News
Royalties and Taxes: Making Money on the Net
Greg Goth

Fifteen years ago, the US Congress amended the National Science Foundation Act of 1950 to allow commercial transactions on the Internet. Ever since, the issues surrounding how much money actually flows over the network and who controls its ultimate destination have grown considerably.

The Internet’s decentralized, distributed nature has often confounded those in both the private and public sectors with vested interests in economic models that the network appears to change or circumvent. One of those issues, the battle over royalty rates owed to musicians from Internet broadcasters, is at fever pitch. Its results could have profound ramifications for not only the economic structure of online entertainment but also the pace of technological innovation in that genre.

A second issue—how to tax online purchases equitably, if at all—is once more being dissected in policymaking bodies around the globe. In the US and the European Union, legislators are discovering the complexities of trying to level the Internet-enabled economic playing field among taxing jurisdictions.

Internet radio royalties: suffocating the next generation?

“Hey mister! I don’t mean to be tellin’ tales outta school, but there’s a man in there hands out ten dollars to anyone sings into his can!” —O Brother Where Art Thou?

In the Coen brothers’ movie about the Homeric travails of three escaped convicts through the US Depression-era backwoods, the power of music to change lives figures prominently. The quotation above draws knowing chuckles from audience members who see the screenwriter’s oblique reference to the swindling of artists from the earliest days of recording and broadcasting technology.

The latest dispute over fair payment for musicians’ work distributed via mass broadcast pits Internet broadcasters against the Recording Industry Association of America and SoundExchange, (http://www.soundexchange.com/). RIAA founded the organization in 2000 (and spun it off as an independent nonprofit in 2003) to collect royalties due from the Digital Performance Right in Sound Recordings Act of 1995. Webcasters claim that new royalty rates, spearheaded by SoundExchange and mandated by the Copyright Royalty Board, (http://www.loc.gov/crb/) will spell the end of Internet radio before it delivers on its promise. SoundExchange claims that webcasters have long had a virtual free ride at artists’ expense (SoundExchange media representatives weren’t available for an interview).

The Information Technology and Innovation Foundation (http://www.itif.org/), a nonpartisan technology policy think tank, released its analysis of the vitriolic dispute on 10 May. It pulls no punches in its assessment. “While some of their [webcasters’] comments have certainly been hyperbole, if the new rates take effect they will have a deleterious effect on Internet radio,” the report’s author, ITIF senior analyst Daniel Castro, wrote.
Castro says the CRB’s decision has created a very prejudiced fee schedule—including royalties due to the copyright holder of the sound recording itself—that penalizes Internet broadcasters above and beyond what terrestrial radio stations (AM and FM frequencies) pay through their existing statutory licenses to music publishers.

“There is, in theory, a different artist being compensated with sound recording royalties,” Castro says, “and there is a valid argument to say there should be a sound recording royalty fee. The problem is, you can’t charge that to one form of broadcast and not another.”

Under the new ruling, webcasters will have to pay royalty rates starting at US$0.0008 per performance retroactively in 2006 and increasing to $0.0019 in 2010. Additionally, webcasters must pay a $500 flat fee per channel.

“It’s going to triple our rates, which makes us uneconomic,” says Tim Westergren, founder of webcaster Pandora (http://www.pandora.com/), which has 6.5 million registered listeners. “There’s no way we can make this business work if our single biggest cost gets tripled in the next couple of years.”

Westergren says the future looks even dimmer for the “mom-and-pop” webcasters as well as small stations such as university-supported Internet broadcasters.

“In the former regime, they paid a percentage of revenue,” he says. “For them, going to a per-song rate in some cases is like a 10- to 12-fold increase. Those numbers look silly. Some places will owe half a million dollars when their revenues were $50,000.”

Westergren says he’s well aware of the perils musicians face in trying to make a living. “Before Pandora, I spent 10 years playing in rock bands,” he says. “I was another one of those idiots driving around in a van, thinking I was actually pursuing an effective marketing strategy. I’ve been in their shoes; I know what goes on.”

However, Westergren believes the distributed nature of Internet technology is profoundly changing what goes on in the music industry. Pandora, for example, is based on the Music Genome Project (http://www.pandora.com/mgp.shtml). A trained musician analyzes each song in the Pandora database, using up to 400 distinct musical characteristics—the genes in Genome. Listeners can create up to 100 personalized “stations” on the basis of their preferred music’s attributes. Through genome-matching, they can discover songs they would otherwise have never heard.

“Until now, radio has been a popularity contest,” Westergren says. “Sure, you had the real maverick DJs, but 90 percent of that still comes to them through the industry that surrounds them. There’s nothing inherently evil with that—it’s just the nature of broadcasting.”

But Internet radio isn’t constrained by an industry mediator. Pandora has 35,000 artists, and Westergren says a song picked at random would likely have spun thousands of times. “I sound like I’m on a soapbox right now,” he says, “but as a musician, for me, this is a watershed. I think it’s transforming the whole basic complexion of the business.”

As IP-based technology extends further into mobile markets, Westergren also sees Internet radio as the medium for much of the listening public’s entertainment away from home. He thinks both artists and fans must heed the danger in suffocating royalty rates.

“This is the one format that is the one bright hope of the music business,” he says. “It’s an extraordinary publicity vehicle for tens of thousands of musicians. The old musician’s mindset was, play and play and play and hope someone discovers you, and that sort of more passive approach to business is changing.”
The money in online services still isn't great, but it does give musicians more control of their music's distribution. And as the potential in these services is realized, Westergren says, "musicians realize that if they do things properly, they can make $40,000 a year online."

**Next steps**

The new rates, originally scheduled to go into effect 15 May, were postponed until 15 July. In the interim, bills rescinding the new rates have been introduced in both the US House and Senate, and a confederation of webcasters, artists, and other interested parties have formed the Save Net Radio coalition (http://www.savenetradio.org/). The ITIF report (http://www.itif.org/files/InternetRadio.pdf), recommends that Congress legislate several steps toward an equitable royalty schedule. These include

- granting the same performance copyright to all broadcast technologies,
- modifying the statutory license to let copyright owners specify separate royalty rates for each sound recording, and
- allowing copyright owners to assign separate royalty rates to small, noncommercial webcaster groups.

Castro says he doesn’t think the impasse will be resolved any time soon, although the proposed legislation has gathered steam more quickly than expected.

"It’s clear it’s unfair," he says. "The problem is, a lot of people don’t notice this happening, and Internet radio listeners tend not to be the constituents most familiar to their representatives in Congress."

Both Castro and Westergren say the impasse has affected the global flow of music over the Internet. Pandora shut down their international streams in early May.

"Laws for webcasting are applied to where the listener sits," Westergren says. "If you stream to the US from the UK, you have to pay US rates on your US listeners. It doesn’t actually directly impact what you pay streaming to Chile. On the other hand, this statutory rate is definitely a benchmark, and if you ask any rights organization anywhere in the world, they’ll tell you they’re sort of looking at this as a precedent."

**Online taxes: More revenue or zero-sum game?**

While the nascent Internet broadcasting community fights for its life, another battle is brewing in several regions regarding the why and what of taxing Internet transactions and how to do it equitably. In the US, a newly elected Democratic-majority Congress is perceived as being more friendly to changing tax law so that states will have a theoretically easier time collecting sales taxes on purchases made out of state via the Internet. In Europe, discussions have arisen regarding the equitable administration of the EU’s value-added tax (VAT) on electronically delivered goods and services such as software, digital music, and scholarly journals.

In the US, levying sales taxes on interstate sales involves reversing a precedent that rests on a 1992 Supreme Court decision. In *Quill Corp. v. North Dakota* (http://www.law.cornell.edu/), the Court held that a state couldn’t force a merchant to collect sales taxes from its residents if the business didn’t have a physical presence in that state.

Of course, thanks to e-commerce, the logistics of interstate commerce have changed dramatically since 1992. While taxpayers are legally subject to use taxes for online purchases, enforcement is virtually impossible. Whether states’ coffers are missing out on a gold mine or a negligible additional amount is hotly debated.
The most comprehensive effort to organize an interstate sales tax agreement is the Streamlined Sales Tax Project, (http://www.streamlinedsalestax.org/). Organized in 2000, the project would establish a uniform agreement in which member states could collect sales taxes from online transactions between merchants and customers in those states. However, the difficulties in establishing a nationwide tax network is exemplified in a recent instance involving Connecticut.

In April, the Connecticut General Assembly’s Finance Committee approved a plan to join the streamline project to simplify collecting online sales taxes. But to do so, the state would have to repeal its exemption on the first $50 of clothing purchased within Connecticut. This led directly to a contest between detractors, who say that joining the project would hurt those who can least afford the exemption’s repeal, and supporters, who argue that the clothing exemption’s repeal will be offset by other tax cuts.

One technology policy lobbyist says this quandary can be multiplied by any number of state and local jurisdictions and demonstrates why the Quill decision is as sound now as it was in 1992.

"My crazy patchwork might be your attempt to be progressive and kind,” says Steve DelBianco, executive director of NetChoice.org, a coalition opposed to the streamline tax plan. “If you ask the states what they really want, they want to force everyone to collect their sales tax, yet preserve the flexibility to make their systems as crazy and complex as they ever have.”

DelBianco says estimates that uncollected sales tax cost states $22 billion annually were overblown by a factor of four, according to US Dept. of Commerce surveys. In fact, he says, the small retailers most often cited as victims of unscrupulous customers using the Internet to avoid paying local sales taxes could lose the most. The technology to collect multiple states’ sales taxes will cost them extra, and the customers who might save on online purchases will likely spend the savings in their local economy.

In the case of a Connecticut resident buying a pair of shoes online from a merchant without a Connecticut facility, DelBianco says enforcing online tax collection doesn’t bring new money into Connecticut. "It’s your money. The fact the merchant would collect it and remit it back to Connecticut, don’t let anybody tell you that’s new money. They’re taking it from your pocket to the state capital. They’re not bringing new money into the state.”

Scott Peterson, executive director of the Streamlined Sales Tax Project, says it’s imperative to convince citizens the plan has merit for them to achieve buy-in.

“I think the thing most elected officials struggle to accomplish is to convince people there is value in the taxes that we pay,” he says, “assuming we’re not talking to somebody who says, ‘I’m going to give you a dollar, and you give me a dollar in return.’ That never works in a representative democracy. There is no quid pro quo.”

The SSTP’s fate might rest in another technology issue only tangentially related to it, DelBianco says. As Congress debates whether to renew the moratorium on locally assessed Internet access taxes, due to expire on 1 November, he says the streamlined tax agenda might be attached to a moratorium extension bill.

SSTP director Peterson says the reliance on the Quill decision might not be pertinent today. "If you change the facts, you change the outcome,” he says. "And we want to change the facts. We want to make it simpler.”

To do so, however, Peterson and his colleagues will have to convince merchants the program won’t be an undue burden; the project does have rebate programs in place for merchants using approved software. Backers will also have to convince consumers that overturning Quill de facto isn’t bad public
policy. And of course, they'll also have to convince officials in thousands of local jurisdictions that supporting SSTP in lieu of the exemptions they might lose won't be political suicide.

**EU tax a VAT of confusion**

Even in a region that has forged a comprehensive e-commerce tax strategy, unforeseen loopholes demonstrate the difficulty of establishing effective revenue regimes. In 2002, the EU passed a value-added tax on electronic goods and services provided by merchants in non-EU member states. The VAT was intended to provide some balance in the global online market. However, the strategy hasn’t been entirely effective, according to Boyana Milcheva of the Center for Law in Information and Communication Technology in Bulgaria. At the April meeting of LEFIS (Legal Framework for the Information Society) in Vilnius, Lithuania, Milcheva offered a presentation (http://www.lefis.org/meetings/workshops/2007/vilnius_2007/Abstracts.doc) countering the view that non-EU vendors would lose their competitive advantage in selling to EU-based consumers (the tax is calculated according to where the buyer resides).

Milcheva argued that, besides being largely unenforceable, the directive created another inequity in intra-EU electronic commerce. Because it didn’t apply to EU vendors, non-EU businesses can and do circumvent it by establishing subsidiaries in EU jurisdictions with the lowest VAT rates, spurring the intra-EU tax competition.

The European Commission itself has discovered another glitch in the electronic VAT tax, one that affects institutions serving the scholarly community especially.

“Across Europe, digital journals are subject to standard rate VAT while paper journals benefit from a reduced rate,” the Commission wrote in a recent report (http://ec.europa.eu/research/science-society/document_library/pdf_06/communication-022007_en.pdf). “Thus the same content triggers a different VAT rate depending on the medium. Moreover, in view of the current rules concerning exemptions, public authorities and subsidies, public research institutes and libraries cannot deduct VAT costs. To address this situation, some Member States refund VAT for digital journal subscriptions to libraries.”

NetChoice’s DelBianco says the perception that the Internet is a mother lode of untapped tax revenue is misplaced. “Before the states set up a brand new toll booth,” he says, “they should be realistic about the tolls it will bring in. And they should net out the cost of running the toll booth.”

**Related URLs**

| Copyright Royalty Board: | www.loc.gov/crb |
| Information Technology and Innovation Foundation: | www.itif.org |
| Music Genome Project: | www.pandora.com/mgp.shtml |
| Pandora: | www.pandora.com |
| **Quill Corp v. North Dakota** Supreme Court decision: | www.law.cornell.edu/supct/html/91-0194.ZO.html |
| Save Net Radio: | www.savenetradio.org |
| SoundExchange: | www.soundexchange.com |
| Streamlined Sales Tax Project: | www.streamlinedsales.tax.org |
Related Links

- DS Online's Peer-to-Peer Community (http://dsonline.computer.org/portal/site/dsonline/)

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