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Taxing the Internet: Analyzing the States' Plan to Derive Online Sales Revenue

By Eric Menhart

Eric Menhart discusses states' efforts to collect taxes on Internet transactions and suggests how they may achieve their goal.

Introduction

On a typical day, millions of consumers engage in online transactions as varied as purchasing books to downloading music to printing out movie tickets. In addition to being a convenient way to order and compare prices, online sales have another benefit to consumers: most are tax-free.

This fact is not lost upon the states of the nation, which heavily rely on sales and use taxes for a vast majority of their annual income. Local "brick-and-mortar" merchants are also against tax-free Internet transactions because of the substantial competitive disadvantage it imposes on their businesses.

Taxing Internet transactions, however, is not as simple as passing legislation in each of the 50 states. States have to overcome significant legal roadblocks imposed by the Constitution, Congress and the federal judiciary if the goal of deriving income from most online transactions is to become a reality.

While there is significant room for discussion regarding the appropriateness of taxing Internet transactions at all,[1] this paper primarily considers the views of states and local merchants: sales taxes on the Internet are important for state revenue[2] and maintaining competitive balance for traditional merchants.[3]

Given this assumption, this paper examines the problem of the present state of the tax law from the states' point of view. Next, it defines and considers the differences between sales and use taxes and explores the current state of law governing Internet sales and use taxes. Third, this paper discusses the states' current and ongoing efforts to collect taxes from Internet transactions. Finally, it proposes suggestions aimed at allowing states to achieve the

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goal of requiring merchants to collect sales taxes on online transactions.

Identifying the States' Problems with the Tax-Free Internet

There are several significant problems with the present state of Internet taxation from the states' point of view. First, states are increasingly finding that Internet transactions are significantly cutting their revenue stream. Forty-five states, as well as the District of Columbia, rely on sales and use taxes on purchases of tangible goods for a substantial portion of their revenue.[4] In addition, "4,696 cities, 1,602 counties, and 1,113 other tax jurisdictions also impose sales taxes."[5] Estimates suggest that states lost $15[6] to $20 billion[7] due to out-of-state sellers conducting business over the Internet in 2003. This lost revenue increases as the Internet becomes a more popular outlet for purchasing goods and services.

Unfortunately for the states, online commerce continues to grow. Total e-commerce sales for 2004 were approximately $69.2 billion, which represented an increase of 23.5 percent from 2003 according to the Census Bureau.[8] If growth continues or maintains at such levels, many states will face significant budget crises.

The second problem of the tax-free Internet is the competitive disadvantage to traditional brick-and-mortar stores. States do not want to create an incentive for shoppers to purchase goods and services online in lieu of local brick-and-mortar stores, because tax-free online shopping grants foreign businesses competitive advantages. The major advantage, of course, is the fact that the average actual cost of goods to consumers will be lower. The costs of running a traditional brick-and-mortar store are "considerably greater than an online store" because costs "such as rent, electricity, payroll, fixtures [and] shrinkage loss all contribute to the gross margin and overhead of 'just doing business' in a shopping center."[9] Encouraging online shopping also results in the opposite reaction of discouraging shopping at local brick-and-mortar stores in which the states would have an expectation of sales tax.

Third, maintaining the present state of the law leads to regressive tax consequences that are in contrast to most states' preferred tax policy.[10] Most online shoppers tend to be on the higher end of the socioeconomic scale because of the traditional resources and skills required to engage in commercial transactions over the Internet.[11] These resources may include ownership of a computer with the hardware necessary to access the Internet, an Internet Service Provider, a valid credit card, and access to a secure delivery location if the intended recipient is not at home.[12]

The regressive nature of the tax-free Internet is especially problematic because states rely on economic activity, particularly that of the rich, to provide revenue for social and protective services. The growth of Internet sales without state taxation will almost certainly "impair the ability of some states and localities to meet demands for education, job training, child care, health, and other services that low- and moderate-income families depend on to get ahead in an increasingly technology-oriented economy."[13]

Losing revenue from more affluent persons' higher spending power is much more problematic than losing sales tax income from poorer consumers. For example, numerous online retailers sell electronics, such as personal computers, online. A consumer from Maryland, where the sales tax is five percent, may choose to purchase a $1,500 home computer from an online retailer based in Texas. If she chooses to do so, her online purchase results in a savings of five percent ($75) in tax that the consumer would have likely otherwise spent in Maryland. In contrast, a poorer consumer will likely not make such major purchases at all, perhaps employing resources at a local public library instead. Even where a poorer consumer does make such major purchases, it is more likely that he will use a brick-and-mortar store for the reasons discussed above.

Sales Taxes, Use Taxes and the Preference of the States

The Difference Between Sales Taxes and Use Taxes

Understanding the difference between sales taxes and use taxes, as well as the different ways in which they are collected, is imperative to understanding how states can solve the problem of Internet sales taxes.

A *use tax*, according to the Supreme Court "is a tax on the enjoyment of that which was purchased."[14] The MERRIAM WEBSTER DICTIONARY OF LAW defines a "use tax" as a:

> tax imposed on the use of personal property and esp. property purchased in another state; specifically: a one-time tax imposed on the exercise or enjoyment of any right or power over tangible personal property that is incident to the ownership, possession, custody, or leasing of it.[15]

A *sales tax*, by contrast, is "a tax levied on the retail price of merchandise and collected by the retailer."[16] Many states also consider certain services to be "sales" under their respective laws.[17] Sales taxes are collected by the entity that is selling the good, which is typically a retailer. The retailer then remits the collective sales taxes it receives to the respective taxing state. In contrast, a use tax is paid directly to the taxing state by the "user" of the good, which is typically an end-user or consumer. Retailers are responsible for accounting for the sales taxes that they collect. Users of a product or service are similarly accountable for tracking their respective use tax liability.

The Problems of Use Taxes

It is important to note that states are *not* legally prevented from mandating and collecting use taxes on products that are being "used" in their states. In fact, most states have active use tax laws on their books. The problem, from the states' point of view, is *enforcement* of collection of use taxes.

The first problem with enforcing a use tax is the problem of educating consumers, because most consumers have no idea how to do the calculation, and very few even know that any such tax is due. States would have to spend significant resources on educating consumers about the existence of the tax and the procedure for filing such returns to even begin to address the problem.

Even if citizens were aware of the use tax and the procedures for filing, the second problem would become clear: few reasonable consumers could or would pay a use tax to the state on their own accord, because there would be limited incentive to do so. Some states, for example, currently provide "use tax forms" to consumers to submit with their tax returns.[18] Despite this effort, few consumers keep records or bother to file these forms. The substantial burden of keeping records for each transaction that is not subject to sales tax and the very limited chance of "being caught" leads to limited interest in consumer compliance.

> States are increasingly finding that Internet transactions are significantly cutting their revenue stream.

The third problem is the substantial cost and difficulty of enforcement. Attempting to track a consumer's spending habits over the course of a year would be administratively difficult. Such enforcement efforts would likely lead to significant costs for the states (and almost certainly above any revenues collected) in attempting to enforce consumer payment of the tax.

Finally, placing the burden of collecting use taxes on consumers is inefficient. The burden of collection shifts from the better-prepared retailers to consumers, who are almost always less willing or able to collect revenue for the states.

The States' Preference for Internet Sales Taxes

The problems of collecting use taxes leads to the conclusion that sales taxes and regulated retailers are the states' best opportunity to collect taxes on Internet transactions. Sales taxes, however, also have unique advantages that make them more attractive to states.

First, online merchants are more likely to be "incentivized" to collect taxes. Merchants are more likely to be "good targets" for enforcement because merchants maintain a greater potential aggregate of funds than any single consumer would. States would have more incentive to enforce their laws against merchants because of the greater expected value of return on the enforcement costs. Since states have the right "expected economic return" to enforce their laws against retailers, merchants would be more fearful of enforcement and more likely to adhere to sales tax laws.

Second, given the available means for collecting sales/use tax revenue, merchants are best equipped for the task because of the resources more likely available to the retailers. For example, merchants may have substantial technological and accounting resources that allow them to collect sales taxes simply and effectively without overburdening administrative costs. Having merchants collect taxes on goods is also preferable from an accounting and administrative standpoint because there are fewer merchants than consumers in the economy. Fewer collectors lead to fewer tax filings with states and a greater expectation of efficiency and accuracy in tracking revenues.

Finally, sales taxes will lead to an overall greater return to state coffers. Merchants are less likely to lose receipts, make accounting errors, or forget to include certain transactions. This is due to state law that holds merchants and retailers to higher standards of conduct and recordkeeping than consumers.[19]

Current Barriers to Taxing Internet Transactions

States have a significant interest in mandating that out-of-state merchants collect sales taxes on purchases. Unfortunately, states have equally significant legal roadblocks in the way of their goal.

Court Decisions

U.S. Supreme Court decisions regarding taxation of out-of-state transactions have produced the most significant roadblocks to states' ability to mandate that retailers collect Internet sales taxes. The Supreme Court's decisions have followed a path that initially provided little hope for states, but have recently provided a glimmer of hope that may provide opportunity for states to achieve their goal.

Early Decisions

In 1940, the Supreme Court first addressed the issue of out-of-state sales tax with the decision in *McGoldrick v. Berwind-White Coal Mining Co.*[20] New York had imposed a sales tax on coal sales made by McGoldrick, a Pennsylvania corporation. McGoldrick maintained sales offices in New York State and made physical deliveries there. The Court found that the tax was "conditioned upon a local activity, delivery of goods within the state upon their purchase for consumption. It is an activity which, apart from its effect on the commerce, is subject to the state taxing power."[21] Thus, the Court held that the New York tax was fairly imposed on the Pennsylvania firm because there was a physical connection between the Pennsylvania corporation's agents and the State of New York.

The Court reached a different result in *McLeod v. J.E. Dilworth Co.*[22] McLeod, the revenue commissioner for the State of Arkansas, attempted to levy an Arkansas sales tax on the respondent firm, which was wholly based in the State of Tennessee. The levy was based on "sales made by Tennessee vendors that are consummated in Tennessee for the delivery of goods in Arkansas."[23] The Court differentiated *McLeod* from *Berwind-White* by noting that in the "Berwind-White Coal case the corporation maintained its sales office in New York City, took its contracts in New York City and made actual delivery in New York City."[24] This was in contrast to the situation in *McLeod*, "where the offices are maintained in Tennessee, the sale is made in Tennessee, and the delivery is consummated either in Tennessee or in interstate commerce."[25] The Court held that the Commerce Clause[26] of the U.S. Constitution "vested the power of taxing a transaction forming an unbroken process of interstate commerce in the Congress, not in the States," and the Arkansas tax on the respondent firm was unconstitutional.[27] The Court, however, did note that a use tax (which the Court defined as "a tax on the enjoyment of that which was purchased") on the Arkansas buyer may have met a different fate had Arkansas chosen to go that route.[28]

Modern Doctrine

The Supreme Court did not reconsider the issue of out-of-state taxation for over 20 years until the case of *National Bellas Hess, Inc. v. Department of Revenue of Illinois.*[29] The taxpayer, Bellas Hess, was a Missouri mail order company that did not have contact with the State of Illinois except for its biannual mailing of catalogs to some residents of the state. Illinois attempted to impose use taxes on Bellas Hess. The Court found that Bellas Hess' contacts were insufficient to allow local taxation, holding that the purpose of the "Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control."[30]

It is also important to note that the *Bellas Hess* Court also found that the "law requiring it to collect Illinois taxes violated the *Due Process Clause*"[31] (emphasis added). This was significant because the Court linked the dormant Commerce Clause analysis with the Due Process Clause[32] analysis and treated the two analyses as one.

The Supreme Court established a four-prong test aimed at determining whether the *dormant* Commerce Clause[33] prohibited a state's imposition of a tax upon an out-of-state vendor in the case of *Complete Auto Transit, Inc. v. Brady*[34] in 1977.[35] In that matter, the Court found that state taxes would not violate the dormant Commerce Clause when the tax "is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by the State."[36] States have faced little trouble meeting the final three requirements, but attempting to pass the substantial nexus test has been the "primary impediment to states' efforts to tax e-commerce."[37]

The most recent and important case considering the issue of taxing out-of-state sellers is *Quill Corp. v.*

North Dakota.[38] In *Quill*, North Dakota sued to collect *use taxes* from Quill Corp., which was a mail-order company with no outlets or representatives in North Dakota. In *Quill*, consistent with the Court's other recent personal jurisdiction decisions,[39] the Court examined the seller's "sufficient contacts" with North Dakota and considered whether a seller could expect to defend a suit there.

The Court specifically found that its own "due process jurisprudence has evolved substantially in the 25 years since Bellas Hess, particularly in the area of judicial jurisdiction."[40] Drawing on *Burger King*, the *Quill* Court found that a corporation (1) that directed its activities at the residents of the forum state, (2) had contacts sufficient for due process purposes, and (3) that was subject to a tax which was related to the benefits the corporation receives from the forum state could be subject to a use tax on *due process* grounds.[41] Thus, the previous requirement that there be a physical presence in the forum state in order to be subject to *sales tax collection* requirements on *due process* grounds was eliminated. Under this analysis, the North Dakota tax would meet the due process requirement, even if it failed a dormant Commerce Clause analysis.

States have to overcome significant legal roadblocks imposed by the Constitution, Congress and the federal judiciary if the goal of deriving income from most online transactions is to become a reality.

Quill was also the first case that applied the principles found in *Complete Auto* to determine whether a "substantial nexus" existed between the seller and the forum state to allow the state to require the seller to collect a *use tax*. In *Quill*, the U.S. Supreme Court retained *Bellas Hess'* requirement that an out-of-state vendor must have a physical presence before it is required to collect state *use taxes*; if that physical presence is lacking, the vendor will not have the requisite substantial nexus with the state.[42]

Whether a physical presence exists depends on an analysis of whether the seller has any office, distribution house, sales house, warehouse or any other place of business … any agent, salesman, canvasser, solicitor or other type of representative to sell or take orders, to deliver merchandise, to accept payments, or to service merchandise it sells … any tangible property, real or personal … [a] telephone listing … and [whether] it has … advertised its merchandise for sale in newspapers, on billboards, or by radio or television in the forum state.[43]

In both *Bellas Hess* and *Quill*, the Court found that the requisite physical presence did not exist, because the only contacts that the seller had with the state were by "United States mail or common carrier."[44]

Despite the newfound due process analysis and the application of the substantial nexus requirement, the ultimate results of *Quill* were largely the same as the previous cases. The Court went on to find that the North Dakota tax was violative of the dormant Commerce Clause because the "North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year." Thus, absent the *Bellas Hess* rule "thousands of vendors, including those who did not make a sale in the state, would be subject to North Dakota's tax."[45]

The decision in *Quill* carried significant importance in another way. In decisions prior to *Quill*, Congress could not have acted to allow states to mandate that out-of-state sellers collect state sales tax because of the implicit due process issues. The *Quill* Court separated the constitutional analyses of the Due Process and Commerce clauses, which had been considered together in *Bellas Hess*, and thus "invited Congress to intervene using its authority under the Commerce Clause"[46] by expressly noting that "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens."[47] By separating the Due Process Clause requirements from the Commerce Clause analysis, Congress now has the power to regulate interstate commerce without fear of overstepping the due process boundaries defined by the Court.

The End Result

The Court's final requirements are now reasonably well defined. According to *Quill*, merchants who direct their commercial activities at a forum state and who have contacts sufficient for due process purposes can be subject to a tax related to the benefits the corporation receives from the forum state under a d*ue process analysis*. However, a merchant is not subject to such a tax if the tax would *impede interstate commerce*. Simply put, "a tax may be consistent with due process and yet unduly burden interstate commerce."[48]

In determining whether a tax would unduly impede interstate commerce, one must determine if a merchant has a substantial nexus with the respective state. According to the *Quill* court, an out-of-state vendor must have a "physical presence" in the state to meet the substantial nexus test. If the merchant does not have the requisite physical presence as defined in *Bellas Hess*, (and set forth above) the state may not require that the merchant collect its sales taxes.

An example of the rules in action may occur as follows. Mirkwood is an online bookseller that sells books and other merchandise only through its Web site. Mirkwood's Web site allows customers from any state in the union to purchase materials from its Web site and have them sent to any domestic address. Mirkwood is incorporated in and has its headquarters in California. Mirkwood also maintains a warehouse in California. In addition, Mirkwood maintains a warehouse in Maryland to expedite orders from consumers on the East Coast of the United States. Under present doctrine, only California and Maryland could require that Mirkwood collect their respective sales taxes because Mirkwood only meets the substantial nexus test of physical presence in California and Maryland. Although Mirkwood delivers its goods to every other state in the nation, it only has contacts with these other states *via* U.S. mail or common carrier, and is not subject to imposition of the collecting requirement.

The problems of collecting use taxes leads to the conclusion that sales taxes and regulated retailers are the states' best opportunity to collect taxes on Internet transactions.

Thus, the current case law effectively bars states from attempting to mandate that any business, other than those that have the requisite physical presence in their respective states, collect their respective sales taxes.

Congressional Barriers

In the last 10 years, Congress has tended to keep the Internet "wild and free" of taxation. Past legislation and more current philosophy suggest that Congress will continue to be a barrier to the states' interest in mandating the collection of online sales taxes.

The Internet Tax Freedom Act (ITFA)

Congress first got involved in the issue of Internet taxation in 1998, when it passed the Internet Tax Freedom Act (ITFA).[49] The ITFA is a moratorium on state and local taxes on Internet access fees, such as those paid by consumers to America Online or similar services to access the Internet. The ITFA did not prevent local sales taxes from being collected by states, but did prevent multiple or discriminatory taxes on electronic commerce by defining such fees as taxes on "interstate commerce."[50] The ITFA defines a discriminatory tax as "any tax imposed by a State or a political subdivision thereof on electronic commerce that is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means … ."[51] The ITFA was originally passed on a temporary basis so that Congress could take a "wait and see" approach to the development of the Internet.

Congress extended the deadline of the ITFA's moratorium two separate times. The most recent extension was in late 2003, when Congress extended the ITFA moratorium until November 1, 2007.[52] The most recent vote to extend the moratorium passed the Senate on a vote of 97 to 3.[53]

Despite a large majority obtained in passing the ITFA, the moratorium continues to be temporary because there are insufficient numbers of senators comfortable making the moratorium permanent. Opponents to a permanent ban say that various House and Senate bills could make important substantive changes to the current law that could eventually cost states as much as $9 billion annually in taxes.[54]

One example of an important substantive change is a proposed expanded definition of "Internet access" that would serve to prevent states from taxing telecommunications services "used to provide Internet access."[55] Such an expansion could mean that wireless phones, personal organizers, and even electricity could eventually not be subject to local taxation, because all have the potential to provide Internet access services.

The ITFA is less important for its limitations on Internet access fee taxes than it is a demonstration of the Congress' unwillingness to allow state taxation rights. In fact, Congress has considered a variety of proposals that would grant states the authority to collect sales taxes on orders taken over the phone or Internet, but all have failed. For example, in the 106th Congress, Senator Ernest Hollings introduced a bill that would have imposed a five percent national retail sales tax on Internet sales, but the bill was almost immediately rejected in the Senate Finance Committee.[56] In contrast, the Congress has seen a wealth of bills that seek to make the ITFA moratorium permanent,[57] and there are constant efforts by lawmakers to guarantee the permanence of the ban.[58]

Congressional Philosophy

The prevailing congressional view at the time of the ITFA's passing was a strong "free market" philosophy. The reasons for this are threefold. First, Congress, from the mid-1990s until 2006, consisted of a majority intent on cutting or preventing new taxes. The Internet was "commercially new" at the time that Congress passed the ITFA, and the Congress viewed the ITFA as an easy way to reduce tax burden, since the states were not already accustomed to revenue from the new technology.

Second, Congress preferred to avoid "getting in the way" of the new technology that had the potential to grow exponentially. This philosophy was based in part on the suggestion of conservative scholars.[59]

Third, by forbidding taxes on Internet access and preventing local sales tax, Congress sought to encourage more people to become active on the Internet at a lower cost, which Congress expected would lead to the growth of the new technology. Congress' continual reluctance to allow states to collect online sales taxes is a natural extension of all of these principles.

Political Restraints

Congress' reluctance to allow states the right to mandate online sales taxes is also grounded in the variety of limits an elected body typically faces. Congress must deal with the variety of competing interests, including online merchants who would be less than willing to simply allow their price advantage to slip through their fingers.[60] The unpopularity of tax increases is also a difficult burden to overcome. Candidates prefer not to be known as the "congressperson that raised your taxes." A final burden is a lack of real consensus on the appropriate way to handle the issues, even if Congress decided it wanted to act. Indeed, just prior to expiration of the ITFA in 2001, Congress considered a variety of bills to find a permanent solution to the problem. Some sought to permanently extend various aspects of the ITFA, others sought to simplify states' tax laws, while still others sought to completely end the ban on taxation of e-commerce transactions.[61]

While the political and philosophical reasons for congressional inaction will likely always be in place in some form or another, there is some hope that recent judicial guidance has helped to eliminate the problem of confusion as to the appropriate legislative content if Congress ever decides to act. *Quill*, *Bellas Hess* and the substantial private interest in the issue has produced a wealth of knowledge that would clearly point Congress in the right direction if it ever sought to allow states the right to mandate online sales taxes.

Current Efforts to Obtain Unreported Tax Revenue

Some states are employing alternative means to enforce collection of sales and use taxes that are not being adequately collected under current laws and practices.

Reciprocity Agreements

Because states are greatly affected by merchants' avoidance of collecting Internet taxes, many have begun to work together to be certain that organizations that meet the physical presence standard in their state collect the appropriate taxes.[62] Every retailer in the country must have a "home state" in which they file tax and corporate returns. Most of the time, the home state simply concerns itself with the retailer's compliance with its own tax and corporate laws. States may audit the firms under their own laws as they see fit. Recently, however, certain states have begun to swap tax data with each other to be certain that all retailers with the requisite physical presence in their states are paying the appropriate tax. In 2001, Connecticut announced that any state that chose to share its tax data with Connecticut would receive a full 25 percent of all lost taxes collected by the state as a result of the referral.[63]

The benefits of these contracts are obvious. Swapping data allows states that would normally not be privy to a merchant's tax data to peruse the data for "a hidden nexus" with their state that the merchant may not be disclosing. Swapping data can also lead to a recovery of tax revenue that might otherwise not be remitted.

There are costs, however. Most significant is the fact that there are substantial administrative and enforcement costs. Referring states incur greater costs because they have to determine which partner states are best suited to receive their data. Receiving states must determine whether the data is useful. If it is, the state must take significant steps to notify the merchant of the transgression and collect the past taxes. In almost every case, the outstanding tax would have to be substantial in order to rationalize the additional costs. While reciprocity agreements might be useful in certain situations, there is no guarantee that the significant time, money and effort will lead to a positive expected value for the states. These agreements are theoretically interesting and possibly useful, but the practical reality paints such agreements as substantial gambles that provide no guaranteed results.

Litigation

At least one state has attempted to enforce collection of online sales taxes *via* litigation. In 2003, the State of Illinois filed lawsuits against the online divisions of Wal-Mart, Target, Office Depot and three smaller retailers seeking to mandate that these retailers collect taxes on Internet transactions because of their "brick-and-mortar" physical presence in Illinois.[64] These suits were a success for Illinois, as the major retailers settled for several million dollars and began collecting the appropriate taxes on their Web sites shortly thereafter.

While litigation is a possible enforcement technique available to the states, it also has its limitations. The costs of litigation make it unrealistic for any but the largest of retailers to be hauled into court by states. Indeed, the Illinois suit targeted three of the largest companies in America, and no subsequent suits have been filed to date. Second, and more substantially, is the fact that litigation is not a tool that will allow enforcement if the states have no legal right to mandate that the retailers collect online sales taxes. The Illinois suit was successful because the state could prove that the named retailers had the appropriate substantial nexus in their state. Such arguments would carry no weight against a large online retailer like our fictitious Mirkwood, which has no substantial nexus with most of the states in which it sells goods.

State Opportunities to Reform the Rules

Finding that current enforcement methods are lacking, the states have recently organized their resources and thinking to make a strong attempt at taxing Internet and other out-of-state transactions.

The Streamlined Sales Tax Project

The Streamlined Sales Tax Project (SSTP) is a project undertaken by 42 states (including the District of Columbia) to develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes for all out-of-state commerce, including Internet transactions.[65] The SSTP is specifically designed to combat the argument that collecting online taxes would impede interstate commerce. The participating states believe that they must demonstrate an ability to efficiently collect taxes without burdening commerce if they are to have any chance of convincing Congress or the courts to reconsider the issue and find in their favor. Thus, the main goal of the SSTP is to promote passage of a federal law that would allow sales tax to be uniformly collected in all domestic Internet transactions requiring out-of-state companies to collect sales tax.[66]

The SSTP has several important features aimed at accomplishing this goal. First, the project creates uniform definitions of products that may be subject to tax.[67] All participating states would be required to agree upon, for example, the definition of a "pack" of cigarettes and carefully define what constitutes a pack. If a participating state's current definition of a product is contrary to the SSTP definition, the respective state would have to bring its definition of the product in line with the SSTP.

Second, the project greatly simplifies rates across borders.[68] States will be allowed one state tax rate for each uniformly defined good, and will be allowed a second rate for very narrowly defined goods such as food and pharmaceuticals. Each local jurisdiction will be granted one local rate for each uniformly defined good. Each respective state legislature would continue to choose what goods are taxed and untaxed in its respective state.[69]

For example, if the SSTP were passed as proposed, a state would define one state tax rate for all products that it chooses to tax. Assume that Maryland, a participating SSTP state, decides that it wishes its tax rate to be five percent. Maryland would convey this rate to the SSTP database. Next, Maryland would identify which universally defined products it wishes to tax. Maryland may choose to tax all clothing and prepared food. Another participating SSTP state may decide that it wishes for its sales tax rate to be six percent, but may choose not to tax clothing. Once each participating state decides its tax rate and the goods to be taxed, the information is relayed to a main SSTP database, which would be publicly accessible to merchants. Merchants could then use the data to facilitate their collection of taxes for customers of each individual participating state.

Third, under the SSTP, the respective states will be required to share the burden of administering all local taxes.[70] Thus, a retailer would only have to file tax returns with each of the participating states, and the states would handle the administration of reimbursing the local governments according to the retailer tax returns. The SSTP also provides for some state funding for some of the "technology models" that would be used to administer the SSTP, uniform audit procedures for the retailers, and simplified exemption administration.[71]

Of particular interest in the SSTP is the decision to grant retailers amnesty for previous failings to collect sales and use taxes for "signing on" to the proposed system.[72] Proponents of amnesty believe that the practical reality of collecting previous tax burdens is simply too great to overcome, given the heavy administrative and personnel costs. Proponents further argued that amnesty would create greater likelihood of attracting voluntary collectors. Others were less willing to grant amnesty because of the significant revenues that the states would be foregoing.[73]

Identify Important Issues of Concern with Current Law

States must identify problems with current law, and propose new ways for the Supreme Court and Congress to think about online transactions. To be successful, states must paint present law as a combination of outdated thinking, practical infeasibility and misguided policy.

States must argue that the case law as it currently stands is based on mail order/catalog disputes that were all decided prior to the Internet's explosion as a substantial marketing and sales tool. While there are similarities between the mail order and Internet sales techniques, there are also substantial differences that should affect judicial analysis. For example, mail order sales almost always result in a physical product being sent or delivered to a physical address. Internet transactions, however, can severely complicate such sales. For example, imagine a consumer, Jane Consumer, who resides in California but is visiting her mother in Minnesota. While at her mother's home in Minnesota, Jane uses her laptop and a public wireless Internet access point to visit an online music download service that is owned and operated by a Texas corporation. Jane finds a song that she likes and pays for it using a credit card in her husband's name (who is a resident of Florida). Such a situation suggests substantial questions. Where has the sale occurred? Where is the delivery point? What state would have the right to tax this transaction? Compare this process with mail order merchandise, which usually has some defined final physical destination that allows for simple sales tax calculation.

> States must identify their challenges, employ systems that reduce the burden on interstate commerce, and provide reasonable alternatives to the present state of law.

States must show that current case law does not provide easy answers to these questions. Simply put, courts have not had an opportunity to examine the issue since the Internet explosion of the late 1990s. States would want to show that an opportunity to re-examine this issue would lead to greater economic certainty and would offer more appropriate guidance for online retailers. Of course, states cannot only show that the current law is confusing, but must also be prepared to show that the SSTP or other procedures would provide greater efficiency and clarity.

Finally, states must show that longstanding principles of federalism and Commerce Clause analysis would not be disturbed because of new technologies or new ways of doing business. Instead, states would want to show that new methods of commerce can still meet constitutional standards if the courts consider the unique ways that Internet transactions provide contacts, and "nexus" with states.

Challenge Previous Case Law

Once the SSTP is in place, states would face the unenviable—but necessary—task of challenging the wisdom of current case law. In order to be effective, states would have to overcome three issues.

Eliminate the Quill Requirement of Physical Presence for Commerce Clause Analysis

First, states would have to show that the *Quill* bright-line physical presence rule is outdated and inapplicable in the new economy. States would have to show that the dissent by Justice White in *Quill* was more appropriate to the modern economic process.

In *Quill*, White noted that "reasonable minds surely can, and will, differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection."[74] Justice White went on to suggest that the majority imposed the rule not out of fairness, but out of "the supposed convenience of having a bright-line rule."[75] White goes on to state that "in today's economy, physical presence frequently has very little to do with a transaction a State might seek to tax."[76] White goes on to find that "an out-of-state direct marketer derives numerous commercial benefits from the State in which it does business."[77]

States would have to convince the Court of the significant changes that have come about since the decisions in *Bellas Hess* and *Quill*. The states should specifically point to transactions like Jane, our music downloader discussed above, where the physical presence could be almost anywhere.

As an alternative, the states should suggest that courts engage in an analysis similar to that found in cases examining personal jurisdiction. If any merchant has the requisite minimum contacts with a state, typically by virtue of advertising and accepting orders from a particular jurisdiction, and can reasonably expect to defend a suit there, that merchant would also be responsible for collecting that state's sales taxes. Such a rule would be consistent with the Court's past due process and personal jurisdiction analysis, and the existence of the SSTP would mean the taxation requirement would have little burden on interstate commerce.

In arguing for this rule, states should expect a reasonable court to question the possible cost burdens on smaller merchants who may make only one or two sales in a particular state in a year. States could cure this concern by offering to impose tax collection burdens only on merchants that make a certain minimum amount of sales in a certain state per year. This rule is likely quite reasonable, so long as the states avoid making the minimum number of sales so low that it would violate notions of fair play and substantial justice under a due process analysis.

Suggest a Rule to Assist in Determining Taxation Jurisdiction

To determine which state should have jurisdiction for purposes of collecting a tax in situations like Jane's, the states should argue for a "point of reference" or home base rule. For example, in our "Jane" case above, the states would argue that the taxing jurisdiction would be Florida because this would be the address most ascertainable during the transaction, given the user's employment of a credit card with a Florida address. The credit card holder's address serves as the point of reference, and although the actual purchaser is a California resident who is currently in New York, her most ascertainable location is Florida, because it can be assessed *via* the payment systems in place by the merchants and states. Such a system eases the guessing game, and leads to the greatest sense of fairness for all involved.

This suggested rule is also quite consistent with principles of uninhibited interstate commerce. Because the point of reference is the most ascertainable physical location, it substantially reduces the burden on merchants to decipher where the actual transaction may be taking place.

Demonstrate That There Is No "Entanglement" Imposed

One of the chief concerns in the *Quill* and *Bella Hess* decisions was the substantial burden imposed by multiple taxing jurisdictions. In *Bella Hess*, for example, the Court found that the "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions."[78] The SSTP was created to handle such concerns, but the states must be certain that the SSTP adequately alleviates the concerns expressed by the Supreme Court.

First, and most simply, the challenging states must be certain to create the most powerful consensus possible among its members, striving for the full support of every state. Second, the SSTP must be practicably feasible. To have any chance to prevail, the states must prove that the system works in both theory and practice, that the mandates are funded and that businesses can easily comply. In a word, the SSTP must be an airtight process in every aspect. If the courts or Congress sense even a chance of impracticability, there will be little chance of meeting the burden of proof that the present state of the law should be changed.

Identify the Questionable Public Policy

States should, while treading lightly, show that the public policy of the present constitutional analysis is inherently unfair. States should specifically point to the fact that their businesses are being unduly discriminated against in favor of international or out-of-state businesses when there is no tax system in place. As Justice White noted, the majority's decision in *Quill* was "very questionable" when considering the "rationality of perpetuating a rule that creates an interstate tax shelter for one form of business—mail-order sellers—but no countervailing advantage for its competitors."[79] Showing that the current policy is discriminatory in nature would be a significant advantage in proposing an overhaul of the present law.

Convince Congress

Convincing Congress to act would be simpler if the states were successful in their court challenge. However, even failing that, Congress has the authority to allow the states to implement their SSTP system if the states can somehow convince the legislative body to act in their favor. However, convincing Congress to act in the states' interest is no easy task.[80]

A Unified Lobbying Front

The states must show solidarity in their lobbying efforts. If the states are not able to convince themselves that they are united, they would have little chance of convincing Congress to support a fractured front. The states would also have to engage in a substantial media and grassroots campaign to support their position. A particular advantage that the states may have is their "localities." If the community mayors, police chiefs and council members were clearly behind the SSTP, it would lead to a much more impressive effort than the 50 governors descending on Capitol Hill. Lobbyists would also likely have friends in business, because "businesses would appreciate tax simplification."[81] In addition, "many state tax officials support [the SSTP] because they believe it will allow them to reap billions in new sales tax revenues."[82]

Create Congressional Incentive

The root of the problem, however, is making the SSTP system make sense to Congress. One particularly effective argument would be the potential results if the SSTP system was not passed. Specifically, there would be substantial increases in state personal income taxes that would be directly attributable to Congress's failure to act. If the states targeted this argument appropriately, it would be quite effective.

Submit Proposals That Make Sense

The states should be careful to avoid making proposals that are "greedy" or infeasible. For example, just as the states would want to avoid due process issues in front of the courts, it would also be important for the states to avoid proposals that are overly restrictive or "unfair." This is especially true given that many onlookers believe that "too few states have brought their laws into complete conformity," and "there has been no demonstration that an interstate sales tax software can work seamlessly in the mainframes of all businesses in America."[83]

States would be wise to be certain that important constituents such as smaller businesses would not be overly burdened by the system. Any proposal should contain minimum transactions requirements or minimum requirements for money exchanged before small businesses or individual artisans are taxed.

Conclusion

The changing economy has led to significant hardship for state revenues. The external barriers to mandating that online merchants collect state sales taxes are great. Despite these challenges, there are significant opportunities for change that will lead to fair results for states, consumers and business. States must identify their challenges, employ systems that reduce the burden on interstate commerce, and provide reasonable alternatives to the present state of law. If states can show that Internet transaction taxation benefits the overall marketplace, there is clear opportunity for change.

ENDNOTES

1 There are several articles that more fully consider the merits of allowing states to tax Internet transactions. *See, e.g.*, Joseph R. Feehan, *Surfing Around the Sales Tax Byte: The Internet Freedom Act, Sales Tax Jurisdiction and the Role of Congress*, 12 ALB. L.J. SCI. & TECH. 619 (2002), *See, e.g.*, Christopher J. Schafer, *Federal Legislation Regarding Taxation of Internet Sales Transactions*, 16 BERKELEY TECH. L.J. 415 (2001), Megan E. Groves, *Tolling the Information Superhighway: State Sales and Use Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 619 (2000).

2 Iris Lav, the deputy director of the Center on Budget and Policy Priorities, testified before the Senate that "the limited obligation of remote sellers to collect taxes is eroding the sales tax base of state and local governments" and resulting in more limited funds to "finance education, health, human services, public safety, and many other essential programs." Iris J. Lav, *Oral Testimony Before Senate Budget Committee* (Feb. 2, 2000), in TAX NOTES TODAY, Feb. 4, 2000, at 24-44.

3 *See generally* Doug Sheppard, *State Tax Administrators on Taxing the Net*, STATE TAX TODAY, Mar. 20, 2000.

4 *Public-Private Sector Study of Cost of Collecting State and Local Sales and Use Taxes*, Streamlined Sales Tax Project, available online *at www.streamlinedsalestax.org* (visited Feb. 28, 2007).

5 *Id.*

6 *State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004*, NewRules.org, available online at

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www.newrules.org/retail/Ecommerceupdates.pdf (visited Feb. 28, 2007).

[7] Groves, *supra* note 1.

[8] *Quarterly Retail E-Commerce Sales 4th Quarter 2004*, Dept. of Commerce, available online at *www.census.gov/mrts/www/data/html/04Q4.html* (visited Feb. 28, 2007).

[9] *Is Shopping Online Really Cheaper?* About.com, available online at *http://couponing.about.com/od/bargainshop/a/onlinecheaper.htm* (visited Feb. 28, 2007).

[10] Maryland, for example, has a progressive personal income tax that is similar to most other states. *Maryland Policy Reports: The Newsletter of the Maryland Budget and Tax Policy Institute, Volume I, No. 3*, available online at *www.marylandpolicy.org* (visited Feb. 28, 2007).

[11] Iris J. Lav, Tax Notes Today, *supra* note 2, at 24-44.

[12] *Id.*

[13] *Id.*

[14] *McLeod v. J.E. Dilworth Co.,* SCt, 322 US 327, 330 (1944).

[15] Merriam-Webster's Dictionary of Law (1996).

[16] The American Heritage Dictionary of the English Language (4th ed. 2000).

[17] Maine, for example, considers "prepaid calling arrangements, transmission and distribution of electricity and the rental or lease for more than one year of an automobile" to be subject to sales tax. *Maine Revenue Services Sales, Fuel & Special Tax Division General Information Bulletin*, Maine.gov, available online at *www.maine.gov* (visited Feb. 28, 2007).

[18] Maine is one such state.

[19] The Maryland Code, for example, has entire chapters for "Business Regulation," "Commercial Law," and "Corporations and Associations," but has few sections regulating consumer accounting practices.

[20] *McGoldrick v. Berwind-White Coal Mining Co.,* SCt, 309 US 33 (1940).

[21] *Id.,* at 58.

[22] *Supra* note 14, at 327.

[23] *Id.,* at 328.

[24] *Id.,* at 329.

[25] *Id.*

[26] The Commerce Clause provides that the Congress shall have the right "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes." U.S. Const. Art. I, §8, cl. 3.

[27] *Supra* note 22, at 331.

[28] *Id.,* at 330.

[29] *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.,* SCt, 386 US 753 (1967).

[30] *Id.* at 760.

[31] Kathleen P. Lundy, *The Taxation of E-Commerce: The Inapplicability of Physical Presence Necessitates an Economic Presence Standard*, 8 RICH. J.L. & TECH. 12 (2001).

[32] *See* U.S. Const. Amend. XIV. ("No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law.")

[33] The dormant Commerce Clause is a legal principle created by the Supreme Court to ensure that local regulations do not burden interstate commerce, which may only be regulated by Congress. For a discussion of the doctrine, *see H.P. Hood & Sons, Inc. v. Du Mond*, SCt, 336 US 525 (1949). If a law is challenged under the dormant Commerce Clause, the Court determines its constitutionality by examining its discriminatory effects. If the law is discriminatory, the law is generally declared unconstitutional. If the law is not discriminatory, the Court proceeds in its evaluation of the law using a balancing test. For discussion of the balancing test employed in determining whether a state law has violated the dormant Commerce Clause, *see Pike v. Bruce Church, Inc.,* SCt, 397 US 137 (1970).

[34] *Complete Auto Transit, Inc. v. Brady,* SCt, 430 US 274 (1977).

[35] *Supra* note 31, at 27.

[36] *Supra* note 34, at 279.

[37] *Supra* note 31, at 28.

[38] *Quill Corp. v. North Dakota,* SCt, 504 US 298 (1992).

[39] *See, e.g., Burger King Corp. v. Rudzewicz,* SCt, 471 U.S. 462 (1985), where the Court held that defendants who "purposefully established minimum contacts within the forum State" would be subject to personal jurisdiction unless the defendant could "present a compelling case that the presence of some other considerations would render jurisdiction unreasonable." *Id.,* at 477.

[40] *Supra* note 38, at 307.

[41] *Id.,* at 308.

[42] *Supra* note 31, at 29.

[43] *Supra* note 29, at 754.

[44] *Id.*

[45] *Id.,* at 313 n. 6.

[46] *Supra* note 31, at 29.

[47] *Id.,* at 318.

[48] *Supra* note 38, at 313 n.7.

[49] Internet Tax Freedom Act, P.L. 105-277, 112 Stat. 2681 (1998).

[50] *Supra* note 31, at 35.

[51] *Supra* note 49.

[52] Internet Tax Freedom Act, P.L. 197-75 (2003).

[53] *Id.*

[54] Roy Mark, *Think Tank: Keep Internet Tax Moratorium Temporary*, Internet.com, available online at *http://dc.internet.com/news/article.php/3096251* (visited Feb. 28, 2007).

[55] *Id.*

[56] S. 1433, 106th Cong. (1999).

[57] *See, e.g.,* Internet Tax Elimination Act, H.R. 3252, 106th Cong. (1999), Internet Non-Discrimination Act, S. 2082, 106th Cong. (2000).

[58] Grant Gross, IDG News Service, *Lawmakers Introduce Bill to Extend Internet Tax Ban*, PC-World, available online at *www.pcworld.com/article/id,120503-page,1/article.html* (last modified Apr. 19, 2005).

[59] *See e.g.,* Dean F. Andal, *Read My E-Mail: No New Taxes*, 12 St. Tax Notes 1387, 1388 (1997).

[60] *See* generally, Nathan Newman, *Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway*, 9 St. Tax Notes 927, 930-31 (1995).

[61] *Supra* note 31, at 35.

[62] *New Rules Project—Ask Dr. Dave—Internet Taxation*, NewRules.org, available online at *www.newrules.org/drdave/5-internettax.html* (visited Feb. 28, 2007).

[63] *Id.*

[64] Norm Alster, *Illinois Joins Suits to Collect Taxes on Internet Sales*, The New York Times, Feb. 22, 2003, at C1.

[65] *Structure and Operating Rules Streamlined Sales Tax Project*, Streamlined Sales Tax Project, available online at *www.streamlinedsalestax.org/oprules.html* (visited Feb. 28, 2007).

[66] *Supra* note 62.

[67] *Streamlined Sales Tax Project Executive Summary*, Streamlined Sales Tax Project, available online at *www.streamlinedsalestax.org/execsum0404 percent20.pdf* (visited Feb. 28, 2007).

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] *Sales Tax Simplification Agreement Becomes Effective Today and Launches Key Element: Amnesty Program*, Streamlined Sales Tax Project, available online at *www.streamlinedsalestax.org/press_rel.html* (visited Feb. 28, 2007).

[73] *Id.*

[74] *Supra* note 38, at 329 (White, J., dissenting).

[75] *Id.*

[76] *Id.,* at 328.

[77] *Id.*

[78] *Supra* note 29, at 760.

[79] *Supra* note 38, at 329.

[80] One conservative political action committee defined an unsuccessful 2002 lobbying campaign by the states as "a full-scale battle in Congress" to encourage congressional action

ENDNOTES

in accordance with *Quill. States Clamoring to Tax E-Commerce (Again!)*, Center for Individual Freedom, available online at *www.cfif.org/htdocs/legislative_issues/federal_issues/hot_issues_in_congress/internet_taxation/states_clamoring.html* (visited Feb. 28, 2007).

[81] Chris Atkins, *108th Congress To Address State Issues*, BUDGET & TAX NEWS, Mar. 1, 2004, at 1.

[82] *Id.*

[83] *Id.*