduce the expansion of the tax gap.

## VI. THE REPORTING PROVISION

Described as a “snippet” in the massive Housing and Economy Recovery Act of 2008,<sup>179</sup> the information reporting requirement for payment card and third-party payment transactions, codified at § 6050W of the Code, will likely have a significant impact on all parties engaged in e-commerce. This provision appears to apply directly to online trading platforms like eBay and its payment system, PayPal.<sup>180</sup> On the E-Business and E-Commerce Recordkeeping page of the IRS website, the IRS explicitly states that for online auction sellers, the new information reporting provision means that credit card and “e-payment” sales will annually be reported to online sellers and to the IRS.<sup>181</sup> This part explores the history of proposals aimed at taxing income derived from e-commerce, outlines the requirements of the new reporting provision, and discusses its several implications.

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176. *Id.*

177. See Adrian Weckler, *Revenue to Clamp Down on Major EBay Sellers*, SUNDAY BUS. POST (Ir.), Dec. 14, 2008.

178. *Id.*

179. Tresa Baldas, *Lawyers Brace for New Rules on Online Payment Networks*, RECORDER, Jan. 23, 2009. See also Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654.

180. See William P. Barrett, *Coming Soon to EBay: The Taxman*, FORBES, Mar. 18, 2009, <http://www.forbes.com/2009/03/17/irs-ebay-audits-personal-finance-taxes-internet-sellers.html>.

181. IRS.gov, Recordkeeping—E-Business & E-Commerce, <http://www.irs.gov/businesses/small/industries/article/0,,id=202944,00.html> (last visited Dec. 26, 2009).

## A. HISTORY OF THE INFORMATION REPORTING PROVISION

Prior to codification of § 6050W of the Code, several recommendations were advanced in proposals by various government bodies to address the issues of underreporting and nonfiling of income by e-commerce sellers.<sup>182</sup> The proposals illustrate that noncompliance by this subset of taxpayers is identified as a significant problem and a contributor to the tax gap. The proposals generally recommended two approaches to increasing reporting of income from Internet sales, both of which are based on the use of information returns: (1) create a new Code section to require information reporting by the online trading platforms and their payment processors or (2) expand the definition of “broker” under § 6045 of the Code to include online trading platforms like eBay.

In February 2006, a proposal to increase information reporting on payment card transactions was included in the Bush administration’s 2007 revenue proposals as one of the ways to address the expanding tax gap.<sup>183</sup> The administration noted that the failure of some retail businesses to accurately report gross income represents a significant contributor to the tax gap.<sup>184</sup> In this report, the administration proposed providing the “Secretary with [the] authority to promulgate regulations requiring payment card issuers to report to the IRS annually the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding for card issuers in the event that a merchant payee fails to provide a TIN.”<sup>185</sup> In explaining the rationale for this proposal, the administration noted that the proposal would impose minimal burdens on card issuers given that they already track payment information and provide it to merchants.<sup>186</sup> Furthermore, implementing a backup withholding system, the administration explained, would materially improve compliance, without imposing tremendous burdens on card issuers.<sup>187</sup>

Additionally, in 2006 the Information Reporting Program Advisory Committee (“IRPAC”) issued a report featuring recommendations aimed at addressing the tax compliance problems posed by the growing number of

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182. See, e.g., 2007 REVENUE PROPOSALS, *supra* note 132; 2008 U.S. DEP’T OF TREASURY GEN. EXPLANATIONS OF ADMIN.’S FISCAL YEAR REVENUE PROPOSALS 65 [hereinafter 2008 REVENUE PROPOSALS].

183. See 2007 REVENUE PROPOSALS, *supra* note 132, at 115, 117.

184. *Id.* at 117.

185. *Id.*

186. *Id.*

187. *Id.*

Americans who report that their primary or secondary source of income is derived from sales on eBay.<sup>188</sup> One recommendation was the implementation of a comprehensive education program, which would involve distributing literature and posting guidance on the IRS website to inform participants of tax obligations and requirements.<sup>189</sup> The IRPAC also recommended collaborating with the auction organizations to require sellers to provide a TIN when they register in order to prepare the auction organizations to report income earned on Form 1099-MISC.<sup>190</sup> The IRPAC's recommendations included a proposal to change § 6045 of the Code concerning returns filed by brokers. The IRPAC stated that "revising IRC Section 6045 may be necessary to strengthen and further clarify the definition of a broker" to enable further enforcement of the other two recommendations.<sup>191</sup>

Similarly, the administration's general explanations for 2008 revenue proposals included a proposal to expand broker information reporting.<sup>192</sup> The administration explained that under § 6045 of the Code, brokers file information returns containing customer name, address, and gross proceeds information with the IRS.<sup>193</sup> It noted that the existing tax law did not clearly impose the requirement on businesses that, "with respect to sales of tangible personal property, may not be acting as agents of the customers (that is, the sellers of the property)."<sup>194</sup> Reasoning that third-party reporting to the IRS significantly increases taxpayer compliance, the administration proposed requiring brokers to make an information return for a customer who employed the broker's services for one hundred or more transactions and generated at least \$5000 in gross proceeds in the year.<sup>195</sup> The proposal suggested providing the IRS and the Treasury Department with regulatory authority to permit exceptions in certain circumstances that it deemed appropriate and where "the benefit of information reporting is outweighed

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188. See BHANSALI ET AL., *supra* note 7, at 1. Established in 1991 by the IRS to discuss improvement to the information reporting program, the IRPAC serves the primary purpose of providing a public forum for such discussions. The IRPAC is comprised of members who represent various segments of the tax professional community, including major national professional and trade associations and state tax agencies. See IRS.gov, Information Reporting Program Advisory Committee (IRPAC) Facts, <http://www.irs.gov/taxpros/article/0,,id=98158,00.html> (last visited Dec. 26, 2009).

189. BHANSALI ET AL., *supra* note 7, at 1-2.

190. *Id.* at 2.

191. *Id.*

192. 2008 REVENUE PROPOSALS, *supra* note 182, at 65.

193. *Id.*

194. *Id.*

195. *Id.*

by the cost of compliance.”<sup>196</sup>

Although the proposed expansion of the reporting requirements for brokers did not explicitly state that it applied to online websites like eBay, the change was reasonably expected to be partly aimed at expanding information reporting requirements to address taxation of income from Internet commerce.<sup>197</sup> As Paul Heller, then chairman of the IRPAC, expressed, “I have no idea who it would be referring to . . . if not online auctions.”<sup>198</sup>

In testifying about the IRS and the tax gap, National Taxpayer Advocate Nina E. Olson emphasized the importance of addressing problems of noncompliance with respect to income generated from e-commerce.<sup>199</sup> Of the belief that “there is a degree to which compliance breeds more compliance and noncompliance breeds more noncompliance,” Olson advocated for expanding third-party information reporting.<sup>200</sup> In order to do so, she noted that various categories of transactions that are currently not subject to information reporting should be identified. Then, these categories should be evaluated on a case-by-case basis to determine whether the benefits outweigh the costs involved in requiring information reporting. Olson noted that in many cases this cost-benefit analysis will yield the conclusion that it is inappropriate to impose such a reporting requirement.<sup>201</sup> Among the categories of transactions for which she recommended information reporting, however, Olson specifically recommended that Congress consider requiring information reporting on gross proceeds from online sales, citing the growing popularity of eBay sales as a source of primary and secondary income for many Americans.<sup>202</sup>

In the GAO’s report that outlines a strategy for reducing the tax gap stemming from sole proprietor noncompliance, the GAO also included a recommendation that the strategy incorporate an information reporting requirement.<sup>203</sup> Specifically, the GAO recommended requiring “businesses that process credit (and debit) card payments to report on the amount of

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196. *Id.*

197. See Kopytoff, *supra* note 10; IRS.gov, General Report—Message from the Chair (2007 IRPAC Report), <http://www.irs.gov/taxpros/article/0,,id=187663,00.html> (last visited Dec. 26, 2009).

198. See Kopytoff, *supra* note 10 (quoting Paul Heller, chairman of the IRPAC).

199. *The IRS and the Tax Gap*, *supra* note 123, at 1–2 (statement of Nina E. Olson, National Taxpayer Advocate).

200. *Id.* at 2–3.

201. See *id.* at 4.

202. *Id.* at 5.

203. U.S. GAO, *supra* note 133, at 30.

payments made to sole proprietors for a tax year.”<sup>204</sup>

In April 2007, Treasury Assistant Secretary for Tax Policy Eric Solomon testified before the Senate Finance Committee on ways to minimize the tax gap and discussed the proposal for payment card reporting.<sup>205</sup> Solomon explained that the use of such payment cards creates a “paper trail” that does not lead to the IRS unless IRS agents actively investigate the trail on a case-by-case basis.<sup>206</sup> He advocated leveraging the information already compiled in these paper trails to generate information reports to provide to the IRS.<sup>207</sup> He expressed that this would be an effective method of “systematically addressing” the issue of underreported income.<sup>208</sup>

In the administration’s report for 2009, the administration highlighted four key principles outlined by the Treasury Department in its 2006 Comprehensive Strategy for Reducing the Tax Gap as important to guiding the strategy for improving tax compliance: (1) addressing both unintentional errors and intentional evasion; (2) specifically targeting sources of noncompliance; (3) combining enforcement activities with a commitment to taxpayer service; and (4) designing tax policy and compliance proposals sensitive to taxpayer rights and cognizant of the importance of maintaining the balance between “enforcement activity and imposition of taxpayer burden.”<sup>209</sup> With these guiding principles in mind, the administration once again proposed expanding information reporting of merchant payment card reimbursements as a means of improving tax compliance.<sup>210</sup>

#### B. SECTION 6050W: RETURNS RELATING TO PAYMENTS MADE IN SETTLEMENT OF PAYMENT CARD AND THIRD-PARTY NETWORK TRANSACTIONS

Codified at § 6050W of the Code, the new legislation, which is similar to the proposal the Bush administration included in its 2009 budget

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204. *Id.*

205. *See Ways to Reduce the Tax Gap*, *supra* note 128 (testimony of Eric Solomon, Treasury Assistant Secretary for Tax Policy).

206. *Id.*

207. *Id.*

208. *Id.*

209. 2009 U.S. DEP’T OF TREASURY GEN. EXPLANATIONS OF ADMIN.’S FISCAL YEAR REVENUE PROPOSALS 61 [hereinafter 2009 REVENUE PROPOSALS] (quoting OFFICE OF TAX POLICY, *supra* note 11).

210. *See id.* at 65.

proposal as a way to ensure collection of owed taxes, states that

[e]ach payment settlement entity shall make a return for each calendar year setting forth—(1) the name, address, and TIN of each participating payee to whom one or more payments in settlement of reportable payment transactions are made, and (2) the gross amount of the reportable payment transactions with respect to each such participating payee.<sup>211</sup>

Subsection (b) of the provision defines “payment settlement entity” as a merchant acquiring entity for payment card transactions and a “third party settlement organization” for third-party network transactions.<sup>212</sup> The provision further defines “third party settlement organization” as the “central organization which has the contractual obligation to make payment to participating payees of third party network transactions.”<sup>213</sup> Third-party network transactions are defined as any transactions settled through third-party payment networks.<sup>214</sup>

Included in subsection (e) of § 6050W is an exception for de minimis payments by third-party settlement organizations that requires information reporting only if the gross amount of payments exceeds \$20,000 and the aggregate number of reportable transactions exceeds two hundred.<sup>215</sup> The E-Business and E-Commerce Recordkeeping page of the IRS website, which notifies sellers of the new provision, explicitly states that even if a seller does not meet the minimum threshold that would require receiving an information return, online auction sales less than the thresholds generally are still taxable,<sup>216</sup> reflecting the broad definition of taxable gross income under § 61 of the Code, as discussed above in Part III. There is a general leniency, however, where the dollar amount is small and where the sale will likely result in a loss.<sup>217</sup>

Moreover, subsection (g) of § 6050W provides that “[t]he Secretary may prescribe such regulations or other guidance as may be necessary or appropriate to carry out this section, including rules to prevent the reporting of the same transaction more than once.”<sup>218</sup>

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211. See Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, sec. 3091(a), § 6050W(a), 122 Stat. 2654, 2908. See also 2009 REVENUE PROPOSALS, *supra* note 209, at 65–66.

212. Housing and Economic Recovery Act of 2008, sec. 3091(a), § 6050W(b), 122 Stat. at 2908.

213. *Id.*

214. *Id.* sec. 3091(a), § 6050W(c), 122 Stat. at 2909.

215. *Id.* sec. 3091(a), § 6050W(e), 122 Stat. at 2910.

216. IRS.gov, Recordkeeping—E-Business & E-Commerce, *supra* note 181.

217. See *supra* text accompanying notes 103–05.

218. Housing and Economic Recovery Act of 2008, sec. 3091(a), § 6050W(g), 122 Stat. at 2910–

## VII. IMPLICATIONS OF THE NEW INFORMATION REPORTING REQUIREMENT

This part discusses several concerns raised regarding the potentially detrimental effects of this new provision and identifies the ways in which many of these fears are unwarranted. The concerns elicited by this new provision range from burdensome administrative costs to invasion of the privacy of online sellers.

For an online seller who exceeds the minimum gross receipt and transaction threshold, a suggested major implication of the new reporting provision is the potential to be the target of an audit by the IRS just because there is a discrepancy between a Form 1099 filed by an entity like eBay's PayPal and the tax return filed by the seller.<sup>219</sup> According to a recent article featured in *Forbes*, "If an audit target fails to produce acceptable documentation of his or her business proceeds and expenses, the IRS might well include all the revenue reported on the 1099s, disallow any undocumented business expenses and then assess taxes, interest and possibly penalties on profits a taxpayer didn't even have."<sup>220</sup> This reflects the fear among taxpayers that this new provision will create an increased need to maintain records of their expenses, which is especially troublesome to small businesses that may not have the financial resources to hire tax preparers to assist them with compliance. In fact, one commentator has expressed that tax compliance tends to be more costly for small firms.<sup>221</sup> As compared to larger businesses, the cost of tax compliance for small firms is estimated to be 67 percent higher.<sup>222</sup>

The fears that sellers will be audited merely because of a mismatch between the gross amount of reportable transactions listed on 1099 Forms and sellers' tax returns are, however, unwarranted given that the IRS will account for the fact that taxpayers deduct ordinary and necessary business expenses<sup>223</sup> and in light of the fact that taxpayers have full control over their own recordkeeping. It is unreasonable to assume that the IRS will compare a gross amount listed on a Form 1099 to an amount reported on a tax return and automatically audit the taxpayer without considering the

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219. See Barrett, *supra* note 180.

220. *Id.*

221. *Electronic Payments Tax Reporting: Hearing Before the H. Comm. on Small Business*, 110th Cong. (2008) [hereinafter *Electronic Payments Tax Reporting*] (testimony of Todd McCracken, President, National Small Business Association).

222. *Id.*

223. See *supra* text accompanying notes 110–12.

appropriate adjustments and expenses that may explain the discrepancy. Given that taxpayers are responsible for keeping proper records of transactions and related expenses, with or without a provision like § 6050W that raises the slight possibility of being audited, there is no cognizable added burden on taxpayers in this regard.

Furthermore, the awareness of the potential to be audited (or the fear of being the subject of an audit) may serve the benefit of inducing compliance: taxpayers will be incentivized to keep accurate records in the first place and to report income accurately when they file. As Lederman has described, “What likely makes information reporting so successful in spurring compliance in the first instance is that, like ‘red light cameras’ that snap pictures of vehicles failing to stop for a red light, the taxpayer is aware that the government is watching.”<sup>224</sup>

For websites like eBay, PayPal, Amazon, and Google Checkout, a primary concern is the cost involved in developing the technological infrastructure to meet the requirements of the new reporting provision.<sup>225</sup> With over 700,000 users who derive their primary and secondary income from eBay<sup>226</sup> (representing the lower-bound estimate of the number of online sellers given that there are several other online trading platforms), compiling information for 1099 Forms for all of these individuals will not be a minor task. And if the online selling platforms do not already have adequate systems in place to accurately and efficiently track the information needed to meet their filing requirements, the costs of implementing a new system are likely to be passed on to online sellers in the form of higher posting fees or commissions.<sup>227</sup>

The third-party networks—presumably, eBay, Amazon, and Google—as opposed to the multitude of online sellers, are required to file information reports that streamline the information-gathering process. As some commentators have observed, implementing a tracking system may not impose additional burdens on websites like eBay given that they already track information for sales transactions taking place via the

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224. Lederman, *supra* note 18, at 1738–39 (footnote omitted). *See also* Lederman, *supra* note 149, at 696–99.

225. *See* Baldas, *supra* note 179.

226. *See supra* text accompanying note 7.

227. *Electronic Payments Tax Reporting*, *supra* note 221 (testimony of Todd McCracken, President, National Small Business Association) (noting that although the direct impact on merchants appears to be limited, “this new level of regulatory burden on credit card issuers likely will lead to increased fees being passed on to businesses which conduct credit card transactions”).

website.<sup>228</sup> According to then-IRPAC chairman Paul Heller, eBay has all of the information needed to comply with filing 1099 Forms for online sellers: “[E]Bay . . . knows that a transaction has been consummated, knows who the seller is, and the seller is registered . . . .”<sup>229</sup>

Moreover, increasing information reporting to require reports from the online trading platforms raises concerns about the increased administrative burden imposed on the IRS. Commentators anticipate that the actual implementation and enforcement of this provision is likely to be costly for the IRS. One likely consequence is an increased number of tax returns flagged as containing a discrepancy requiring an audit. As the executive director of the National Association of the Self-Employed (“NASE”),<sup>230</sup> Kristie L. Darien, points out, the parties subject to reporting requirements are not the only parties who will need to devote substantial financial and human capital to comply with the reporting requirement; the IRS will also face significant costs in implementing the provision on its end.<sup>231</sup> According to the NASE, “[I]ncreased information reporting on electronic payment transactions would have the opposite intended effect and actually increase costs for . . . the federal government, due to implementation and enforcement needs.”<sup>232</sup>

The NASE has raised the question of whether the IRS has the appropriate infrastructure to handle the volume of paperwork that would result from this legislation,<sup>233</sup> especially given statistics indicating that

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228. See, e.g., Declan McCullagh, *Selling Stuff Online? Here Comes the IRS*, ZDNET NEWS, Apr. 13, 2007, [http://news.zdnet.com/2100-9595\\_22-151834.html](http://news.zdnet.com/2100-9595_22-151834.html).

229. *Id.* (quoting an interview of Paul Heller, then chairman of the IRPAC and tax director for JP Morgan Chase’s treasury business).

230. “The NASE was founded in 1981 to provide day-to-day support, benefits and consolidated buying power that traditionally had been available only to large corporations. Today, the NASE represents hundreds of thousands of entrepreneurs and micro-businesses, and is the largest nonprofit, nonpartisan association of its kind in the United States.” National Association for the Self-Employed, About NASE, <http://www.nase.org/about.aspx> (last visited Dec. 17, 2009). One of the NASE’s main tasks is to represent the interests of the self-employed among legislators in Washington, DC, putting “the smallest businesses on more equal footing with their corporate counterparts.” National Association for the Self-Employed, Frequently Asked Questions, <http://www.nase.org/About/FAQ.aspx> (last visited Dec. 17, 2009).

231. *Electronic Payments Tax Reporting*, *supra* note 221 (testimony of Kristie L. Darien, Executive Director, NASE). See also Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX REV. 371, 391 (2007) (“The issuance of information returns is not an entirely cost-free enterprise to the government either. It must process the information returns it receives and be in a position to challenge taxpayers who are putatively derelict.”).

232. *Electronic Payments Tax Reporting*, *supra* note 221 (testimony of Kristie L. Darien, Executive Director, NASE).

233. *Id.* In 2008, the IRS expected to “process nearly 140 million individual tax returns.” *IRS Operations and Fiscal 2009 Budget: Hearing Before the Subcomm. on Oversight of the H. Comm. of*

more than 700,000 users of eBay derive their primary and secondary income from online sales.<sup>234</sup> One commentator has suggested that the provision “could result in millions of information returns being filed with the IRS.”<sup>235</sup> The anticipated increase in the number of audits to be performed entails an increased need for IRS employees to perform the audits. According to the president of the National Small Business Association,<sup>236</sup> “[T]he sheer volume of the information returns generated by this proposal will ensure most of it will never be evaluated or used by the IRS.”<sup>237</sup> Given the \$20,000 and two hundred–transaction threshold minimums required by the provision, however, the reporting requirement is not expected to apply to a large number of casual sellers who merely sell a few items per year.<sup>238</sup>

In light of the ease of registering selling accounts on eBay as described in Part II.C, there is concern that taxpayers may easily circumvent the requirements of the new provision. Lederman has suggested that high-volume sellers, who exceed the de minimis exception, “may be able to use self-help to limit the effectiveness of the reporting requirement.”<sup>239</sup> She suggests that this can be accomplished by creating multiple user accounts, registering some accounts in the name of a spouse or children, and dividing up the merchandise listings on the several accounts.<sup>240</sup> Lederman also explained that an online seller trying to qualify for the de minimis exception may sell items on the different online selling platforms.<sup>241</sup>

These concerns of evasion opportunities are, however, unwarranted; in fact, this new information reporting requirement likely discourages tax

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*Ways and Means*, 110th Cong. 3 (2008) [hereinafter *IRS Operations*] (testimony of Linda Stiff, Acting Comm’r, IRS).

234. See *supra* text accompanying note 7.

235. FRIEDMAN, *supra* note 41, at 1. Note that this estimate likely also includes information returns filed by the payment settlement entities affected by § 6050W given that payment settlement entities are also subject to information reporting under § 6050W. See Housing & Economic Recovery Act of 2008, Pub. L. No. 110-289, sec. 3091(a), § 6050W, 122 Stat. 2654, 2908–11.

236. “The National Small Business Association (NSBA) is a national nonprofit membership organization founded in 1937, representing America’s Small Business Companies and Entrepreneurs.” National Small Business Association, About Us, <http://www.nsba.biz/about.html> (last visited Dec. 26, 2009). Its “primary mission is to advocate state and federal policies that are beneficial to small business, the state, and the nation—and promote the growth of free enterprise.” *Id.*

237. *Electronic Payments Tax Reporting*, *supra* note 221 (testimony of Todd McCracken, President, National Small Business Association).

238. See Barrett, *supra* note 180.

239. Lederman, *supra* note 18, at 1751.

240. *Id.* (citing a suggestion by Kristen Fowler).

241. *Id.*

evasion opportunities. Given that a seller's history and reputation are a critical element of attaining success in online marketplaces,<sup>242</sup> the hypothesized avoidance tactic of spreading one's inventory over several platforms will be ineffective since the seller has strong incentives to consolidate its sales on a single website. Furthermore, the new provision is likely to require the platforms to request a unique TIN from each seller, which then enables the IRS to aggregate sales on multiple platforms by the same user. Moreover, imposing criminal penalties for failure to disclose income in a manner that is evidence of a tax avoidance purpose can also be an effective means of deterring such behavior.

Although information returns may provide the IRS with a starting point to determine which taxpayers to audit, it has been suggested that the information reports cannot provide all of the information necessary to match them to taxpayers' returns.<sup>243</sup> One issue that may contribute to the incomplete nature of the information obtained through the required returns is that eBay is an online marketplace and only has information pertaining to agreements to buy or sell.<sup>244</sup> In some cases, sales are not completed; in other cases, sales may be completed but for more or less than the original price. Entities such as PayPal, however, reflect transactions that reached the payment stage. Moreover, as discussed above, recordkeeping by online sellers will help to ensure that they are taxed on the appropriate amount.

Another concern raised is that the term "gross amount" has the potential to overstate the amount of actual taxable income earned. For instance, overstating gross income, itself, may stem from a failure to account for adjustments when items are returned to the seller requiring a refund.<sup>245</sup> Additionally, as discussed in Part III, the taxable amount of a

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242. As noted by Janelle Elms, coauthor of JANELLE ELMS, MICHAEL BELLOMO & JOEL ELAD, *EBAY YOUR BUSINESS: MAXIMIZE PROFITS AND GET RESULTS* (2004), consultant on maximizing eBay business, and teacher of courses on eBay selling, an important aspect of running a successful eBay business is having a selection of products from the beginning. Moran, *supra* note 45. Thus, dividing one's inventory over several platforms is not likely to be a good strategy.

243. Lederman, *supra* note 18, at 1751.

244. The eBay User Agreement explicitly states that eBay is "not involved in the actual transaction between buyers and sellers." eBay, Your User Agreement, *supra* note 5. See also Email from Margaret M. Richardson, Former IRS Comm'r, to Eric Solomon & Michael Desmond (Apr. 16, 2007), reprinted in *TAX NOTES TODAY*, Apr. 25, 2007 (reiterating in correspondence to the Treasury following a meeting on third-party information reporting that "eBay is not a broker or middleman and is therefore not aware of actual sales"). Margaret M. Richardson, IRS Commissioner from 1993 to 1997, met with the Treasury Department to discuss third-party information reporting. See *id.*; IRS.gov, Previous IRS Commissioners (1955–2008), <http://www.irs.gov/irs/article/0,,id=184235,00.html> (last visited Dec. 26, 2009).

245. See Baldas, *supra* note 179 ("Attorneys said that, as in most bank reports, mistakes are likely to happen when tracking online sales for merchants like eBay sellers. For example, credits may have

sale is not necessarily the price at which the item was sold; the taxable amount must account for the item's adjusted basis. Determining the seller's basis in an item can be complicated by several factors. As Lederman noted, "[A]n eBay seller's basis in the property would not be verifiable without an audit."<sup>246</sup> As it stands, the eBay marketplace does not take title to the goods sold on its site<sup>247</sup> and thus has no means of determining a seller's basis in merchandise sold. The goods sold on websites like eBay include "thousands of disparate items," making even estimating bases for items a daunting task.<sup>248</sup>

Concerns about the new provision failing to account for a taxpayer's basis in an item are unwarranted given that, as discussed above, it is the taxpayer's responsibility to maintain records of his or her transactions, especially records of amounts that should be deducted from gross amounts. The informational returns produced by the provision are understandably gross amounts, leaving taxpayers responsible for providing information on the amounts to be netted for determining taxable income.

Despite the potential additional burdens imposed by more detailed recordkeeping of transactions, information reporting may actually enhance administrative convenience. One predicted enhancement is that the legislation provides the advantage of centralization, although the creation or improvement of infrastructure capable of effectively using the resulting information returns is likely to entail some cost.<sup>249</sup> According to Jay A. Soled,<sup>250</sup> who has explored the policy implications associated with expanding information reporting, taxpayers would have the convenience of having all the information they need to file their taxes.<sup>251</sup> For online sellers who may not have sophisticated software in place to track their transactions, receiving a Form 1099 can in fact reduce the time and money required for tax preparation.<sup>252</sup> Moreover, given that information returns have been deemed to be suitable in situations where parties transact at arm's length, as discussed by Lederman, information reporting is likely

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been issued for a particular purchase, but the refunds won't be reflected in the total receipts.").

246. Lederman, *supra* note 18, at 19.

247. The eBay User Agreement states that eBay "do[es] not transfer legal ownership of items from the seller to the buyer." eBay, Your User Agreement, *supra* note 5.

248. See Albring et al., *supra* note 15, at 1155.

249. Lederman, *supra* note 18, at 1751.

250. Jay A. Soled is a professor at Rutgers University School of Business. Soled, *supra* note 231, at 371.

251. *Id.* at 389.

252. See *id.*

appropriate in this context.<sup>253</sup> There is no indication that the online trading platforms or the payment entities like PayPal discussed in this Note transact with sellers in a manner that is anything but arm's length.

Beyond the issues raised from the possibility of overestimating taxable income, commentators have voiced broader public policy concerns involving the privacy of online transactions. Chairman of FreedomWorks<sup>254</sup> Dick Armey argues that the "privacy implications for America's small businesses are breathtaking."<sup>255</sup> The FreedomWorks organization has asserted that the provision "would require the nation's payment systems to track, aggregate, and report information on nearly every electronic transaction to the federal government."<sup>256</sup> Moreover, one blogger expressed the concern that this reporting requirement would violate rights protected by the Fourth Amendment of the U.S. Constitution, claiming that it would lead to the creation of a "gargantuan database of individual transactions" that would be vulnerable to abuse and fraud.<sup>257</sup> This fear is unwarranted, however, given that existing information reporting provisions in the Code, such as employer and stockbroker reporting, already gather similar private information.

Some organizations are specifically concerned about the way in which the IRS will use the data obtained from information reporting. The NASE expressed that its primary concern is that the data could be used "to create industry profiles, taking the total credit card receipts reported for a particular business sector and then extrapolating this information to create industry averages."<sup>258</sup> The NASE asserts that the danger posed by these industry profiles is the potential for the IRS to use them to evaluate other items on a tax return: where one business in a given industry happens to

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253. Lederman, *supra* note 18, at 1739–41, 1751 (discussing the several factors that are relevant to deciding whether information returns are appropriate for a variety of contexts and explaining that situations involving parties who generally transact at arm's length are more likely to be suitable for information reporting).

254. FreedomWorks is an organization headquartered in Washington, DC and comprised of activists who advocate for "less government, lower taxes, and more freedom." FreedomWorks, About FreedomWorks, <http://www.freedomworks.org/about/about-freedomworks> (last visited Dec. 17, 2009).

255. Press Release, Adam Brandon, FreedomWorks, Senate Housing Bill Requires EBay, Amazon, Google, and All Credit Card Companies to Report Transactions to the Government (June 19, 2008), available at <http://www.freedomworks.org/press-releases/senate-housing-bill-requires-ebay-amazon-google-an>.

256. *Id.*

257. Paul Joseph Watson, *EBay Responds to Privacy Busting Payment Legislation*, PRISONPLANET.COM, June 24, 2008, [http://www.prisonplanet.com/articles/june2008/062408\\_privacy\\_busting.htm](http://www.prisonplanet.com/articles/june2008/062408_privacy_busting.htm).

258. *Electronic Payments Tax Reporting*, *supra* note 221 (testimony of Kristie L. Darien, Executive Director, NASE).

significantly deviate from the calculated industry average, the IRS may end up questioning that return and increase the number of audits it performs on the tax returns of small businesses.<sup>259</sup>

There does not, however, appear to be a “danger” in the IRS using information to try to efficiently determine which returns to audit; the IRS needs some sort of basis or foundation upon which to evaluate the returns that may require an audit. In line with the tax principle of administrative ease, the IRS should be allowed to leverage available information to make its processes more efficient.

### VIII. IMPROVEMENTS AND RECOMMENDATIONS

Given the magnitude of the estimated tax gap, information reporting is a valuable tool in efforts to reduce it. Although precise estimates of the tax gap stemming from unreported or underreported e-commerce income are not available, it is a segment of the economy that is inherently ripe for income tax evasion, and efforts to increase compliance in this area through information reporting are appropriate. As the director of tax issues of the GAO noted, “Once withholding or information reporting requirements are in place for particular types of income, compliance tends to remain high over time.”<sup>260</sup> To the extent that this new section of the Code yields accurate informational returns, this provision will be an effective means of helping to reduce the expansion of the tax gap.

Further guidance on this new Code section is essential to facilitating compliance because, like many provisions in the Code, this legislation “is complicated inasmuch as it uses terms of art that are then defined using other terms of art.”<sup>261</sup> Due to the lack of IRS guidance on the terms used in the new information reporting requirement, the concerns raised by many parties—from e-commerce website spokespeople to the National Small Business Association—need to be addressed.<sup>262</sup> For instance, the NASE has expressed the concern that the provision is vulnerable to significant unintended consequences, noting that it “lacks clear details regarding its

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259. *See id.*

260. *Tax Compliance*, *supra* note 145, at 12 (statement of Michael Brostek, Director, Tax Issues, Strategic Issues, U.S. GAO).

261. FRIEDMAN, *supra* note 41, at 1.

262. For instance, Matt Stinchcomb, vice president of marketing for Etsy.com, a website that allows people to buy and sell handmade products, stated that requiring information reporting for online selling platforms is a “total nightmare.” McCullagh, *supra* note 228. Stinchcomb expressed that “Etsy would be uncomfortable asking its users to divulge their Social Security numbers, which are required on the IRS 1099 forms used to report untaxed income.” *Id.*

implementation.”<sup>263</sup>

IRS Notice 2009-19, in which the IRS and the Treasury Department invited public comments to assist them in drafting guidance under the new provisions of § 6050W, highlights several open questions that are especially relevant to this statute as it applies to online platforms like eBay, Amazon, and Google Checkout and to sellers using these websites.<sup>264</sup> The Notice asks (1) “[w]hether the Form 1099 series is appropriate for Section 6050W reporting”; (2) “[h]ow to interpret the statutory definition and scope of ‘third party payment network’”; and (3) whether “gross amount” means “gross receipts or sales” or whether adjustments should be made to this figure.<sup>265</sup>

As to the first issue, in light of the potential confusion between the various information returns existing under current tax law,<sup>266</sup> creating a new form to be used specifically for reporting under § 6050W would help minimize confusion.<sup>267</sup> The IRPAC specifically suggests adopting the existing practices for most other information returns, such as the use of the Filing Information Returns Electronically (“FIRE”) system,<sup>268</sup> which requires payers to use a certain type of software to put return information in a particular format compatible with IRS use.<sup>269</sup>

Along these lines, a cost-efficient infrastructure must be developed and implemented by the IRS in the next few years to ensure that the sheer volume of documents that will result from this legislation is properly and effectively managed. One way in which this may be accomplished is to leverage the use of electronic filing given that paper forms are more costly for the IRS to process.<sup>270</sup> Processing paper forms is a “labor-intensive process” that involves scanning the forms into a database, followed by visual verification to ensure that the form was scanned correctly.<sup>271</sup> In fact, parties required to file information returns to the IRS are required to also

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263. *Electronic Payments Tax Reporting*, *supra* note 221 (testimony of Kristie L. Darien, Executive Director, NASE).

264. See I.R.S. Notice 09-19, 2009–10 I.R.B. 660, available at <http://www.irs.gov/pub/irs-irbs/irb09-10.pdf> [hereinafter Internal Revenue Bulletin].

265. *Id.*

266. See *supra* note 115 and accompanying text.

267. Letter from Jon Lakritz, 2009 Chairperson of the IRPAC, to Douglas Shulman, Comm’r of Internal Revenue (Mar. 17, 2009), available at [http://www.irs.gov/pub/irs-utl/irpac\\_6050w\\_comments\\_march\\_17\\_2009.pdf](http://www.irs.gov/pub/irs-utl/irpac_6050w_comments_march_17_2009.pdf).

268. See *id.* at 2.

269. U.S. GAO, *supra* note 133, at 18 (describing the FIRE system).

270. *Id.*

271. *Id.*

provide such statements to the recipients of the income, and those who file 250 or more must do so electronically.<sup>272</sup>

There is some indication that the magnitude of increased costs stemming from this provision is exaggerated given taxpayers' increased use of electronic filing of their tax returns. For instance, in the 2007 filing season, nearly 60 percent of all income tax returns were electronically filed ("e-filed").<sup>273</sup> Moreover, in March 2008, "[o]ver 14 million returns [had] been e-filed by people from their personal computers, up from over 12.2 million for the same period" in the previous year.<sup>274</sup>

Although some opponents have expressed the concern that increased information reporting will be an administrative nightmare, according to Soled, using information returns can provide an often overlooked benefit.<sup>275</sup> Because a lot of the work involved in issuing and monitoring information returns can be automated, this system has the potential to free IRS staff to fulfill other responsibilities. Soled explained that "once the wheels of information return issuance are set in motion, the system can generally function on autopilot, periodically generating computerized assessment letters to delinquent taxpayers."<sup>276</sup>

In order to facilitate maximizing the benefits of increased information reporting, it is important that the IRS "embark on a comprehensive outreach campaign to educate" the online selling platforms and online sellers.<sup>277</sup> In addition, the IRPAC recommends that the IRS provide "generous transition rules and penalty waivers" during the first year or two of reporting and be cognizant of the inexperience of the parties, especially as forms and instructions are created or revised.<sup>278</sup>

With respect to the second issue of how to define "third-party network," it appears that this term was specifically targeted at entities like eBay's PayPal, in light of the proposals discussed above.<sup>279</sup> In particular, the proposals to expand the definition of "broker" to include auction-like websites like eBay and to reference to the growing number of taxpayers who indicate that they derive significant income from online sales suggests that "broker" covers PayPal, Amazon, and Google Checkout. Moreover, in

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272. IRS.gov, A Guide to Information Returns, *supra* note 31.

273. *IRS Operations*, *supra* note 233 (testimony of Linda Stiff, Acting Comm'r, IRS).

274. *Id.*

275. See Soled, *supra* note 231, at 389.

276. *Id.*

277. See Letter from Jon Lakritz to Douglas Shulman, *supra* note 267, at 2.

278. *Id.*

279. See *supra* Part V.

its recommendation, the IRPAC expressed that “[i]t is commonly believed that the ‘third party network’ (3PN) was directed at PayPal and similar entities where widely disparate ‘merchants’ are paid for goods and services through a credit-card-like service.”<sup>280</sup>

Although the many proposals prior to the enactment of this legislation suggest that the term “third party network” constitutes entities like PayPal, the IRS should provide further guidance specifically defining the term to avoid potential confusion. A representative of the Electronic Transactions Association,<sup>281</sup> responding to the IRS’s request for comments in the IRS Notice 2009-19, expressed the view that the definition of “third party payment network” was intended to cover PayPal and

similar “closed-loop” payment systems that involve both the establishment of accounts by sellers, and contractual arrangements with buyers and sellers to use their network, and was not intended to cover routine banking transactions, wire transfers, . . . online “Bill Pay” arrangements, or payment mechanisms that do not require the seller to have an account with the payment facilitator.<sup>282</sup>

In particular, explicitly defining the term “third party networks” is critical to ensuring that it is applied to the appropriate entities and that it is applied equitably. The broad term has caused concern that the statute may be applied inappropriately and lead to “double counting.”<sup>283</sup> The IRPAC has identified two scenarios to which the broad interpretation of this term may be inappropriately applied: (1) the healthcare carriers who have contracts with a network of providers who provide services to members under both insured and administrative service contract health plans and (2) accounts payable departments who outsource payments to third parties.<sup>284</sup> The IRPAC recommends that the IRS define “third party network” to exclude these two types of entities and similar networks because existing law already includes reporting requirements for these forms of payment.<sup>285</sup> The IRPAC has also stated that it “will continue to work toward providing specific wording to define third party networks to

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280. Letter from Jon Lakritz to Douglas Shulman, *supra* note 267, at 5.

281. The Electronic Transactions Association (“ETA”) is “an international trade association representing companies who offer electronic transaction processing products and services,” whose membership includes financial institutions, transactions processors, independent sales organizations, and equipment suppliers. Email from Mary Weaver Bennett, Director of Gov’t & Indus. Relations, ETA, to the IRS (Mar. 18, 2009), *reprinted in* TAX NOTES TODAY, Mar. 27, 2009.

282. *Id.*

283. *See* Letter from Jon Lakritz to Douglas Shulman, *supra* note 267, at 5, 7–8.

284. *Id.* at 5

285. *Id.*

eliminate any confusion and establish that such payments are reportable only once by any party under existing provisions.”<sup>286</sup>

In the same vein, the IRS should provide clear guidance on the extent of the “contractual obligation” required between the third-party networks and participating payees. Given that the participation or terms of use agreements by the eBay, Amazon, and Google Checkout websites can be carefully written to circumvent the contractual obligation to online sellers—and specify that the buyers themselves have the contractual obligation to make the payment—these sites may be able to assert that the provision is not applicable to their businesses. As noted by one commentator, “An organization that does not have contractual agreements with sellers and merely processes electronic payments (such as wire transfers, electronic checks, and direct deposit payments) between buyers and sellers is not required to report under the new law.”<sup>287</sup>

Another key consideration that must be accounted for in implementing this information reporting provision is ensuring equity in its application. Consistent with the tax principles described in Part V.A, it is critical that any newly enacted tax legislation apply in the same way to both online and offline entities. In responding to the Bush administration’s 2008 proposal to expand broker information reporting, eBay expressed concern that the provision would “put the company at a competitive disadvantage” because sellers may instead opt to conduct their transactions on classified websites like Craigslist, for example, that do not track transactions.<sup>288</sup> Similar concerns are applicable to the third-party network information reporting provision, bolstering the need for greater specificity in terms of what constitutes a third-party network and ensuring that it is applied equitably.

For the third issue identified by the IRS as relevant to third-party network reporting—the ambiguity surrounding the term “gross amount”—additional guidance is needed to ensure that the information reports reflect any appropriate adjustments to a business’s income. In its notice inviting comments from the public on § 6050W of the Code, the IRS framed the issue as being “whether the ‘gross amount’ of the reportable payment transaction should be defined as ‘gross receipts or sales’ or whether adjustments should be made for credits, cash equivalents, discount

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286. *Id.*

287. FRIEDMAN, *supra* note 41, at 2.

288. See Dan Mitchell, *Sell and Tell (the I.R.S.)*, N.Y. TIMES, Mar. 3, 2007, at C5. Craigslist is a website that features “[l]ocal classifieds and forums” worldwide. Craigslist.org, Fact Sheet, <http://www.craigslist.org/about/factsheet> (last visited Dec. 17, 2009). “[J]ust about anything” can be found on the website, including goods, services, and jobs. *Id.*

amounts, fees, refunded amounts, or other amounts.”<sup>289</sup> To the extent that the online selling platforms can maintain records of adjustments for credits or refunds, more accurate information returns can be filed with the IRS. Additionally, as discussed above in Part VII, detailed recordkeeping by the online sellers themselves will help to ensure that the proper amounts are taxed. Cooperation from these parties in this respect will help to narrow any potential inconsistencies between the amount reported on 1099 Forms and the amount reported as gross sales or receipts by taxpayers on their returns. Reducing this inconsistency is likely to translate into fewer inefficient audits.

Additionally, in order to ensure that the appropriate amount of income is being taxed, it is critical that education provided to online sellers include instruction on maintaining records. Although the IRS website is easily navigable and has portions specifically addressed to online auction sellers,<sup>290</sup> the IRS may improve public awareness of taxpayer obligations by collaborating with the online selling platforms. In particular, providing online sellers with education to understand how this reporting provision will be used by the online trading platforms is important to enabling the online sellers to develop appropriate recordkeeping of their own.

The privacy concerns involved in the collection of information, such as the risk of identity theft, are no different from the ordinary risks involved in the every-day exchange of information on the Internet. As for anyone providing private information on the Internet, online sellers should be selective in deciding where to conduct their online sales and should restrict their use to trusted websites only. The expansion of e-commerce reflects a growing trust of engaging in transactions on the Internet that involve submitting personal information. For example, online banking is widely used and involves inputting bank account numbers over the Internet. Additionally, when completing a Free Application for Federal Student Aid (“FAFSA”) on the Internet, applicants submit a substantial amount of personal information including their social security number, driver’s license number, adjusted gross income, and savings and checking account balances.<sup>291</sup> It is the responsibility of sellers who choose to engage in e-

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289. Internal Revenue Bulletin, *supra* note 264.

290. By simply typing “online sales” into the search window on the IRS website, numerous results containing links to tax guidance for online sellers are returned. For instance, the first three links listed feature the following titles: “Tax Tips for Online Auction Sellers”; “Tax Tips—E-Business & E-Commerce”; and “Tax Laws and Issues for Online Auction Sellers.” See IRS.gov, <http://www.irs.gov> (search for “online sales”) (last visited Dec. 17, 2009).

291. Fed. Student Aid, U.S. Dep’t of Educ., 2009–2010 FAFSA on the Web Worksheet, *available at* <http://www.fafsa.ed.gov/fafsaws90bw.pdf>.

commerce to be conscientious when disclosing their personal information. For instance, online sellers have been advised to avoid using their social security number as their TIN for business purposes and instead to obtain a separate federal employee identification number.<sup>292</sup>

#### IX. CONCLUSION

Given the expansion of both the tax gap and e-commerce, it is imperative that tax policy be shaped to facilitate effective information reporting of the income derived from this increasingly important sector of our economy. The information reporting requirement included in the Housing and Recovery Act of 2008 appears to be an effective means of addressing the underreporting of income from online sales; the benefits of centralization of information and increased confidence among taxpayers that their fellow citizens are not circumventing their tax obligations will likely outweigh the additional administrative costs. In the next few years, before the provision is applied to annual tax returns, the IRS should continue to provide guidance for the terms used throughout the provision to ensure that any ambiguities discussed in this Note are addressed. As long as the guiding principles of traditional tax policy are integrated into the execution of this new provision, the expanding tax gap can be addressed without stunting the growth of e-commerce.

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292. Barrett, *supra* note 180.

