Saving E-Commerce From 'Virtual Nexus' Predators: ITFA to the Rescue

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In this edition of Eyes on E-Commerce, Isaacson and Schaefer explain that Congress, through the Internet Tax Freedom Act, has long safeguarded internet vendors from discriminatory sales and use tax collection obligations by rejecting aggressive state efforts to redefine substantial nexus with reference to the modalities of electronic commerce.

It is now almost cliché to recite that the internet has dramatically altered the retail marketplace over the past two decades. The significance of that change regarding the *Quill* physical presence standard of "substantial nexus" for state sales and use taxes, as reaffirmed by the Supreme Court in 1992,[1] has been hotly debated. Many in the industry have noted that the physical presence rule, which the Court adopted under the commerce clause to protect pre-internet transactions — in part because it was "difficult to conceive of transactions more exclusively interstate in character than the mail order transactions" then at issue[2] — has only become increasingly important in the even more intensely interstate environment of electronic commerce. Others — among them Justice Anthony M. Kennedy — have argued that *Quill* physical presence should be revisited on the theory that by means of the internet "a business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term."[3]

Some state legislators and tax officials have pointed to Kennedy's remarks and have sought to make the case that internet technologies and marketing methods establish a sufficient "presence" (albeit a "virtual presence") to permit a state to require an online retailer to collect use tax on its sales to customers in the state, even if the retailer itself is physically present only in one or more remote jurisdictions.[4]

[1] *Quill Corp. v. North Dakota*, 504 U.S. 298, 313-19 (1992).

[2] *See National Bellas Hess Inc. v. Illinois Department of Revenue*, 386 U.S. 753, 759 (1967).

[3] *Direct Marketing Association v. Brohl*, 135 S.Ct. 1124, 1135 (2015) (Kennedy, J., concurring).

[4] *See, e.g.*, Massachusetts Department of Revenue Directive 17-1 (issued Apr. 2, 2017) (revoked June 28, 2017).

What those state officials fail to recognize is that a higher authority — Congress, to which the Constitution assigns the responsibility for regulating interstate commerce under the commerce clause[5] — has already intervened to prevent states from using internet-based contacts as grounds for requiring e-commerce vendors to collect state sales and use taxes, when it enacted the Internet Tax Freedom Act (ITFA) in 1998.[6] Indeed, ITFA's legislative history indicates that Congress expressly rejected state attempts to use internet-based contacts as a factor in determining whether an out-of-state business has substantial nexus with the state.[7] Any assertion that *Quill*'s traditional, physical presence standard does not apply to internet sellers is therefore directly at odds with congressional intent and preempted by ITFA.[8]

ITFA's Discriminatory Taxes Prohibition

ITFA was designed by Congress to accomplish two primary objectives in limiting state taxes on internet-related activity. The first was the familiar moratorium on internet access taxes, which has no application to state laws seeking to redefine the principles of substantial nexus for internet vendors.[9] The second is ITFA's prohibition on "multiple or discriminatory taxes against electronic commerce."[10] Both restrictions on state taxing authority were made permanent in 2016.[11]

ITFA's nondiscrimination provisions have been far less frequently litigated than the prohibition against state taxes on internet access services. They are taking on new significance as states seek to justify expanding their taxing authority to require sales and use tax collection by internet vendors on the theory that they are "present" in states through their online sales and marketing activity.[12] While the prohibition against multiple or discriminatory taxes on electronic commerce encompasses numerous components, the legislative history of ITFA demonstrates that state efforts to redefine nexus based on internet contacts with a state are at the very heart of ITFA's nondiscrimination protections.

In 1997 then-U.S. Rep. Christopher Cox of California first introduced a bill known as the Internet Tax Freedom Act,[13] then filed updated versions in May and June 1998.[14] After revisions, edits, and synthesis of competing draft bills, the original version of ITFA, with Cox as its principal author in the House of Representatives, was enacted by Congress in October 1998.[15]

The nondiscrimination provisions of ITFA have remained remarkably stable over the years. Regarding the act's prohibition against states and localities imposing "discriminatory taxes on electronic commerce," the relevant provisions of the consolidated bill introduced by Cox in June 1998 and the ITFA provisions made permanent by Congress in 2016 are substantively identical. In particular, ITFA defines electronic commerce to mean "any transaction conducted over the internet or through internet access, comprising the sale, lease, license, offer or delivery of property, goods, services, or information, whether or not for consideration."[16] A tax under ITFA includes both revenue-raising measures and "the

[5] *See* U.S. Const., Art. I, Sec. 8, Cl. 3.

[6] The provisions of ITFA were originally set forth as Title XI of P.L. 105-277, 105th Congress (1997-1998) (signed into law Oct. 21, 1998), which was codified as a note to 47 U.S.C. section 151. Citations to ITFA herein refer to the section numbers assigned within the text of ITFA, as amended and made permanent in 2016. *See* P.L. 114-125, 114th Congress (2015-2016), section 922(a) (enacted Feb. 24, 2016).

[7] *See* Speech of Hon. Christopher Cox of California, 144 Congress Rec. E1288-03 (June 23, 1998), at 4.

[8] Under the supremacy clause of the U.S. Constitution, ITFA preempts state laws or regulations that violate its prohibitions. *See PLIVA Inc. v. Mensing*, 564 U.S. 604, 617 (2011) ("Where state and federal law directly conflict, state law must give way" (internal quotation omitted)). ITFA has been held to preempt the application of a discriminatory state tax law under the supremacy clause. *See Performance Marketing Association v. Hamer*, 998 N.E.2d 54, 59-60 (Ill. 2013).

[9] ITFA section 1101(a)(1).

[10] *Id.* section 1101(a)(2).

[11] *See* P.L. 114-125, 114th Congress (2015-2016), section 922(a) (enacted Feb. 24, 2016).

[12] The only reported appellate court decision concerning ITFA's ban on discriminatory tax collection obligations is the Illinois Supreme Court's ruling in *Performance Marketing Association*, 998 N.E.2d at 59-60 (striking down law requiring retailers completing transactions via internet marketing methods to collect use tax where other remote sellers engaged in similar, offline marketing methods were not required to collect the tax).

[13] *See* H.R. 1054, 105th Congress (1997-1998).

[14] *See* H.R. 3849 and H.R. 4105, 105th Congress (1997-1998).

[15] *See* P.L. 105-277, 105th Congress (1997-1998), tit. XI.

[16] ITFA, section 1105(3).

imposition on a seller of an obligation to collect and to remit to a governmental entity any sales or use tax imposed on a buyer by a governmental entity."[17] The term "discriminatory taxes" likewise includes "any tax imposed by a State or political subdivision thereof on electronic commerce that . . . imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means."[18]

Thus, discrimination for purposes of ITFA concerns not only the application of the sales or use tax itself,[19] but also of the obligation to collect the tax. While a state law that imposes a sales or use tax solely on an internet transaction would clearly run afoul of ITFA, laws that require only internet vendors to collect a tax, and do not require other remote sellers — including vendors who market via catalog, telephone, or television infomercial — to collect tax on similar transactions, also plainly violate ITFA.[20]

Also, the act's legislative history makes clear that ITFA prohibits states from targeting online sellers with state sales tax collection obligations based on activities and contacts associated with commerce conducted online when retailers engaged in similar activities and contacts offline are not required to collect the tax. During the lead-up to the passage of the initial version of ITFA, Cox, as the principal sponsor of the legislation, submitted a speech concerning the intent of the key provisions of the bill that was to become ITFA.[21] No contrary statement of intent appears in the Congressional Record.

In his statement of intent, Cox specifically discussed the purpose of the act's prohibition on discriminatory taxes on electronic commerce. He said that those provisions were "intended to prohibit states and localities from using internet-based contacts as a factor in determining whether an out-of-state business has 'substantial nexus' with the taxing jurisdiction."[22] He further stated that efforts by a state to use some form of virtual or electronic presence to impose tax obligations on internet retailers are directly contrary to the intent of Congress in enacting ITFA.[23] The statement of intent makes crystal clear Congress's objective to foreclose aggressive nexus theories targeting internet vendors, in response to state theories of electronic presence:

> [ITFA's nondiscrimination provision] is a direct response to testimony from a State tax administrator, who offered his view to Congress at a July 1997 hearing that the *Quill* protections provided to remote sellers without a substantial in-State physical presence should not apply to businesses engaged in electronic commerce. . . .
>
> The Act rejects this approach. The promotion of electronic commerce requires faithful adherence to the U.S. Supreme Court's clear statement in *Quill* that a "bright-line" physical presence — *not some malleable theory of electronic or economic presence* — is required for a State to claim substantial nexus. Even without the Act, the courts, in light of *Quill*, are likely to view such arguments by State tax administrators with great skepticism. But the Act provides clarity and far greater certainty by *specifically outlawing State or local efforts to pursue aggressive theories of nexus*.[24]

[17] *Id.* section 1105(8).

[18] *Id.* section 1105(2)(iii) (emphasis added).

[19] To be sure, the act does not render remote transactions conducted via electronic commerce exempt from state sales and use tax. A consumer purchasing goods online in a state that has an applicable sales or use tax owes the state the tax and is obligated to pay it, just as consumers who buy from an out-of-state seller via catalog or TV infomercial must report and pay the use tax.

[20] *See American Catalog Mailers Association & NetChoice v. Heffernan*, Mass. Super. Ct. No. 2017-1772 BLS1, Memorandum of Decision and Order Entering Declaratory Judgment on Count I of Plaintiffs' Verified Complaint (June 28, 2017), at 4 ("An intent of ITFA appears to be to insure that Internet vendors are treated by State departments of revenue in the same manner that *Quill* directed mail order houses be treated under the Commerce Clause") (invalidating Mass. DOR Directive 17-1 on other grounds).

[21] 144 Congress Rec. E1288-03 (hereafter, "statement of intent").

[22] Statement of intent at 4.

[23] *Id.* at 4-5.

[24] *Id.* at 5 (ellipsis and emphasis added).

Thus, when the Congress enacted ITFA in 1998 to protect the nascent internet from discriminatory state tax laws targeting electronic commerce, it expressly rejected state efforts to redefine substantial nexus for purposes of online vendors that were not physically present in a state.

States' 'Virtual Nexus' Theories

Many state revenue officials have chafed under the physical presence standard reaffirmed by the Court in *Quill* and the limitations that the commerce clause imposes on state taxation and regulation of interstate commerce. Encouraged by Kennedy, they maintain that the advent of electronic commerce calls for an expansion of state taxing authority over internet vendors, based on principles that are, at best, only loosely tied to the requirement of a physical presence or the argument that the internet warrants a new concept of virtual presence as a basis for establishing substantial nexus.[25] These theories posit that an online seller's nonphysical, electronic contacts with a state — derived from how consumers in a state gain access to and complete transactions with out-of-state internet vendors — provide an adequate basis for a state to assert its taxing power to require the out-of-state vendor to collect and remit state sales and use taxes. For example, the HTML code necessary to present a remote seller's website on a user's computer is deemed a form of "in-state software" that renders the retailer "present" in the state when stored by the computer browsers of consumers in the state.[26] Similarly, internet cookies, which are no more than small text data files stored by a user's computer when interacting with an internet vendor's website, are supposedly another form of electronic presence for the retailer.[27] Two states also recently sought to enshrine in law the proposition that the use by a retailer of a so-called content distribution network that has servers in the state also justifies imposing a tax collection obligation.[28]

There are numerous flaws in virtual presence theories of nexus that relate to basic misconceptions about the nature of the alleged electronic contacts with the state, and whether the internet vendor ultimately owns or controls the digital bits of data and code residing on a user's computer. (Cookies, for example, can be readily blocked or deleted by the consumer.) States, however, have an even more fundamental problem in relying on those elements as a basis for regulating interstate commerce over the internet, even if internet-based contacts could somehow be deemed to render an out-of-state internet vendor present in the state. Congress confronted — and rejected — these theories as a basis for asserting nexus by enacting ITFA. In the face of ITFA's prohibition on state laws that impermissibly target internet sellers for sales or use tax collection based on their electronic contacts with the state, this virtual nexus theory is a nonstarter.

Indeed, Cox's statement expressly provides that the act's nondiscrimination provision "is intended to provide added assurance that the protections of *Quill* . . . including its requirement that substantial nexus be determined through a 'bright-line' physical-presence test . . . will continue to apply to electronic commerce just as they apply to mail-order commerce, unless and until a future Congress decides to alter current nexus requirements."[29] In exercising its plenary power to regulate interstate commerce, Congress ensured nearly 20 years ago that the new electronic marketplace would be allowed to develop free from aggressive state nexus theories targeting the modalities of the internet as grounds for asserting the authority to require sales and use tax collection by online vendors.

In 2016 Congress made those provisions permanent. It is not within the power of states or even the courts to intrude on that freedom today

[25] *See* Tax Commissioner's Merit Brief, *Crutchfield v. Testa*, Supreme Court of Ohio No. 15-0386 (Oct. 20, 2015), at 40. Although the Ohio tax commissioner argued virtual nexus theories to the Ohio Supreme Court in 2015 in a case involving the constitutionality of the Ohio commercial activity tax, the Court declined to reach them in its decision in the case. *See Crutchfield v. Testa*, 2016 Ohio 7760, at 56; *see also* Massachusetts DOR Directive 17-1, at 2.

[26] Massachusetts DOR Directive 17-1 (revoked June 28, 2017), at 2.

[27] *Id.*

[28] Massachusetts DOR Directive 17-1; *see also* 132nd Ohio General Assembly, Am. Sub. H.B. 49 (June 30, 2017), at 2305-06 (creating a presumption that a person has substantial nexus with the state if the person "enters into an agreement with another person to provide a content distribution network in this state").

[29] Statement of intent at 5.

with discriminatory nexus provisions, regardless of whether they may believe that an internet seller can be viewed as virtually present in a state. In ITFA, Congress foresaw the potential of the internet to drive economic growth, as well as the need to protect the internet from the overreaching grasp of state governments and their tax officials. The internet is inherently an instrument of interstate commerce, and ITFA makes clear that transactions conducted via the internet cannot be targeted for discriminatory treatment. ■