

## FEDERAL LEGISLATION REGARDING TAXATION OF INTERNET SALES TRANSACTIONS

By Christopher J. Schafer

In October 1998, amid the general confusion surrounding the taxation of Internet sales, Congress enacted the Internet Tax Freedom Act ("ITFA").<sup>1</sup> This law imposed a three-year moratorium on all new sales and use taxes<sup>2</sup> on electronic commerce. Congress passed this bill partly in response to the confusion surrounding remote sellers' sales tax liability and the lack of judicial guidance on that subject.

Generally backed by the Internet industry and ostensibly designed to prevent duplicative and discriminatory taxation of Internet sales,<sup>3</sup> the ITFA arguably threatens state sovereignty.<sup>4</sup> House Bill 3709, a bill that would have extended the ITFA for 5 years, passed the U.S. House of Representatives in mid-2000.<sup>5</sup> Its counterpart in the U.S. Senate, Senate Bill 2255, died in the Senate Committee on Commerce, Science and Transportation at the end of the 106th Congress.<sup>6</sup> Several other bills, introduced in both the House and the Senate, also aimed to extend the moratorium.<sup>7</sup>

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1. Internet Tax Freedom Act, Pub. L. No. 105-277, Div. C, Title XI, §§ 1100-1104, 112 Stat. 2681, 2681-719 (1998), available at <http://www.house.gov/chriscox/nettax/law.html> (last visited Nov. 5, 2000).

2. More properly called a "compensating use" tax, a "use tax" is designed as a supplement to the sales tax. Such taxes are levied when the buyer purchases a good or service from another state that would have been subject to sales tax if purchased in the buyer's home state. AARON LUKAS, CATO INSTITUTE, TAX BYTES: A PRIMER ON THE TAXATION OF ELECTRONIC COMMERCE 5 (1999). The term "use tax" is used interchangeably with "sales tax" here. If it is not, this will be made clear in context.

3. James John Jurinski, *Federalism and State Taxation of E-Commerce: Is the End in Sight for State Sales Taxes?*, 18 J. ST. TAX'N 30, 37 (1999).

4. See Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 423 n.17 (1997) (citing Letter from the Nat'l Governors' Ass'n to Sen. John McCain, chairman, Comm. on Commerce, Science and Transportation & Sen. Ernest F. Hollings, ranking member, Comm. on Commerce, Science, and Transportation (Oct. 6, 1997), available at <http://www.nga.org/Releases/Letters/971010letter.htm>).

5. Internet Nondiscrimination Act of 2000, H.R. 3709, 106th Cong. (2000).

6. See Bill Summary & Status for the 106th Congress, S.2255, at <http://thomas.loc.gov/cgi-bin/bdquery/z?d106:SN02255:@@L&summ2=m&> (last visited Nov. 5, 2000).

7. See, e.g., H.R. 4460, 106th Cong. (2000); S. 2775, 106th Cong. (2000); H.R. 4462, 106th Cong. (2000); H.R. 4267, 106th Cong. (2000).

Along with the extension, some of these bills invited the states to enter into a compact that would simplify individual states' taxation systems.<sup>8</sup> Only upon agreeing to the compact would the states have been allowed to levy sales and use taxes on e-commerce transactions.<sup>9</sup> The tax system embodied by them would substantially change the way that the federal structure of our government operates and could undermine state sovereignty. To avoid this, it may be necessary to retool the current judicial standard for assessing tax liability, the "physical presence" standard. This standard would need to be redefined as a "significant" physical presence.

## I. BACKGROUND

### A. Taxing Jurisdictions in the United States

The ITFA alleviates some problems facing e-commerce vendors prior to its passage, such as taxation of the same transaction by multiple jurisdictions.<sup>10</sup> The federal nature of the U.S. government allows the states and their various localities to control taxation within their jurisdictions.<sup>11</sup> While usually not problematic, this system creates difficulties when the levying jurisdiction tries to tax a sales transaction in a jurisdiction where the buyer resides but the seller does not.<sup>12</sup> Due to the lack of interstate cooperation and uniform standards that dictate which jurisdiction may tax a certain transaction, it was possible that multiple jurisdictions could tax the same transaction.<sup>13</sup>

Compounding the problem of multiple taxation is that over 7,500 jurisdictions in the United States currently impose some form of sales or use tax.<sup>14</sup> These jurisdictions apply many different tax rates and define a tax-

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8. See H.R. 4460, 106th Cong. § 2(b)(2) (2000); S. 2775, 106th Cong. § 5 (2000); H.R. 4462, 106th Cong. § 5 (2000).

9. See H.R. 4460, 106th Cong. § 2(b)(2) (2000); S. 2775 106th Cong. § 7 (2000); H.R. 4462 106th Cong. § 7 (2000).

10. Internet Tax Freedom Act, Pub. L. No. 105-277, Div. C, Title XI, § 1104(6)(a), 112 Stat. 2681, 2681-719 (1998), available at <http://www.house.gov/chriscox/nettax/law.html> (last visited Nov. 5, 2000).

11. Jurinski, *supra* note 3, at 33.

12. Note that in the e-commerce context (as with sales taxes in general) the buyer actually pays the tax, rather than the seller. See MERRILL MATTHEWS JR., SHOULD WE TAX THE INTERNET? 5 (Institute for Policy Innovation, Policy Report No. 152, 2000). Since buyers will not ordinarily volunteer to pay such a tax and since it is not feasible to collect directly from the buyer, the issue is when the state has the power to impose a duty on the seller to collect the tax.

13. See generally KARL FRIEDEN, CYBERTAXATION: THE TAXATION OF E-COMMERCE 151-155 (2000).

14. *Id.* at 184.

able good or transaction in many different ways.<sup>15</sup> The multitude of jurisdictions, rates, and rules makes it difficult for any remote vendor to comply with all of them.<sup>16</sup> This is especially true of e-commerce vendors, who are accessible nationwide wherever an Internet connection is available. This morass of regulations may create an incentive for remote vendors to avoid tax liability.

## B. The Current Standard for Taxation of Remote Sales: The Physical Presence Standard

### 1. Supreme Court Precedent

In 1967, the Supreme Court laid down the current standard for the taxability of remote vendors in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.<sup>17</sup> In *Bellas Hess*, the State of Illinois sued a mail-order house to recover unpaid use taxes.<sup>18</sup> The defendant corporation was incorporated in Delaware and had its principal place of business in Missouri.<sup>19</sup> It communicated with customers in Illinois only by mail or common carrier.<sup>20</sup> The Court ruled that requiring the mail-order house to pay the use tax violated the Due Process and Commerce Clauses of the Constitution, in part because the tax placed an undue burden on interstate commerce.<sup>21</sup> The holding required that the remote seller have "retail outlets, solicitors, or property within a State" in order to be taxable there.<sup>22</sup> In other words, *Bellas Hess* created a physical presence requirement.

In 1992, the Court revisited that requirement in *Quill Corp. v. North Dakota*.<sup>23</sup> In reaffirming the *Bellas Hess* standard,<sup>24</sup> the Court stated that "*Bellas Hess* . . . stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause."<sup>25</sup> Justice White's vig-

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15. See *id.* at 85, 116.

16. A vendor is responsible for collecting of taxes which it owes under the law of the applicable jurisdiction. Often, vendors avoid collection even when liability is clear. See *id.* at 355.

17. 386 U.S. 753 (1967).

18. *Id.*

19. *Id.* at 754.

20. *Id.*

21. *Id.* at 758-60.

22. *Id.* at 758.

23. 504 U.S. 298 (1992).

24. While the Court reaffirmed the standard with respect to tax liability, it did distinguish between the standards used to determine liability for taxation under the Due Process and Commerce Clauses. See *id.* at 305.

25. *Id.* at 311.

orous dissent questioned the logic of this "substantial nexus," or "physical presence" standard, arguing that the standard did not provide the bright-line rule that the majority claimed.<sup>26</sup>

## 2. *Congressional Moratorium on E-Commerce Taxation*

Both state and federal courts have interpreted the "physical presence" standard in various ways,<sup>27</sup> creating confusion as to when remote vendors will be liable for sales taxes. In response to this threat to the burgeoning area of electronic commerce, Congress passed the ITFA in October 1998.<sup>28</sup> The bill placed a moratorium on all taxes on the Internet, and on Internet transactions that were not already "generally imposed and actually enforced."<sup>29</sup> The moratorium will expire in October 2001.<sup>30</sup>

To find a more permanent solution to the problem of Internet taxation, the ITFA also created the Advisory Commission on Electronic Commerce to study the problem and report to Congress in 2000.<sup>31</sup> Although it released its report in April 2000, the Commission failed to offer any official findings or recommendations addressing the problem of sales and use taxation of e-commerce.<sup>32</sup> Partly as a result of this lack of findings, several bills were introduced in the 106th Congress that would have extended the moratorium for another several years.<sup>33</sup>

## II. **BILLS INTRODUCED IN THE 106TH CONGRESS**

Though none of the bills that were pending in the 106th Congress were enacted, they are important in understanding the situation surrounding e-commerce, and it is possible that similar legislation will be introduced in the 107th Congress. House Bill 3709 passed the House of Representatives on May 10, 2000.<sup>34</sup> The bill called for a five-year extension of the original

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26. *Id.* at 321-33 (White, J., dissenting).

27. *See, e.g.*, *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel Co. v. Dep't of Revenue of Ill.*, 419 U.S. 560 (1975); *Scholastic Book Clubs, Inc., v. State Bd. of Equalization*, 207 Cal. App. 3d 734 (1989).

28. *Internet Tax Freedom Act*, Pub. L. 105-277, Div. C, Title XI, §§ 1100 to 1104, 112 Stat. 2681, 2681-719 (1998).

29. *Id.* § 1101(a)(1).

30. *Id.* § 1101(a).

31. *Id.* § 1102.

32. The Commission's proposal on sales and use taxes passed by only a majority, and was therefore considered neither an official finding or recommendation. ADVISORY COMMISSION ON ELECTRONIC COMMERCE, REPORT TO CONGRESS 20 (2000).

33. *See* H.R. 3709, 106th Cong. (2000); S. 2255, 106th Cong. (2000); H.R. 4460, 106th Cong. (2000); S. 2775, 106th Cong. (2000).

34. *Internet Nondiscrimination Act of 2000*, H.R. 3709, 106th Cong. (2000).

ITFA moratorium.<sup>35</sup> It also included a "Sense of the Congress" section that delineated what the states should include in any tax "relating to electronic commerce."<sup>36</sup> These factors included uniform definitions for goods or services, uniform tax returns, and other features that "the member States deem warranted to remote [sic] simplicity, uniformity, neutrality, efficiency and fairness."<sup>37</sup>

The Senate version of the House Bill, Senate Bill 2255, called for a five-year extension of the current moratorium but did not include any section corresponding to the Sense of the Congress section of House Bill 3709.<sup>38</sup> Related bills included House Bill 4460, House Bill 4462 and Senate Bill 2775, which also sought to extend the current moratorium.<sup>39</sup> Although they also included provisions paralleling the Sense of the Congress section of House Bill 3709, these bills also called for the creation of an interstate compact that would uphold the values of simplicity, uniformity, neutrality, efficiency and fairness in e-commerce taxation as promoted in House Bill 3709. Resembling House Bill 3709's Sense of Congress, the compact would allow only those states agreeing to its terms<sup>40</sup> to levy sales and use taxes on electronic commerce.<sup>41</sup> The most sweeping provisions in these bills required uniformity in the definitions of taxable services and goods, and mandated a single statewide sales and use tax rate.<sup>42</sup>

### III. DISCUSSION

The taxation of e-commerce presents three interrelated problems. First, the standard for such taxation is not clear. Second, even if the standard were clear, there is little agreement on whether taxing e-commerce would be beneficial as a policy matter. Third, federal control of e-commerce taxation would infringe state sovereignty and local control.

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35. Though the bill in its final form called for a five-year extension, the original version of the bill called for a permanent exemption for the taxation of e-commerce. H.R. 3709 § 2, version 1, available at [http://thomas.loc.gov/cgi-bin/query/D?c106:\]/temp/~c106CP8;TM::](http://thomas.loc.gov/cgi-bin/query/D?c106:]/temp/~c106CP8;TM::) (last visited Nov. 5, 2000). Perhaps this attests to the somewhat political nature of the legislation.

36. H.R. 3709, § 4.

37. *Id.*

38. See S. 2255.

39. H.R. 4460, 106th Cong. § 2(a) (2000); S. 2775, 106th Cong. § 3 (2000); H.R. 4462, 106th Cong. § 3 (2000).

40. H.R. 4460 § 2(b)(2); S. 2775 § 5(a); H.R. 4462 § 5(a).

41. H.R. 4460 § 2(b)(2); S. 2775 § 7(a); H.R. 4462 § 7(a).

42. H.R. 4460 § 2(b)(2); S. 2775 § 4(a); H.R. 4462 § 4(a).

## A. The Physical Presence Rule Is Unworkable

The physical presence standard is unworkable in the e-commerce context because it was crafted for a world based on mail-order commerce. Although similar in many areas, electronic and mail-order commerce differ significantly enough to render the physical presence standard inapplicable to e-commerce taxation. Additionally, the vague formulation of the standard compounds this difficulty.

### 1. Differences between Mail-Order and Electronic Commerce

Though the above bills would treat e-commerce differently from mail-order commerce, vendors in either type of commerce are currently subject to taxation according to the same physical presence standard. On its face, this rule makes sense; after all, both types of sales occur across jurisdictional (usually state) boundaries. However, electronic and mail-order commerce differ in several respects, making a physical presence requirement designed for mail-order commerce difficult to apply to electronic commerce.

First, the medium that facilitates the sale is different. Mail-order sales depend on the mail or a common carrier for the delivery of catalogs or promotional materials. On the other hand, delivery of the informational material for electronic sales happens across some sort of cable, usually telephone lines, with modems facilitating the process. Obviously, these two methods are similar in their delivery of information across jurisdictional lines. The difference between them, however, may be important given the Supreme Court's emphasis on mail or a common carrier when it originally articulated the physical presence standard in *Bellas Hess*. There, the Court found that a mail-order seller whose only contact with the buyer's state was through the mail or a common carrier did not meet the threshold for taxation.<sup>43</sup> Arguably, if the delivery of information over telephone lines and in-state modems constitutes more of a physical presence than delivery through the mail, the vendor would then become subject to taxation. This is conceptually plausible because the Court in *Bellas Hess* specifically mentioned its concern with those situations in which "the out-of-state seller was plainly accorded the protection and services of the taxing State."<sup>44</sup> Although the use of telephone lines and modems is not much of a physical presence, the equipment is more permanent and more likely to be maintained by the state than the facilities used by a transitory common carrier to deliver catalogs and mailings. Using telephone lines and

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43. Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753 (1967).

44. *Id.* at 757.

modems to deliver information could conceivably, but not necessarily, fall under this "protection and services" language.<sup>45</sup>

A second difference between the two types of commerce is the protracted nature of mail-order transactions as compared to electronic transactions. Mail-order transactions occur at the speed of the postal service. The buyer must fill out her form and return it to the vendor through the mail. This transaction may require several days and span several states. In contrast, e-commerce transactions take place much faster, usually within seconds. Though an e-commerce vendor will often deliver products using the mail or a common carrier just like a mail-order seller,<sup>46</sup> the e-commerce vendor and its customer seal the agreement to purchase the good or service when the buyer clicks a mouse. The fact that the purchasing agreement takes place wholly within the buyer's state and is nearly instantaneous makes it unclear whether taxing such a transaction creates a burden on interstate commerce of the magnitude that the physical presence standard aims to prevent.<sup>47</sup>

A third important difference relates to the general nature of the Internet. Whereas mail-order sellers must direct their sales materials to a given state or jurisdiction, the average e-commerce vendor can reach anyone with Internet access simply by putting up a website. On an intuitive level, a mail-order seller should be amenable to taxation by a particular jurisdiction, because it reaches into and intends to transact business within that jurisdiction. This is not necessarily the case with e-commerce vendors, who may not intend to sell within any specific jurisdiction. Arguably, putting up a website renders a vendor liable to be taxed in every jurisdiction where the site is viewed or in which a buyer purchases from it. However, to hold the vendor liable for taxation within every jurisdiction would be procedurally ineffective and unwieldy, as well as unfair. So, though electronic and mail-order commerce are broadly similar, the differences be-

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45. It has been suggested that a web page may be viewed as software, at least if it is an interactive page. FRIEDEN, *supra* note 13, at 117. If categorized as such, the site would probably fall into the exception for software the Court seems to have created in *Quill* with its refusal to allow a few diskettes to count as physical presence. *Id.* at 288. That would require a more substantial showing of nexus. For example, Connecticut takes the position that America Online has nexus within the state because of the modems it owns therein. *Id.* at 287.

46. Though the product may be delivered through the mail or by common carrier, certain products, such as software, may be downloaded through the computer itself and eliminate any need for the common carrier. *See id.* at 106. Examples include the online software vendor Beyond.com.

47. *See Bellas Hess*, 386 U.S. at 753.

tween them hint that a single standard for the taxation of both types of commerce is at best inefficient and at worst infeasible.

## 2. *The Vagaries of the Physical Presence Rule*

Taxing e-commerce necessarily implicates the Dormant Commerce Clause of the Constitution. Inferred from the Commerce Clause,<sup>48</sup> the Dormant Commerce Clause stands for the proposition that, since regulation of interstate commerce is a power affirmatively granted to the Federal government, the states have no right to regulate it.<sup>49</sup> *Quill*'s reaffirmation of the physical presence standard represents an effort to uphold this doctrine by placing limits on a state's ability to tax remote sellers. However, the physical presence rule is difficult to apply to new technologies and new ways of remote selling because the rule itself is fundamentally vague.

Not only is it difficult to apply to electronic commerce, it is not the bright-line standard that it appears to be. Justice White clearly noted this point in his dissent in *Quill*.<sup>50</sup> He stated that, in his view, "the question of *Quill*'s actual physical presence is sufficiently close to cast doubt on the majority's confidence that it is propounding a truly 'bright-line' rule . . . it is a sure bet that the vagaries of 'physical presence' will be tested to their fullest in our courts."<sup>51</sup> He was correct. Even before *Quill*, the physical presence standard was difficult to apply, with courts reaching dissimilar results through the application of this supposed bright-line standard.<sup>52</sup> *Quill* only exacerbated the difficulty.

### a) The Standard Was Uncertain Before *Quill*

The difficulty began before the *Quill* decision. In *Bellas Hess*, the Court ruled that a seller must have "retail outlets, solicitors or property within a State" in order for it to be taxed by that state.<sup>53</sup> After *Bellas Hess*, the Court gradually moved away from the physical presence standard<sup>54</sup> and this complicated what had been an already difficult standard. As a re-

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48. U.S. CONST. art. I, § 8, cl. 3.

49. See *Gibbons v. Ogden*, 22 U.S. 1, 15-16 (1824).

50. *Quill Corp. v. North Dakota*, 504 U.S. 298, 330 (White, J., dissenting).

51. *Id.* at 330-31 (White, J., dissenting).

52. See, e.g., *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel Co. v. Dep't of Revenue of Wash.*, 419 U.S. 560 (1975); *Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 207 Cal. App. 3d 734 (1989).

53. *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 758 (1967).

54. See *Tyler Pipe*, 483 U.S. at 232; *Standard Pressed Steel*, 419 U.S. at 560.

sult, different courts applied the idea of physical presence in diverging ways and with different reasoning.<sup>55</sup>

The Supreme Court itself applied different rationales for the imposition of a tax under the physical presence standard at times. For instance, in *Standard Pressed Steel Co. v. Department of Revenue of Washington*,<sup>56</sup> the Court stated that the presence of an employee of a corporation within a state in which the corporation owned no property<sup>57</sup> “made possible the realization and continuance of valuable contractual relations” within the state.<sup>58</sup> While it is easy to see how an employee representing a company could constitute a physical presence for the company, since that person physically resides within the state, the rationale that the Court stated is overbroad. Both mail-order catalogs and interactive websites that allow purchasing facilitate “contractual relations”<sup>59</sup> in the same manner as the employee liaison in *Standard Pressed Steel*. Yet, catalogs are not sufficient to confer liability according to *Bellas Hess*.<sup>60</sup>

The Court further muddled the standard in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*.<sup>61</sup> There, the Court found that a nexus existed where the out-of-state seller used independent contractors to solicit sales.<sup>62</sup> The company neither owned property in the state nor employed residents of Washington.<sup>63</sup> The Court cited with approval the lower court’s determination that “the crucial factor governing nexus is whether the activities performed in th[e] state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in th[e] state.”<sup>64</sup> Again, a website or a catalog could be “significantly associated with the taxpayer’s ability to establish and maintain a market,” leading to further confusion in applying that rationale.

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55. See, e.g., *Tyler Pipe*, 483 U.S. at 232; *Standard Pressed Steel*, 419 U.S. at 560; *Scholastic*, 207 Cal. App. 3d at 734.

56. 419 U.S. 560 (1975).

57. The employee in question worked out of his home and therefore the employer did not own any office space to house him. *Id.* at 561.

58. *Id.* at 562.

59. *Id.*

60. See *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753 (1967).

61. 483 U.S. 232 (1987). In *Tyler Pipe*, the Court vacated and remanded two cases where claimants asserted the invalidity of a tax exemption regarding a remote seller that sold into Washington state. However, the Court did affirm that an out-of-state manufacturer had sufficient nexus to be amenable to taxation where sales representatives performed certain activities related to the manufacturer’s business. See *id.* at 250-251.

62. *Id.* at 249.

63. *Id.*

64. *Id.* at 250 (citing *Tyler Pipe Indus., Inc. v. Wash. State Dep’t of Revenue*, 105 Wash. 2d 318, 323 (1986)).

State courts have made similar determinations to facilitate taxation. In *Scholastic Book Clubs, Inc. v. State Board of Equalization*,<sup>65</sup> Scholastic appealed a grant of summary judgment denying its claim for a refund of use taxes.<sup>66</sup> Scholastic used teachers as its liaisons with California students who purchased books from the company.<sup>67</sup> The court reasoned that the teachers were agents of the seller because they obtained "sales within California from local customers for a foreign corporation."<sup>68</sup> The California court further stated that, as agents, they created the necessary nexus and therefore tax liability for Scholastic. Yet again, websites can be thought of as "obtaining sales," making the court's reasoning confusing in an e-commerce setting. These decisions considerably confused the physical presence standard which originally created a tax exemption only for those remote sellers "whose only connection with customers in the State is by common carrier or the United States mail."<sup>69</sup>

b) *Quill* Did Little to Clarify the Physical Presence Standard

Enter *Quill*. The *Quill* Court reaffirmed the bright-line, physical presence rule it first propounded in *Bellas Hess*. However, when applying the standard, the Court did not seem to be applying a bright-line test of any sort. Though the remote seller did not have any store or salesperson within the taxing state, it did own some software that it licensed to its in-state clients.<sup>70</sup> The Court, in a footnote, dismissed the idea that this software showed a substantial nexus.<sup>71</sup> This rejection of a small amount of property as sufficient nexus introduces confusion into the supposed bright-line standard.<sup>72</sup> The issue became not whether the remote vendor owned "property within a State,"<sup>73</sup> but rather whether the property owned exceeded some minimal, undefined amount (here, a few diskettes did not suffice).<sup>74</sup>

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65. 207 Cal. App. 3d 734 (1989).

66. *Id.* *Scholastic* involved the issue of whether an out-of-state book seller was amenable to taxation when it used teachers to facilitate book sales. The company had neither a physical facility nor a regular employee in the state. *Id.* at 736.

67. *Id.*

68. *Id.* at 740.

69. *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 758 (1967).

70. *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 (1992).

71. *Id.* at 315 n.8.

72. Steven J. Forte, *A Cyberspace Perspective: Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?*, 15 J. MARSHALL J. COMPUTER & INFO. L. 203, 222 (1997).

73. *Bellas Hess*, 386 U.S. at 758.

74. *Quill*, 504 U.S. at 315.

So, while the Supreme Court purported to adhere to a bright-line rule in determining the taxability of a remote vendor, its latest word on the subject demonstrated otherwise. The *Quill* test fails to accurately predict tax liability because the rationales underlying the test do not give accurate guidance as to when such liability attaches. As mentioned above, several of the reasons given seem applicable to things that arguably have no physical root in the state, like websites. Despite these possibilities, commentators have argued that merely maintaining a website will not subject a company to tax liability.<sup>75</sup>

A further example of the uncertainty of applying the physical presence standard is the problem of servers. A server houses and routes information from place to place and contains information therein for a period of time.<sup>76</sup> It is possible that a server owned by a particular company constitutes a physical presence under the *Quill* standard.<sup>77</sup>

States have addressed this issue in varying ways. Both New Jersey and Texas treat servers as a substantial nexus for taxation.<sup>78</sup> California, on the other hand, in an effort to create a friendly climate for e-commerce, enacted a specific provision in its legal code that forbids using a server as the basis for taxation.<sup>79</sup> The Supreme Court has yet to address this issue. That there can be a difference between states on this issue points to the inadequacy and indeterminate nature of deciding tax liability for e-commerce vendors under the physical presence standard.

#### **B. Whether to Tax E-Commerce: The Case for and against Taxation**

Even if there were a judicially manageable standard for the taxation of remote commerce, there is no clear consensus as to whether, as a matter of public policy, government should tax such commerce. With the ITFA-mandated moratorium set to expire in October 2001,<sup>80</sup> several factions are

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75. Brian G. Ritz, Comment, *Nexus on the Net: A Taxing Question*, 36 DUQ. L. REV. 921, 946 (1998) (citing Gregory A. Ichel, *Internet Sounds Death Knell for Use Taxes: States Continue to Scream Over Lost Revenues*, 27 SETON HALL L. REV. 643, 655 (1997)).

76. See, e.g., FRIEDEN, *supra* note 13, at 162.

77. See *id.* at 154, 178.

78. *Id.* at 154; Hollis L. Hyans & Amy F. Nogid, *Oh Those Internet Sales; Dispute Over Whether to Tax Rages On*, N.Y. L.J., Mar. 6, 2000, at 7.

79. CAL CODE REGS. tit. 18, § 1684 (2001); see RICH PREM ET AL., ESTABLISHING A FRAMEWORK TO EVALUATE E-COMMERCE TAX POLICY OPTIONS 8 (2000).

80. Internet Tax Freedom Act, Pub. L. 105-277, Div. C, Title XI, § 1101, 112 Stat. 2681, 2681-719 (1998).

trying to advance their tax policy positions. The two basic positions are explained below.

### 1. *Pro-Taxation Arguments*

Proponents of taxation often note the amount of lost revenue attributable to the failure to tax Internet sales. Though states lose revenue, the exact amount remains in doubt.<sup>81</sup> Also, it is unclear whether the amount collected under a sales tax would be worth the probable discouragement of using the Internet as a shopping medium and the corresponding depressant effect on the U.S. economy.<sup>82</sup>

The U.S. General Accounting Office ("GAO") reported in March 2000 that estimated tax revenue losses for Internet sales ranged from \$300 million to \$3.8 billion in 2000.<sup>83</sup> The report noted, however, that "[l]ittle empirical data exist on the key factors needed to calculate the amount of sales and use tax revenues that state and local governments lose on Internet . . . sales."<sup>84</sup> This partly explains the wide variation in the estimates, but it also points to the fact that, in shaping Internet taxation policy, there are few, if any, absolute figures upon which to rely.

Moratorium critics and taxation proponents point to figures like those from the GAO to support their call for an Internet sales tax. Often, these proponents come from small states that perceive uncollected sales tax to be vastly undermining their state's revenue and therefore endangering their essential services due to a lack of funding.<sup>85</sup> It seems clear, however, that uncollected Internet sales taxes do not yet significantly affect state economies. Though there is a definite revenue loss, the amounts lost may be quite insubstantial compared to the states' revenue as a whole.<sup>86</sup> There is less agreement, however, on whether or not a permanent moratorium on

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81. U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/GGD/OCE-00-165, SALES TAXES: ELECTRONIC COMMERCE GROWTH PRESENTS CHALLENGES; REVENUE LOSSES ARE UNCERTAIN (2000) [hereinafter GAO REPORT].

82. PREM ET AL., *supra* note 79, at 3.

83. GAO REPORT, *supra* note 81, at 19.

84. *Id.* at 3.

85. See, e.g., *Taxing Internet Sales Levels the Playing Field*, BUS. WEEK, Mar. 27, 2000, at 234 (describing an interview with Kentucky Governor Paul E. Patton).

86. See ROBERT J. CLINE & THOMAS S. NEUBIG, ERNST & YOUNG ECONOMICS CONSULTING AND QUANTITATIVE ANALYSIS, THE SKY IS NOT FALLING: WHY STATE AND LOCAL REVENUES WERE NOT SIGNIFICANTLY IMPACTED BY THE INTERNET IN 1998 11 (1999) (finding that the losses due to uncollected Internet sales tax in 1998 represented less than one-tenth of one percent of state and local sales and use tax revenues); see also PREM ET AL. *supra* note 79, at 20-21 (citing Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, NAT'L TAX J. 413-28 (1999)).

the collection of an Internet sales tax would eventually cause critical revenue consequences.<sup>87</sup>

Uncollected sales tax revenue does not, however, uniformly affect each individual state. Along with the lack of uniformity in taxation rules comes a lack of uniformity in reliance on revenue generated by sales taxes.<sup>88</sup> For example, the states of the Southwest—Arizona, New Mexico, Oklahoma and Texas—average a greater reliance on sales tax than do many other states.<sup>89</sup> Thus, it stands to reason that the uncollected sales taxes could have a larger effect on these states than others.

The second major pro-taxation argument is that it is simply an issue of basic fairness to tax Internet sales at the same rate as conventional “brick and mortar” sales. Proponents argue that no reason exists to give a subsidy to this industry, especially one that comes at the expense of conventional retailers.<sup>90</sup> Moratorium critics argue that this type of subsidy “violates traditional notions of tax neutrality, which strive to tax similarly situated taxpayers equally.”<sup>91</sup>

The last major pro-taxation argument is that the digital age requires a simplification of existing tax structures. Currently, more than 7,500 jurisdictions in the United States impose a sales tax.<sup>92</sup> Arguably, federal management of an Internet sales tax could be a viable way to simplify the sales tax structure and avoid the problems that come with remote vendors trying to comply with such a large number of sales tax rates.<sup>93</sup> Software currently available can keep track of the various tax rates of each jurisdiction in which a vendor sells and can assess the tax burden accordingly.<sup>94</sup> However, this software is often very expensive because it necessarily requires updates as a consequence of changing laws in the various taxing jurisdictions, as well as being costly to implement and install.<sup>95</sup> The federal government possibly could subsidize the purchase and dissemination of this

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87. Compare PREM ET AL., *supra* note 79, at 21 with LUKAS, *supra* note 2, at 10. See also ADVISORY COMMISSION ON ELECTRONIC COMMERCE, *supra* note 32, at 14-15.

88. See FRIEDEN, *supra* note 13, at 84.

89. *Id.*

90. See, e.g., *Taxing Internet Sales Levels the Playing Field*, BUS. WEEK, Mar. 27, 2000, at 234.

91. Jurinski, *supra* note 3, at 40-41.

92. FRIEDEN, *supra* note 13, at 184.

93. MATTHEWS, *supra* note 12, at 4 (describing but not endorsing such a policy).

94. PREM ET AL., *supra* note 79, at 3.

95. *Id.* at 3, 11. In addition to the cost issue, the software is not capable of determining tax exempt sellers, products or services. *Id.* at 11.

software.<sup>96</sup> Alternatively, it could exempt vendors who have revenue below a certain predetermined level from having to comply with the tax rates.<sup>97</sup>

## 2. *Anti-Taxation Arguments*

Opponents of e-commerce taxation primarily argue that a ban on such taxation is necessary to encourage dispersal of this beneficial technology.<sup>98</sup> They claim that the Internet is so important a technology that the United States ought not to discourage its growth through taxation.<sup>99</sup> Indeed, one study has suggested that enforcing currently existing sales taxes on Internet sales could reduce the number of online purchasers by twenty-four percent.<sup>100</sup> Since e-commerce may spur economic growth as a whole, not just the growth of online sales, discouraging Internet commerce through taxation could have a deleterious effect on the entire economy.<sup>101</sup>

Taxation opponents also argue that nontaxation of Internet commerce does not significantly diminish state and local revenues. A 1999 study found that the estimated revenue loss in 1998 due to uncollected e-commerce transactions was only approximately one-tenth of one percent of total sales and use tax collections.<sup>102</sup> If so, the potential revenue gained from placing a sales tax on e-commerce transactions may not counterbalance the negative effects such a tax would have on the economy through a decrease in the number of e-commerce transactions.<sup>103</sup>

An extension of this argument is that before taxing e-commerce transactions, it would be much more beneficial to place a tax on non-Internet remote transactions like mail-order sales. The amount of revenue lost due to these types of remote sales is currently much greater than that lost through Internet transactions.<sup>104</sup> Such taxation would create a large source of revenue for the states and at the same time, leave the Internet tax-free and encourage its growth.

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96. See, e.g., *id.* at 33 (summarizing David Polatseck's Sales Tax Simplification Proposal).

97. See *id.* at 17; H.R. 4462, 106th Cong. § 4(a)(12) (2000).

98. PREM ET AL., *supra* note 79, at 16.

99. See *id.*; *Taxing Internet Sales Hurts Consumers*, BUS. WEEK, Mar. 27, 2000, at 236 (interview with Massachusetts Governor Paul Cellucci).

100. MATTHEWS, *supra* note 12, at 15 (citing AUSTAN GOOLSBEE, *IN A WORLD WITHOUT BORDERS: THE IMPACT OF TAXES ON INTERNET COMMERCE* (1999)).

101. See *id.* at 11-13.

102. See CLINE & NEUBIG, *supra* note 86, at 9.

103. See, PREM ET AL., *supra* note 79, at 3.

104. GAO REPORT, *supra* note 81, at 19 (reporting non-Internet remote sales revenue loss of \$1.3 billion to \$5.3 billion).

Finally, opponents of taxation often argue that the existence of more than 7,500 sales tax imposing jurisdictions in the country<sup>105</sup> makes it difficult if not impossible to comply with all applicable taxes to which a company will be subject in the course of doing business. Use of the software described above is one way to deal with this problem.<sup>106</sup> However, such software places an expensive burden on Internet business. Due to the more burdensome cost structures of a small business,<sup>107</sup> not only would requiring such software place smaller vendors at a competitive disadvantage, but it also may discourage entry into the market because of the high cost of purchasing and updating the software.

### 3. *The Perils of Too Extreme a Position on Either Side*

The basic policy positions explained above create very different ramifications. It is indisputable that the pro-tax position certainly would allow states to earn more revenue. What is disputable is how much they would gain<sup>108</sup> and whether that amount would significantly aid state economies. Since e-commerce will likely become a much larger part of the national economy,<sup>109</sup> it is probable that the amount of money lost through untaxed e-commerce will greatly increase in the future. At the present time, however, the amount of money lost is probably not significant.

If taxation causes a decline in the number of people who buy over the Internet, this may affect growth in the e-commerce sector,<sup>110</sup> but it is unclear whether taxation will have any effect on this growth over the long term. As a public policy matter, then, the issue becomes how the United States as a society wants to balance the twin goals of keeping states' revenues at acceptable levels and encouraging the growth of a perceived beneficial industry. Commentators have argued that too extreme a position will have deleterious effects.<sup>111</sup>

## C. **Federal Control Would Infringe State Sovereignty and Local Control**

As illustrated above, many have commented on the wisdom of taxing or not taxing e-commerce. Despite the amount written, few have touched

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105. FRIEDEN, *supra* note 13, at 184.

106. *See supra* notes 92-97 and accompanying text.

107. *See* PREM ET AL., *supra* note 79, at 11, 17.

108. *See* GAO REPORT, *supra* note 81, at 19, 59-61.

109. *See* PREM ET AL., *supra* note 79, at 20-21.

110. *See* MATTHEWS, *supra* note 12, at 15 (citing AUSTAN GOOLSBEE, IN A WORLD WITHOUT BORDERS: THE IMPACT OF TAXES ON INTERNET COMMERCE (1999)).

111. *See, e.g.,* PREM ET AL., *supra* note 79, at 3, 21.

upon the effects that such policies would have on our federal system of government.

While there has been a recent spate of Supreme Court cases that reassert the sovereignty of the states,<sup>112</sup> it is indisputable that Congress has the power to control interstate taxation through the Commerce Clause.<sup>113</sup> It is another issue, however, whether the exercise of that power is a wise choice as a matter of public policy.

State and local control of taxation is a significant component of federalism.<sup>114</sup> Sales tax revenues often fund areas traditionally within state control, such as education.<sup>115</sup> The federal government, in turn, has traditionally respected the taxation of in-state commerce as a function of the states.<sup>116</sup> This is good policy, not only as a matter of tradition, but because states and their localities are better able to foresee their financial needs and deal with them in an effective manner. This is partly why a multitude of sales tax regimes exists in the United States,<sup>117</sup> and why there is no federally mandated general sales tax comparable to those in place in other nations, such as the European value-added-tax.<sup>118</sup> In fact, several governors charged that the suppression of the states' ability to tax through the ITFA was "the greatest affront to state sovereignty in ten years."<sup>119</sup>

If the federal government is to respect the ability of the states to levy sales and use taxes as they see fit, then one of the best ways to do this and simultaneously provide a feasible framework for taxation appears to be the use of the software described above.<sup>120</sup> However, this "software solution" also infringes on the rights of the states. As commonly envisioned, the use-tax-tracking software involves a third party, such as a federal adminis-

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112. See, e.g., *United States v. Morrison*, 529 U.S. 598 (2000) (striking down a provision of the Violence Against Women Act as outside of Congress's commerce power); *United States v. Lopez*, 514 U.S. 549 (1995) (striking down a law prohibiting gun possession near schools as outside of Congress's commerce power).

113. U.S. CONST. art. I, § 8, cl. 3 ("The Congress shall have Power To . . . regulate Commerce . . . among the several States.").

114. See Jurinski, *supra* note 3, at 33.

115. See *Taxing Internet Sales Levels the Playing Field*, BUS. WEEK, Mar. 27, 2000, at 234; see also LUKAS, *supra* note 2, at 13-14 (arguing that remote e-commerce firms shouldn't have to help cover the costs of local services).

116. FRIEDEN, *supra* note 13, at 83.

117. See *id.* at 184.

118. See *id.* at 81-82.

119. McLure, *supra* note 4, at 423 (citing Letter from the Nat'l Governors' Ass'n to Sen. John McCain, chairman, Comm. on Commerce, Science and Transportation & Sen. Ernest F. Hollings, ranking member, Comm. on Commerce, Science, and Transportation (Oct. 6, 1997)), available at <http://www.nga.org/Releases/Letters/971010letter.htm>.

120. See *supra* notes 92-97 and accompanying text.

trator, to mediate and validate the results from the use of the software. It is not clear that states would want to assign such a valuable and important function to a third party, federal or otherwise.<sup>121</sup> Relinquishing this sort of important state function to another entity is perhaps as great a relinquishment of sovereignty as federal preemption of taxation.

Another option for allowing states to collect revenue while preserving their sovereignty is an interstate compact, as proposed in the 106th Congress.<sup>122</sup> The provisions which sought to extend the moratorium posed an obvious challenge to state sovereignty by preventing states from collecting new revenue from e-commerce.<sup>123</sup> The proposals to create an interstate compact to simplify the tax system and allow only states that participate to collect sales taxes on e-commerce, while less intrusive, still infringe on state sovereignty.<sup>124</sup>

This point was not obvious from the face of the bills. Senate Bill 2775 provided for "State administration of all State and local sales and use taxes."<sup>125</sup> This language masked the fact that the federal government would still impede the states' ability to collect revenue by putting conditions on such collection. Additionally, other provisions impeded the states' capability to react to their own needs and change their tax policies. For instance, the bills provided for uniform definitions of goods and services that may be taxed.<sup>126</sup> Localities, however, may have valid reasons for exempting certain goods or services from taxation, such as giving certain industries an incentive to settle in or do business within the jurisdiction. If the actual terms of the compact deny these exemptions, certain localities would become disadvantaged. Thus, the compact would rob the state of a valuable tool—local administration and leadership of economic development—that is necessary for building its economy.

Furthermore, the bills may have eliminated the incentive for a company to relocate to a state with no sales tax. The bills may have removed this incentive to relocate because, if the compact provided for the taxation

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121. See MATTHEWS, *supra* note 12, at 4-5.

122. H.R. 3709, 106th Cong. (2000); S. 2255, 106th Cong. (2000); H.R. 4460, 106th Cong. (2000); S. 2775, 106th Cong. (2000). Though these bills died in the 106th Congress, they may be introduced in the 107th Congress.

123. H.R. 4460 § 2(a); S. 2775 § 3; H.R. 4462, 106th Cong. § 3 (2000).

124. H.R. 4460, § 2(b)(2); S. 2775 § 5(a); H.R. 4462 § 5(a).

125. S. 2775 § 4(a)(9). H.R. 4460 provides for substantially the same thing in § 2(b)(2).

126. H.R. 4460 § 2(a)(2); H.R. 4462 §§ 2(3), 4(a)(2); S. 2775 §§ 4(a)(2), 4(a)(4).

of the transaction in the state of purchase,<sup>127</sup> then the vendor would lose that tax advantage whenever it would sell out of state. If it anticipated that it would do most or all of its business outside of a state with no sales tax,<sup>128</sup> the vendor would have no incentive to locate there. This would rob the state of a valuable bargaining chip in its competition to attract businesses to the state.

Another problem was that the bills also mandated that the states should choose a uniform statewide sales tax rate for remote sales.<sup>129</sup> Though this could be a "blended" rate that reflected the average of the sales tax rate within a state,<sup>130</sup> this uniform rate would still inhibit the states' and localities' ability to adapt to their own particular circumstances. The federal government would effectively forbid the states from letting their localities determine their own needs and tax rates.

However, the compact would at least have allowed the states to collect revenue from e-commerce and would have defined the *Quill* standard for e-commerce. The compact would have prevented excessive burdens on interstate commerce. It would also have addressed the problem of the exemption from taxation for remote commerce.<sup>131</sup> As a matter of public policy, we should ask whether the resulting infringement on state sovereignty and local control is worth the additional revenue gain.

From the point of view of states' rights, the optimal solution to this dilemma would be to lift the ITFA and prohibit federal control over e-commerce taxation. The obvious problems with this suggestion lie in the tremendous administrative problems and the lack of fairness. It is easy to imagine a remote seller being taxed by several jurisdictions for the same transaction. If a buyer purchased in one state from a vendor located in a second state, and the order traveled through a server in a third state, then the seller could conceivably be liable for three separate taxes on that individual sale.

To combat this problem, the physical presence standard should be strengthened, perhaps through a federal statute, to allow only taxation of companies or sales with a "significant" physical presence. Perhaps servers

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127. The authorization to enter into a compact did not provide for the exact terms of such a compact, so it is possible that the transactions would not have been taxed at the point of purchase.

128. Indeed, the states that currently do not have sales taxes are among the less populous in the Union. See FRIEDEN, *supra* note 13, at 82. This leads to the conclusion that there would be less reason to locate in these states as they offer fewer customers.

129. H.R. 4460 § (2)(b)(2); S. 2775 § 6(a); H.R. 4462 § 6.

130. H.R. 4460 § (2)(b)(2); S. 2775 § 6(a); H.R. 4462 § 6.

131. *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992).

and buyers would not trigger such a requirement, and sales could be taxed at the point of origin. This more territorial approach to the problem could help eliminate severe administrative problems and still preserve the sovereignty of the states while maintaining local governmental control.<sup>132</sup>

#### IV. CONCLUSION

The lack of a manageable judicial standard for determining remote sellers' tax liability led to Congressional legislation on the issue. The Internet Tax Freedom Act currently prohibits the imposition of any new taxes on the Internet or e-commerce, but it is set to expire in late 2001. Many bills were introduced in the 106th Congress that would have extended this tax moratorium for several more years while creating an interstate compact to harmonize Internet taxation.<sup>133</sup> This compact would have streamlined the complicated tax system currently in place. However, these bills would have infringed upon traditional considerations of federalism and state sovereignty. In addition, from the standpoint of public policy, it is unclear whether taxing e-commerce would be beneficial. We must balance considerations of lost revenue and encouragement of a beneficial technology in order to determine a workable solution. A strong possibility for such a solution is for the federal government to take a "hands-off" approach to e-commerce taxation, coupled with the strengthening of the existing physical presence standard for determining amenability to such taxation.

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132. Note that because the tax on e-commerce sales is actually a tax on the buyer, questions could arise as to the state's jurisdiction to impose a tax on a person outside its borders.

133. Though the bills all died in the 106th Congress, they set forth the context regarding the debate around taxing e-commerce, and they may be reintroduced in the current congressional session.

