CHAPTER 10

A TAX WHOSE TIME HAS PASSED? PROBLEMS WITH STATE SALES AND USE TAXES IN AN ELECTRONIC COMMERCE ENVIRONMENT

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Synopsis

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¶ 1000 INTRODUCTION

Many state and local government officials extol the sales tax as a reliable source of revenue and a model of efficient tax administration. Indeed, states and municipalities have become hooked on the sales tax. Forty-five states and over 7,500 local jurisdictions have adopted transaction taxes. Nationwide, sales and use taxes have become the single largest source of state tax revenue, and they provide an ever-increasing proportion of local government revenues as well. Governments favor the sales tax because they do not have to administer it. Not only is the tax collection responsibility offset onto retailers, but, should the retailers err in applying or collecting the tax, they, themselves, become liable for it. From a tax administrator's perspective, this means that the tax is extremely efficient (*i.e.*, the cost of tax collection is a small percentage of the revenues realized).

Most state and local government officials assume that the sales tax is a fixed star in the constellation of state taxes. The sales tax may be unworthy of such celestial status. It is hardly a paragon of clarity, consistency, or fairness. Its claim to fame

rests largely on its rapid growth and broad popularity among state and local governments, which amounts to little more than a self-endorsement by the revenue beneficiaries. There are serious questions whether state and local transaction taxes are suited to an electronic commerce environment. This article probes some of those issues.

¶ 1001 HISTORICAL ROLE OF SALES TAXES IN THE UNITED STATES

The sales and use tax is not an American icon, and it lacks an illustrious past. Its history in this country is neither long nor distinguished. Sales taxes were first adopted in the United States as a response to the fiscal crisis the states encountered during the Great Depression.[2] The economic turmoil of that period led to a dramatic decline in state revenues from other tax sources. Business bankruptcies and worker unemployment resulted in a sharp reduction of revenues from state income taxes. Despite the loss of tax revenues, state governments were confronted with new financial demands to address the dire economic condition of their citizens. Federally mandated participation in New Deal programs placed additional financial strains on state resources, as did increases in state grants to municipalities to assist with local programs, such as schools and food banks. At the same time, again due to massive unemployment and citizen fears of losing their homes to tax foreclosures, there was a strong popular drive to reduce the burdens of property taxes, and many states passed constitutional amendments limiting overall property tax rates. Simply put, the states had vastly increased financial burdens and vastly decreased revenues available to address them.

Sales taxes presented an attractive means of meeting state revenue needs during those hard economic times. They

[2] Prior to the states instituting sales taxes, there had been prior drives for a national sales tax. It is not surprising that those efforts also were precipitated by national crises. Congress considered such a tax in 1865 as a way to address the economic burdens of the Civil War. A national sales tax was also given serious consideration during World War I. *See* Alfred G. Buehler, *General Sales Taxation* (1932)

combined low tax rates, high yields, and limited collection difficulties. They appeared to be a natural choice as a new source of revenue. The first state sales tax arrived in 1932 when Mississippi converted its business levy into a retail sales tax by eliminating the multiple-tier structure of the levy and increasing the tax to a full 2 percent. Pennsylvania enacted its own sales tax the same year.[3] By May 1, 1934, fifteen states imposed sales taxes,[4] and, by the end of the Depression, fully 28 states and Hawaii had done the same.[5] When adopted, sales taxes were viewed as emergency measures necessitated by the unique economic circumstances of the Depression. They were not intended to be a permanent source of revenue. The legislation that created the sales tax in 11 states included requirements that it expire by 1937.[6] Interestingly, shortly after the states began adopting sales taxes in significant numbers, a federal tax on retail sales was proposed, but was ultimately rejected because it was viewed as regressive.[7]

The second phase of adoption of state sales taxes began in 1947, when Tennessee instituted the tax. By 1969, 45 states had a sales tax. The states have grown increasingly reliant upon this form of taxation. Sales and use taxes now account for over one-third of all state tax revenues and approximately 11 percent of local government tax revenues. Among those states that have sales and use taxes, reliance ranges up to a high of 80 percent of total tax revenues in Nevada. The sales tax, once viewed as a temporary, emergency measure, is now well-ensconced in state tax systems.

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3 Shoup and Haimoff, "The Sales Tax," 34 Colum. L. Rev. 809, 810 (1934).

4 Hellerstein, "Significant Sales and Use Tax Developments During the Past Half Century," 39 Vand. L. Rev. 961, 962 (1986).

5 Due and Mikesell, *Sales Taxation: State and Local Structure and Administration* 2(1983); Neil H. Jacoby, *Retail Sales Taxation* 75-77 (1938).

6 Carpentier, "State Sales Taxes on Services: A Perspective on the 'New Old Tax,'" Det. L. R., 561, 572 (1992).

7 Margaret G. Myers, *A Financial History of the United States* 65 (1970) *See also Carpentier, supra*. Although Congress rejected a general retail sales tax at the federal level, it did levy excise taxes on liquor, tobacco, occupational licenses, and certain other products. *Id.*

The initial popularity of the sales tax, among governments, businesses, and consumers, was due to its simplicity and low rate. The tax was collected at the sales counter, at a single rate, when the consumer, the retailer, and the product were all in the same place at the same time. The tax rate was generally one or two percent, and there was only one jurisdiction whose tax code applied to all sales by the retailer.

From its modest beginnings, acceptance of the sales tax by state and local governments grew rapidly. Today, there are over 7,500 different sales and use tax jurisdictions in the United States, and the number of taxing jurisdictions increases every year. Over 30,000 local jurisdictions have the legal authority to impose such taxes should they so choose. As sales taxes spread across the country, they grew in complexity. In each state, unique and confusing definitions, exemptions, and tax rates evolved. These systems have also been in a perpetual state of flux. Each year and for each state, ornate tax exemptions and exclusions are added and deleted, and definitions are modified. As a result, among the states there is absolutely no consistency, or coordination, regarding tax bases or systems of tax administration. Moreover, sales tax rates continue to rise. The average sales tax rate, combining state, county and municipal levels, reached 8.25 percent in 1998.[8] The average combined rate has increased every year since 1981, when the average rate was 6.74 percent.

¶ 1002 CONSTITUTIONAL RESTRICTIONS ON THE SCOPE OF STATE POWER TO IMPOSE TAX COLLECTION OBLIGATIONS

¶ 1002.1 Constitutional Limitations

Although the sales tax is a consumption tax (*i.e.*, a tax on consumers' use of goods), state and local governments have relied upon retailers to collect the tax at the time of sale.

[8] Information obtained from Vertex, Inc. (a developer of state and local tax compliance software based in Berwyn, Pennsylvania). The national average sales/use tax rate for states was 5.1 percent. The combined average rate for cities and counties reached a record high of 3.14 percent. The Cullman County portion of Arab, Alabama has the highest combined sales tax rate (11 percent) in the country.

When a transaction occurs completely within a state, the state clearly has the authority to impose a tax collection and remittance obligation on the in-state merchant. However, when the seller and buyer are located in different states, and the product sold is delivered by an interstate common carrier, then the Commerce Clause of the United States Constitution[9] limits the extent to which a tax collection obligation can be imposed on an out-of-state merchant.

On its face, the Commerce Clause is simply an affirmative grant of power to Congress "to regulate Commerce with foreign nations, and among the several States, and with the Indian Tribes." It says nothing about the protection of interstate commerce in the absence of any action by Congress. Early in our constitutional history, however, the Supreme Court interpreted the Commerce Clause as also prohibiting the states from regulating those aspects of interstate and foreign commerce which are inherently national in character and require a uniform rule that only Congress could provide.[10] Thus arose the doctrine of the "dormant" or "negative" Commerce Clause.[11] In *Case of the State Freight Tax*, the Supreme Court employed this doctrine as a limitation on state power to tax interstate commerce.[12]

At first, the Supreme Court adopted a view that the Commerce Clause prohibited the taxation by a state of "interstate commerce in any form."[13] That approached changed radically with the adoption of the multiple taxation doctrine in 1938. In *Western Live Stock v. Bureau of Revenue*, the Supreme Court upheld a business privilege tax on activities that crossed state borders.[14] The court pointed to the need for state taxing systems to accommodate themselves to the "demand that interstate business pay its way," subject to the proviso

[9] Art. 1, § 8, cl. 3.

[10] *Cooley v. Board of Wardens*, 53 U.S. 299 (1852).

[11] In an earlier case, *Gibbon v. Ogden*, 22 U.S. 1 (1824), Justice Johnson suggested in his concurring opinion that the Commerce Clause is more than an affirmative grant of power but has a negative sweep as well.

[12] 82 U.S. 232 (1872).

[13] *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888).

[14] 303 U.S. 250 (1938).

that such business "not be burdened with cumulative exactions which are not similarly laid on local businesses."[15]

The current test for determining the validity of a state tax under the Commerce Clause can be found in *Complete Auto Transit, Inc. v. Brady*.[16] The test has four parts. First, the tax must be applied to an activity that has a substantial nexus with the state. Second, the tax must be fairly apportioned to activities carried on by the taxpayer in the state. Third, the tax must not discriminate against interstate commerce. Fourth, the tax must be fairly related to services provided by the state.[17]

The first prong of the *Complete Auto* test, requiring that a "substantial nexus" be shown, echoed the Court's 1967 decision in *National Bellas Hess, Inc. v. Dep't of Revenue*, the landmark decision confirming the need for a physical presence in the taxing state before sales and use tax collection obligations can be imposed on a nonresident retailer.[18] Satisfaction of this first part of the *Complete Auto* test has been the primary consideration in limiting a state's power to impose sales and use tax collection and remittance obligations on remote sellers. A state tax affecting interstate commerce will not be sustained unless there is a substantial nexus between the state and the person, property, or transaction it seeks to tax. In the sales and use tax context, the issue is not

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[15] *Id.* at 258. The Commerce Clause analysis thus shifted to an inquiry as to whether the interstate business being taxed was subject to multiple taxation, either actual or potential.

[16] 430 U.S. 274 (1977). It must be noted, however, that serious disagreement exists among the current Justices of the United States Supreme Court as to whether the dormant Commerce Clause doctrine is legitimate. Justice Scalia believes that there exists no textual support for the notion that, by its silence in matters affecting interstate commerce, Congress erects a zone of non-interference prohibiting state regulation. *See, e.g., Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232, 260 (1987) (Scalia, J., concurring in part, dissenting in part). "There is no conceivable reason," Justice Scalia wrote, "why congressional inaction under the Commerce Clause should be deemed to have the same preemptive effect elsewhere accorded only to congressional action. There, as elsewhere, 'Congress' silence is just that—silence.'" *Id.* at 232, 262 (citation omitted).

[17] The *Complete Auto* standard found its beginnings in *Northwest States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), in which the Supreme Court allowed the door to open to non-discriminatory taxes affecting interstate actors.

[18] 386 U.S. 753 (1967).

whether a state has the authority to impose a tax on its residents' use of goods brought into the state after being purchased from an out-of-state vendor. Rather, the constitutional question is whether the out-of-state vendor has a sufficient nexus with the taxing state to support that state's delegation of a tax collection duty on the remote seller.

In *National Bellas Hess*, the Supreme Court rejected an attempt by Illinois to impose use tax collection and remittance obligations on a mail order company that lacked a physical presence in the state. The Supreme Court observed that National Bellas Hess did not maintain in the state "any office, distribution house, sales house, warehouse or any other place of business."[19] Nor did it have "in Illinois 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."[20] Finally, *National Bellas Hess* did not own any "tangible property, real or personal, in Illinois; it [had] no telephone listing in Illinois and it has not advertised its merchandise for sale in newspapers, on billboards, or by radio or television in Illinois."[21] Absent such a direct, physical presence in the taxing state, the Court held that *National Bellas Hess* could not be enlisted, against its will, as a tax collector for the State of Illinois without violating the company's rights under the Commerce Clause and the Due Process Clause of the Fourteenth Amendment to the United States Constitution.[22]

In *Quill Corp. v. North Dakota*, the Supreme Court reaffirmed its holding in *National Bellas Hess*, that a state lacks

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[19] *Id.* at 754.

[20] *Id.*

[21] *Id.*

[22] *Id.* at 756-58. The Court reached this conclusion over a strenuous dissent by three Justices. Justice Fortas, writing in dissent, observed that "[t]here should be no doubt that this large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market is a sufficient 'nexus' to require Bellas Hess to collect from Illinois customers and to remit the use tax, especially when coupled with the use of the credit resources of residents of Illinois, dependent as that mechanism is upon the State's banking and credit institutions. Bellas Hess is not simply using the facilities of interstate commerce to serve customers in Illinois. It is regularly and continuously engaged in 'exploitation of the consumer market' in Illinois." *Id.* at 761 (citation omitted).

the power to compel an out-of-state vendor with no physical presence in the state to collect use taxes on goods sold to customers in the taxing state.[23] The Court rejected the adoption of an "economic presence" test, as urged by the states, and maintained, a "bright-line" physical presence test which the court concluded was both more certain and more consistent with precedent. The Court held that ". . . the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause"[24] ; and that ". . . a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals."[25]

In restricting state taxing authority, the Supreme Court in *Quill* recognized the substantial burdens which would be

[23] 504 U.S. 298 (1992). In the years intervening between the *National Bellas Hess* and *Quill* decisions, the Supreme Court continued to apply the "substantial nexus" test in sales and use tax collection cases, as well as in cases involving other kinds of state taxes. Perhaps the most important case decided in this intervening period was *National Geographic Soc'ty v. Board of Equalization*, 430 U.S. 551 (1977). In *National Geographic*, the Court rejected California's effort to replace the "substantial nexus" test with a "slightest presence" test—an effort presaging the current tactics of some state tax administrators to reduce the level of physical presence required by the Commerce Clause to an absolute minimum. However, the Court also explained that the physical presence required to impose use tax collection obligations did not need to be related to the mail order operations sought to be taxed. Thus, the maintenance by National Geographic of two offices in California for other company business satisfied the *National Bellas Hess* standard. *Id.* at 556. In *dictum*, the Court suggested that the nexus standard would be even higher in the case of a direct tax—such as an income or franchise tax—rather than a case involving the mere collection and remittance of tax from third parties. *Id.* at 560. However, the Court has not had occasion to decide explicitly whether such an enhanced level of instate presence must be shown in connection with direct taxes, and a significant dispute has arisen among state courts and taxing agencies as to whether the "substantial nexus" rule, or a variant thereof, applies to non-use tax collection cases.

[24] *Id.* at 314.

[25] 504 U.S. at 316. The Court observed that the Commerce Clause "substantial nexus" requirement is not the same standard as the Fourteenth Amendment Due Process "minimum contacts" requirement. Consequently, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause and yet lack the 'substantial nexus' with the State as required by the Commerce Clause." *Id* at 313. Indeed, the *Quill* Court held that the out-of-state mail order company satisfied Due Process nexus requirements because it "purposefully directed its activities at North Dakota residents." *Id* at 308. It did not, however, have "substantial nexus" with North Dakota for Commerce Clause purposes because it did not meet the physical presence test.

associated with multistate tax collection if the Commerce Clause did not constrain the scope of state taxing power. The Court referred to the fact that ". . . obligations might be imposed by the Nation's 6,000 plus taxing jurisdictions" and also referred to the "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements [which] could entangle a mail order house in a virtual welter of complicated obligations."[26]

The dormant Commerce Clause, however, is only a restraint on state taxing power in the absence of congressional action. It does not restrict Congress, pursuant to the exercise of its Commerce Clause powers, from granting states authority to impose use tax collection duties on remote sellers.[27] Although bills toward that end have been repeatedly introduced at the urging of state and local governments,[28] Congress has steadfastly declined to enact such a law. State and local governments persist, however, in seeking federal legislation that would extend the jurisdictional reach of their tax systems across state borders to impose duties on merchants throughout the United States.

While the *Quill* decision upheld the need for an instate physical presence as a prerequisite to a state imposing sales and use tax collection and remittance obligations on nonresidents, it did not bring to an end disputes concerning the scope of the substantial nexus rule. Even after *Quill*, many states continue to press for increased authority over non-resident sellers, including both mail order companies and Internet retailers. While the states are no longer asserting that the physical presence requirement should be replaced by an "economic presence" test in sales and use tax cases, they now

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[26] 504 U.S. at 313.

[27] The *Quill* Court observed: "No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions." 504 U.S. at 318.

[28] *See e.g.*, S. 1825, 103rd Cong., S. 1825, Tax Fairness for Main Street Business Act of 1994; S. 545, 104th Cong., Consumer and Main Street Protection Act of 1995; S. 1586, 105th Cong., Consumer and Main Street Protection Act of 1997.

contend that the physical presence can be satisfied by slight and indirect physical contacts within the taxing state.[29]

¶ 1002.2 State Court Decisions After *Quill*

Prior to the *Quill* decision, states sought to challenge directly the "substantial nexus" rule enunciated in *National Bellas Hess*. They did so through litigation and by amending their sales and use statutes to reach companies which lacked a physical presence within their borders. A majority of the statutes intended to overrule the "substantial nexus" test remain on the books, despite being unconstitutional.[30] The principal argument adopted by the states, and explicitly renounced in *Quill*, was that a sufficient volume of commerce involving instate consumers was enough to overcome any constitutional obstacles to forcing direct marketers to collect and remit sales and use taxes.

After *Quill*'s reaffirmation of the *National Bellas Hess* decision, however, the battleground shifted. Through litigation, many states are now focused on defining the outer reaches of the concept of substantial nexus and its core

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[29] Because *Quill* involved sales and use taxes only, a number of states have argued, some successfully, that the physical presence rule should not apply to other taxes. In *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993), the Supreme Court of South Carolina declined to follow the *Quill* rule in a case involving the taxation of royalty income. Geoffrey, Inc. ("Geoffrey"), a subsidiary of Toys R Us, Inc. ("Toys R Us"), licensed its trademark and tradenames to Toys R Us for use in retail stores in South Carolina. In return, it received royalties. Geoffrey, itself, had no physical presense in South Carolina. "In our view," the court wrote, "Geoffrey's reliance on the physical presence requirement of *Bellas Hess* is misplaced." 313 S.C. at 23. More recently, however, the Court of Appeals of Tennessee rejected the distinction made in *Geoffrey*, holding that the "substantial nexus" rule applied to all state taxes, including franchise and excise taxes. *J.C. Penney National Bank v. Johnson*, No. M1998-0497-COA-R3CV,1999 WL 1206684, slip op. (Tenn. Ct. App. Dec. 17, 1999). In *J.C. Penney*, the taxpayer ("JCPNB") was a federally charted national banking association incorporated and with its principal place of business in Delaware. The Tennessee Department of Revenue sought to impose franchise and income taxes against JCPNB on income generated by credit card activities within the state. In rejecting the argument that *Quill* did not apply, the Court of Appeals explained that "[w]hile it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be any different in the present case."

[30] *See* David E. Hardesty, "Sales and Use Tax and E-Commerce," *eCommerce Strategies for Success In the Digital Economy* § 1189 (P.L.I. 1999).

physical presence requirement. In other words, rather than attacking the need for an instate physical presence, states are engaged in an effort to lower and redefine the physical presence threshold itself.[31] Significant litigation has ensued as to when, and under what circumstances, *Quill*'s bright-line has been crossed. Since 1992, state courts have looked not only at the nature of instate activities that might lead to the requisite nexus, but have also wrestled with whether or not such activities are of a sufficient quality or quantity to justify the imposition of sales tax collection obligations. The resulting decisions have been inconsistent and, in some instances, contradictory. As a result, interstate retailers face an array of constitutional interpretations as varied and confusing as the state sales tax systems themselves.

At one end of the continuum of post-*Quill* nexus decisions is *Orvis Company, Inc. v. Tax Appeals Tribunal of the State of New York*, decided in 1995 by the Court of Appeals of New York.[32] *Orvis* represents a reduction of the physical presence requirement to a barest minimum. In *Orvis*, the court held that the physical presence required by the Commerce Clause need not be "substantial." "Rather," the court wrote, "it must be demonstrably more than a 'slightest presence.' "[33] Once this low threshold was set, the court found it easily satisfied. According to the court, the evidence suggested "systematic visitation [by Orvis' personnel] to as many as 19 wholesale customers on the average of four times a year [during a three

[31] Among the theories being considered or advanced by states in the wake of *Quill* are, for example, that the leasing of goods creates nexus since the lessor retains title to the leased goods or that "affiliate" referral relationships between internet sellers and third parties create a sufficient "agency" relationship for nexus purposes. States have also actively attempted to impute the nexus of instate "brick and mortar" retailers to their mail order subsidiaries or affiliates.

[32] 86 N.Y.2d 165, 654 N.E.2d 954, 630 N.Y.S.2d 680, *cert. denied*, 116 S.Ct. 518 (1995). The *Orvis* decision actually consolidated two cases, one involving The Orvis Company, Inc. ("Orvis") and the other involving Vermont Information Processing ("VIP"), Inc. Both cases involved the same underlying Commerce Clause nexus question. Only VIP sought a writ of *certiorari* from the United States Supreme Court.

[33] 630 N.Y.S.2d at 687 (citations omitted). The court in *Orvis* obviously recognized that, in *National Geographic Society v. Board of Equalization*, 430 U.S. 551, 556 (1977), the United States Supreme Court had explicitly rejected a "slightest presence" test for nexus purposes.

year period]."[34] As for VIP, the evidence showed travel to New York customers on "41 occasions [over three years] to resolve the more intractable problems involving its computer hardware."[35] In both instances, the Court of Appeals viewed these activities as "definite and of greater significance than merely a slightest presence."[36]

Several courts have subsequently adopted the *Orvis* test, though none of those case presented as thin a connection to the taxing state as *Orvis*.[37] In *Brown's Furniture, Inc. v. Wagner*, the Supreme Court of Illinois relied on *Orvis* in declining to require that a substantial physical presence was necessary to impose use tax collection obligations. "The *Orvis* court stated—correctly, we believe—the rule regarding substantial nexus"[38] The court found that the *Orvis* test was easily met by Brown's averaging "between 15 and 18 trips into Illinois per month" to deliver furniture in company trucks.[39] In *Magnetek Controls, Inc. v. Dep't of Treasury*, a case involving a single business tax, the Michigan Court of Appeals observed that "[o]f the many precedents cited by both parties

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[34] *Id.* at 688.

[35] *Id.*

[36] *Id.* (citation omitted).

[37] In a vigorous dissent in *Orvis*, two of the judges on the Court of Appeals recognized how minimal a connection to New York existed in the case, and concluded that "the minuscule, infrequent activities in New York by [Orvis and VIP] do not satisfy the 'substantial nexus' threshold requirement imposed by the Commerce Clause of the United States Constitution (art. I, 8, cl. [3]), and the governing interpretations promulgated by the United States Supreme Court. It seems to us that the majority's articulation miscasts the evolution of United States Supreme Court Commerce Clause precedents and injects confusion when a 'substantial nexus' bright line has been the guiding hallmark and jurisprudential goal. Functionally and commercially, telling out-of-state businesses that they dare not dip their toes within New York's borders without incurring New York taxes is not the teaching of the United States Supreme Court cases. Rather, deterring interstate traffic in such respects by taxation is precisely what is forbidden under the mantle of the Commerce Clause. Thus, absent evidence of a 'small sales force, plant, or office' (*Quill Corp. v. North Dakota*, 504 U.S. 298, 315, 112 S.Ct. 1904, 1914, 119 L.Ed.2d 91), or 'continuous local solicitation' (*Scripto v. Carson*, 362 U.S. 207, 211, 80 S.Ct. 619, 621, 4 L.Ed.2d 660 [emphasis added]), within New York State, imposition of the taxes at issue should be unconstitutional." *Id.* at 688-89 (Bellacosa, J, dissenting).

[38] 171 Ill.2d 410, 424, 665 N.E.2d 795, 216 Ill. Dec. 537, *cert. denied*, 519 U.S. 866 (1996).

[39] *Id.* at 425. Of note, the court in *Brown's Furniture* hinted that the result might

from other jurisdictions applying *Quill*, we find [*Orvis*] most instructive."[40] The court rejected the argument that "substantial nexus requires 'substantial amounts of in-state people or property' and that an in-state sales force continuously soliciting customers is needed."[41]

At the other end of the continuum of post-*Quill* cases—the end favoring a more expansive view of the physical presence necessary to create a substantial nexus—is *Dep't of Revenue v. Share Int'l, Inc.*[42] In *Share*, the Florida District Court of Appeal held nexus was not created even though Share employees sold products at instate seminars, a decision later upheld by the Supreme Court of Florida. For three days each year, Share displayed and sold chiropractic supplies and training materials at locations in Florida.[43] In concluding that an insufficient physical presence existed, the District Court of Appeal rejected the Department of Revenue's argument that a slight physical presence created tax liability. Even if a vendor possessed a physical presence in the state, the court observed, it still "must be determined whether the vendor's activities within the state establish a substantial nexus with the taxing state such that imposing the duty to collect and remit tax on sales to residents of the taxing state does not violate the Commerce Clause."[44] The *Share* approach was also adopted by the Arizona Board of Tax Appeals in *Care Computer Systems, Inc. v. Arizona Dep't of Revenue*.[45] In *Care*, the Board wrote that, to have the requisite nexus, "a business must have more than just a large number of sales and occasional visits of personnel."[46]

Numerous state court cases have produced results that fall somewhere between the extremes of *Orvis/Share* contin

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[40] 221 Mich.App. 400, 410, 562 N.W.2d 219 (1997).

[41] *Id* at 411-12.

[42] 667 So.2d 226 (App. 1995), *aff'd*, 676 So.2d 1362 (Fl. 1996), *cert. denied*, 519 U.S. 1056 (1997).

[43] *Id*. at 227.

[44] *Id*. at 230.

[45] Docket No. 1049-93-3, 1995 WL 331507 (Ariz. Bd. Tax Appl. 1985).

[46] *Id*.

uum.[47] Litigation in this area has accelerated in recent years, leading to a relatively large number of reported and unreported decisions by courts and administrative agencies. Most recently, in *J.C. Penney, supra* note 29, in applying the substantial nexus test in a franchise and excise tax case, the Court of Appeals of Tennessee held that the requisite instate presence had not been established. First, the court rejected the Commissioner's argument that JCPNB's ownership of between 11,000 and 17,000 credit cards in Tennessee created a sufficient physical presence. "While we agree that a credit card is tangible and that it can be seen and touched, we do not agree that the presence of the credit cards in Tennessee is constitutionally significant. Additionally, we do not find it relevant that JCPNB retained ownership of the cards."[48] The court also rejected the Commissioner's argument that JCPNB had nexus because its parent corporation of owned and operated retail stores in the state. "This argument lacks merit," the court wrote, "because the retail stores were not affiliated with JCPNB's Visa and MasterCard credit card operations."[49] "The record shows that one could not apply for the JCPNB credit cards at the J.C. Penney retail stores, nor could individuals make payment on their Visa and MasterCard account at the retail stores."[50]

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[47] *See, e.g.*, *Furnitureland South, Inc. v. Comptroller*, Docket No. C-97-378720C, slip op. (Cir. Ct. August 13, 1999)(finding nexus on the basis of activities by third party company that delivered, assembled, set-up, and repaired furniture sold by the taxpayer and promoted the taxpayer's business); *Talbot's, Inc. v. Arizona Dep't of Revenue*, Docket No. 1255-94-s/u, 1995 WL 767154 (Ariz. Bd. Tax App. 1995) (the physical presence required to create nexus must be " 'real,' 'true,' 'important,' 'essential,' 'considerable in quantity,' and 'significantly large' ").

[48] Slip op. at 7.

[49] Slip op. at 8.

[50] *Id.* A number of other state courts, before and after *Quill*, have addressed the issue of whether the presence of a corporate subsidiary or affiliate in the taxing state can create the requisite nexus. *See* Bertoni and Eisenstein, "Defending Against Affiliate Nexus In Sales and Use Tax Collection Liability Cases," 6 Journal of Multistate Taxation 1 (1996). The general principles that can be gleaned from such cases is that nexus may be imputed between related corporations if (1) the affiliate or subsidiary is substantially dominated and controlled by its corporate relative or they are substantially integrated in their operations; (2) separate incorporation was accomplished solely for some improper purpose; or (3) the affiliate, subsidiary, or parent acts as the instate agent of the taxpayer. *Id. See, e.g.*, *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn.), *cert. denied*, 501 U.S. 1223 (1991)(finding in

¶ 1003 INHERENT SHORTCOMINGS OF STATE SALES AND USE TAX SYSTEMS

Extension of tax collection duties to remote sellers (*i.e.*, retailers that have no physical facilities or employees within the taxing state) would be the next historic stage in the growth of sales and use taxation in this country. State and local government officials argue that an expansion of their tax jurisdiction is urgently needed because Internet sales by out-of-state merchants are causing a substantial loss of tax revenues. Some analysts believe that such fears are overstated.[51] Moreover, many advocates of electronic commerce believe that an expanded duty to collect taxes, especially under current sales and use tax systems, will impede the continued growth of e-commerce to the overall detriment of consumers and the national economy.

As a temporary, emergency tax during the Great Depression, the sales tax served its intended purpose well. The fiscal crisis then confronting the states required bold action. Mere inertia, however, is no justification for the maintenance of a bad tax system or for its further expansion. Indeed, at a time when states and local governments are calling for an enlargement of their sales and use tax authority, it is useful to examine the structural weaknesses of this form of taxation, and examine the unique problems sales and use taxes will encounter in an electronic commerce environment.

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favor of the taxpayer); *Bloomingdale's By Mail, Ltd. v. Dep't of Revenue*, 567 A.2d 773 (Pa. Cmmw. Ct. 1989), *aff'd*, 591 A.2d 1047, *cert. denied*, 504 U.S. 955 (1992)(accord); *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St. 3d 119, 652 N.E.2d 693 (1995)(accord).

[51] In a paper entitled "The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted By the Internet in 1998", Robert Cline and Thomas Neubig, economists with Ernst & Young, estimate that ". . . the sales and use tax not collected in 1998 from the increase in remote sales due to the Internet is less than $170 million, or only one-tenth of one percent of total state and local government sales and use tax collections." The small amount of lost tax revenue is due, in large part, to the fact that 80 percent of current e-commerce is business-to-business sales, which are either not subject to sales tax or the tax is directly paid by the business purchaser; and because most e-commerce sales are of intangible services, such as travel and financial services, which generally are not subject to sales tax.

¶ 1003.1 A Confusing and Uncoordinated Sub-National Tax System

The United States is a relative rarity among economically developed countries in having an extensive system of sub-national transaction taxes. In contrast to the Value Added Tax (VAT), common throughout Europe and imposed at the national level, transaction taxes in the United States are the primary prerogative of the states and their political subdivisions.[52] The result has not only been an enormous number of taxing jurisdictions, but a totally uncoordinated system of taxation among the states. For interstate merchants that have nexus in every state, the compliance challenges are daunting.

As currently structured, there is no consistency or uniformity among the states as to tax rates, exempt products, exempt transactions, definitions, reporting and remittance requirements, and audits. The states defend their disparate tax systems on the grounds of "state rights," and point to the constitutional doctrines of federalism and state sovereignty in support of their position. Such an insistence on maintaining totally independent tax systems provides a disturbing backdrop to the states' equally fervid insistence on the need to expand their tax jurisdiction to remote sellers located far beyond their borders.

¶ 1003.2 Regressive Taxation

A "regressive tax" is one that takes a bigger share of taxpayers' income as their income falls, in contrast to a "progressive tax" which takes a larger share of personal income as income rises. A progressive income tax, for example, has progressively higher tax rates for successively higher income brackets.

The sales tax is an inherently regressive tax. Low and middle-income families spend a proportionately larger share

[52] In addition to the 45 state sales taxes, 32 states now authorize local option taxes. Twenty-six states allow multiple jurisdictions (counties, municipalities, special districts) to levy a tax, while 6 states allow only counties to levy sales taxes. Two states allow only cities to levy the tax.

of their disposable income on consumables than do higher income families. (The savings and investments of high-income families are not subject to the sales tax.) Consequently, even though a high income taxpayer may incur a greater total annual sales tax liability, in terms of absolute dollars, than does a person of more modest means, such taxes are invariably a much smaller percentage of the wealthy person's total income than are the annual sales taxes paid by a person who earns less. Higher tax rates on tobacco, alcohol, telephone charges, and gasoline can have an even greater regressive impact. Many states attempt to ameliorate the regressive impact of sales taxes by exempting essential goods, such as prescription drugs, non-prescription drugs, and food.[53] Not all states grant such product exemptions, however, and, even where such products are excluded from the tax base, the effect is only to lessen, and not eliminate, the regressive effect of the sales tax.[54] The exclusion of services from the sales tax base enhances the regressive nature of the tax. The wealthy regularly employ the professional services of lawyers, accountants, investment advisors, etc. Such services are less frequently used by middle and low-income families.

¶ 1003.3 Double Taxation

Of the 45 states that have adopted sales taxes, 37 of those states also impose personal income taxes on their citizens. Consequently, most states are taxing the same income twice—once when the taxpayer's money is earned and again when the taxpayer's money is spent. Such a system of double taxation by a single governmental entity is fundamentally unfair.

The problem of double taxation is worsened when the relationship between state sales taxes and federal income taxes is examined. Prior to the Tax Reform Act of 1986, all state and local taxes, including sales and use taxes, were

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[53] Of the 45 states with sales and use taxes, 26 states exempt food from their state sales tax base, 8 states exempt non-prescription drugs, and 44 states exempt prescription drugs.

[54] See Citizens For Tax Justice & Institute On Taxation And Economic Policy, *Nickels & Dimes: How Sales & Excise Taxes Add Up In The Fifty States* (1988).

deductible from federal income taxes, at least for those taxpayers who itemized their deductions.[55] The problem of taxpayers having to maintain accurate records of their retail purchases was alleviated by the I.R.S. providing taxpayers with standardized tables of estimated sales taxes paid. The Tax Reform Act eliminated the deductibility of state sales taxes, but continued the deduction for other state and local taxes, including income taxes and property taxes.

The net effect is that Americans owe federal income taxes on the sales and use taxes they pay to their state and local governments. One might have expected that the Tax Reform Act of 1986 would have resulted in a change in state tax policies away from reliance on sales and use taxes. Because state and local income and property taxes are deductible from federal income taxes, a shifting of the tax burden to those taxes would result in a "tax break" for citizens when it came time to pay their federal income taxes. This did not occur, however. Since the Tax Reform Act of 1986, states and localities have steadily increased their sales tax rates, and they have maintained their overall levels of reliance on those taxes as a percentage of their total tax revenues.

A different form of double taxation occurs when a sales tax is imposed on goods purchased by a business which is itself involved in the manufacture and sale of tangible personal property. In this situation, there is a form of tax pyramiding, which is inconsistent with the theory that a sales tax is supposed to tax only the final purchase of goods for consumption. Double taxation through tax pyramiding is minimized by the provision of exemptions for goods purchased for resale, raw materials, and equipment used or consumed in the production of property for sale. These business input exemptions are incomplete, however, and to avoid all double taxation, all business purchases should be exempted from application of the sales tax.

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[55] I.R.C. § 164 (1986).

¶ 1003.4 Intrusion On Consumer Decisions

The state income tax is a less intrusive and discriminatory form of taxation on earned and disposable income than is the sales tax. Generally, an income tax on earnings does not distinguish between various types of employment. Residents are taxed on their earnings, whether the source of that income is from hourly wages, salaries, fees for professional services, etc. The income tax does not have a bias, or distorting effect, on individual decisions regarding how to earn a living.

On the other hand, the sales tax is highly discriminatory in its treatment of disposable income, and there are substantial tax consequences that flow from consumers' decisions on how to spend the money they have earned. For example, because most states exclude services from the sales tax base, if a consumer goes to a hair stylist to change the color of his or her hair, there is no tax imposed on the amount charged for that service. If the same consumer goes to a drug store and buys a hair dying kit in the cosmetics department, the sales tax is added to cost of the goods. These anomalies are common in the current scheme of state sales taxes. It is hard to understand the public policy underlying the difference in tax treatment of two similar transactions, or, for that matter, why consumer spending decisions should be favored or disfavored by government tax policy.

Certainly, there is a limited role for the use of taxes to influence consumer spending. For example, high taxes on liquor and tobacco products are specifically intended to deter use of those products. Such "sin taxes" are justified as a means of furthering government social policy.[56] Similarly,

[56] It is ironic that many state governments are in the business of promoting "sin," as well as taxing it. State governments run or participate in the operation of gambling programs, in the form of lotteries, in 37 states, with total lottery sales of approximately $36 billion per year. Moreover, it can not be argued that state-sponsored gambling is merely a means of controlling an undesirable activity in which individuals would participate in the absence of a state-controlled monopoly. In 1996, state governments spent over $400 million to promote their state lotteries. It is also important to note the regressive nature of such lotteries, if the income obtained by the states is viewed as a form of tax on gambling proceeds. A substantial portion of the revenue states realize from lotteries comes from individuals with relatively low incomes, many even below the poverty level.

imposing a high tax on gasoline sales to encourage car-pooling and deter the manufacture of gas-guzzling automobiles could further government conservation and environmental policy. Sales tax proponents, however, make no claim that the overall purpose of the sales tax is to deter the purchase of the goods to which the tax applies. To the contrary, sales tax advocates rely on the unproven belief that consumer spending is relatively constant and inelastic and, therefore, consumer decisions are unaffected by the imposition of a sales tax.[57]

The impact on consumer spending decisions is not due solely to the discrimination in sales tax treatment between goods and services. Goods themselves are selectively chosen for inclusion and exclusion from the sales tax base in a relatively arbitrary manner. Indeed, the only clear factor in driving those decisions appears to be the lobbying influence of particular trade and consumer groups within a state. The arbitrary nature of these differences in state tax bases is demonstrated by the wide variations among the states in the products subject to tax. This non-neutral application of the sales tax makes this form of taxation extremely intrusive into the personal buying decisions of individual taxpayers, certainly more so than with the state income tax or local property tax.

¶ 1003.5 Volatility of Sales Taxes

Sales tax revenues vary considerably with economic cycles. The level of volatility is greater than with other types of taxes. Tax collections slow dramatically during recessions, as consumers defer major purchases for such durable goods as automobiles and major appliances. Recreational and entertainment spending declines, as travel and dining out are among the first casualties of reduced personal incomes. A decline in tourism results in reduced lodging and meal tax

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57 State tax officials take inconsistent positions regarding the impact of sales taxes on consumer buying patterns. In their defense of the overall sales tax structure, officials argue that the sales tax does not impact personal buying decisions because the rate is not high enough to influence consumer spending. On the other hand, state tax officials rail against the impact of cross-border sales (consumers crossing state borders to make purchases in no-tax or low-tax states) and the loss of revenues due to mail order sales where no use tax is collected by the out-of-state merchant.

revenues. As new home construction slows, so does the purchase of home furnishings. The revenue loss to those states that are highly dependent on the sales tax can be substantial.[58] Conversely, during times of economic boom, sales tax revenues are likely to increase rapidly. These fluctuations are generally unpredictable, turning revenue estimating and the budgetary process into a guessing game. The boom and bust cycle is a major problem for those states that are most reliant on the sales tax.[59]

Tax systems that are more dependent upon the personal and corporate income tax generally have less volatile revenue streams. Moreover, the annual growth rates of those states' tax revenues tend to match more closely the states' overall economic growth rates. In sales tax dependent states, however, revenue growth often lags behind growth in personal income. This is due to the narrow base of the sales tax. While the sales tax base is usually limited to tangible personal property, the service sector has been the most rapidly expanding area of commerce in most states in recent years. Because state sales taxes have not been broadly applied to the consumption of services, sales and use tax revenues have grown at a slower rate than the states' economies as a whole.[60]

One possible response to the problem of sales tax revenues lagging behind economic growth rates would be to raise the sales tax rate. Indeed, nationwide average combined state and local sales tax rates have steadily risen over the last 25 years. As the tax rate increases, of course, the various adverse impacts of the sales tax become more pronounced and problematic. An alternative response would be to broaden the tax base to include services as well as tangible personal property. Application of the sales tax to professional and consumer

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58 *See* Zingale & Davies, "Why Florida's Tax Revenues Go Boom or Bust, and Why We Can't Afford It Anymore," 14 Fla. St. U, L. Rev. 433 (1986). Florida relies on the sales tax for approximately 70 percent of its tax revenues and does not levy a personal income tax.

59 *See* Williams, "The Sales Tax Roller Coaster," Florida Trend Magazine, July, 1990.

60 *See* State Comprehensive Plan Committee, *Keys To Florida's Future: Winning In A Competitive World* 25 (1987) (Commission established by Ch. 85-57, §3, 1985 Fla. Laws 295, 322).

services, however, presents a number of administrative problems, including the difficulty of "situsing" many service transactions for sales tax purposes. Of even greater significance is the unpopularity of a tax on services among the general public. When the concept has been seriously considered, or adopted, it has invariably met with blistering opposition from both consumers and professional groups.[61] Given the fate of service tax proposals in the past, it is unlikely that an expansion of the sales tax to include services will be widely adopted in the future.

¶ 1003.6 "Fiscalization" of Land Use Decisions

The local option tax has become an increasingly common means for sub-state political jurisdictions to raise revenue. There are now over 7,500 local tax jurisdictions in the United States. Moreover, it is not uncommon for these local tax jurisdictions to pile one sales tax rate on top of another.[62] The increased dependency of local governments on the sales tax to fund their budgets[63] has resulted in aggressive competition among counties and municipalities to induce retailers to locate retail facilities within their borders.

This process of local officials promoting sales tax-generating projects, such as shopping centers and automobile malls, over other land uses has produced a syndrome known

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[61] See Webber, "Florida's Fleeting Sales Tax on Services," 15 Fla. St. U.L. Rev. 613 (1987). It is useful to note that when the Florida services tax was repealed in 1987 (the same year that it was adopted), it was replaced with an increase in the sales tax on goods from five percent to six percent.

[62] For example, the current California sales tax rate is 6 percent. Cities in California generally receive an additional one percent, and counties receive another one-quarter percent. To this standard 7.25 percent minimum tax, another one-half percent was added for public safety programs in 1993. In addition, a number of jurisdictions are authorized to impose additional sales taxes (*e.g.*, transportation districts, hospital districts), bringing the rate up to as high as 8.75 percent in some areas. San Francisco and San Mateo counties are authorized to impose a tax rate of up to 9 percent and 9.25 percent respectively.

[63] In some states this increased reliance is attributable, at least in part, to citizen-initiated state constitutional amendments to restrict increases in property taxes. The best known of these initiatives is Proposition 13, passed by a two-to-one margin of California voters in 1978. (Cal. Const. Art.XIIIA) Overall, the sales tax accounts for 11 percent of total local government tax revenues.

as "fiscalization of land use." It has prompted one commentator to conclude that in the eyes of a municipal official "the vision of a model city is a monster mall surrounded by car dealers."[64]

The emphasis on promoting land use that will generate sales taxes has a number of distorting effects. Environmental concerns, preservation of open spaces, availability of reasonably priced residential housing, protection of neighborhoods are all demoted in their relative importance. As fierce rivalries develop among municipalities to attract large retail developments, the inevitable consequence is that local governments compete with each other in offering incentives to shopping center developers and large retailers for the siting of their facilities. These incentives often take the form of sales tax rebate agreements, by which a city promises to return a portion of the additional sales taxes generated by the new land use. Cities may also agree to subsidize the cost of developing the site, including the construction of water mains, sewer pipes, underground electrical conduits, and access roads. In other circumstances, cities are even willing to exercise their rights of eminent domain to secure land for private retail development.[65]

The fiscalization of land use decisions is largely the product of the winner-take-all nature of local sales tax systems. The municipality that wins the battle to attract a major shopping center gets to keep all of the local sales tax revenue generated, irrespective of where the shoppers reside. The end result is that both land use practices and tax policy suffer.

¶ 1003.7 Cognitive Profile

Despite its regressive nature, the sales tax is not disfavored among the electorate when compared to other forms of taxation.[66] One explanation for the public's apparent acceptance

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[64] Richard Day, Editorial, "Retail Boom a Bust; Mall Mania Not Revenue Answer," Press Democrat (Santa Rosa, Ca.), Dec. 11, 1994.

[65] *See* Note, "Prisoners of Proposition 13: Sales Taxes, Property Taxes, And The Fiscalization of Municipal Land Use Decisions," 71 S. Cal. L. Rev. 183 (1997).

[66] For example, a survey conducted by the Florida State University Department

of the sales tax is that, in comparison to the income tax and the property tax, the sales tax has a lower cognitive profile.[67]

The sales tax is an add-on. While the total sales tax due on a transaction may not be insubstantial, and certainly the annual cumulative cost of the sales tax on most families is considerable, a state or municipality's decision to raise the applicable sales tax by one percent or less may seem relatively minor at the time of its enactment. Few individuals will pause to calculate the annual impact of such a tax increase. To that extent, the tax has a low profile and is even somewhat hidden.

Although the average combined state, county and city sales tax rates have steadily risen in recent decades, the slow, incremental nature of those increases reduces their cognitive impact. It is also frequently assumed that "others" may bear the greatest portion of a sales tax increase. In-state residents may expect tourists to pick up a major portion of the tax. Low-income voters may believe that the wealthy buy more and, therefore, will pay more in sales taxes, not stopping to reflect on the relative impact of a sales tax increase on their lower disposable incomes. High-income taxpayers may be aware of, and welcome, the regressive nature of the sales tax.

In contrast, income taxes and property taxes have a high cognitive profile. When added to already high federal income taxes, any increase in state income taxes may seem confiscatory. Property taxes arrive in the form of a bill. The impact is sudden, substantial and often unbudgeted. Whereas the decision to make a particular retail purchase involves some measure of discretion, the property tax is an unavoidable obligation, and the consequences of non-payment are dire. The prospect of losing one's house through tax foreclosure, or even the remote possibility of facing such a dilemma at

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of Policy Science in 1988 asked Florida voters what type of tax increase they would prefer if state government had to raise taxes substantially. 38.7 percent said they would prefer an increase in the state sales tax; 30.2 percent said they would prefer that the sales tax be extended to services, 13.8 percent said they would prefer a state income tax be adopted, 8.7 percent expressed no opinion, 7.6 percent volunteered that they opposed any tax increase, and 1 percent volunteered that programs should be cut.

67 See McCaffery, "Cognitive Theory and Tax," 41 UCLA L. Rev. 1861 (1994).

some uncertain future time, strikes at the heart of the American dream of home ownership. These apprehensions are a powerful force, which can be channeled by any group opposing property tax increases. California's Proposition 13 demonstrates the political popularity of limiting property taxes.

¶ 1004 THE UNIQUE PROBLEMS OF APPLYING SALES AND USE TAXES TO ELECTRONIC COMMERCE TRANSACTIONS

¶ 1004.1 What's Different About Electronic Commerce

The sales tax is entirely dependent on geographic and political borders. Its administration requires identification of the specific tax jurisdiction with authority to impose its tax on a given transaction. When sales taxes were first adopted in the 1930s, there was little problem determining the location, or situs, of a sales transaction. Buyer and seller were present together at a real physical location and at a real point in time. As cash and goods were exchanged over the sales counter, it was a relatively easy task for a merchant to collect the appropriate tax amount. State and municipal borders were meaningful in a tax system where the location of brick and mortar stores governed selection of the applicable tax rate and regulations. The Internet, on the other hand, disregards municipal, county, state, and even national borders. In this respect, it is inherently anarchic. Information moves across the World Wide Web with no consideration for political boundaries.

It is not just communications that flow seamlessly across the Web. Increasingly, products themselves are delivered to customers in digital form. Moreover, many digital products can be substituted for items that are also sold in the form of tangible personal property. Books, magazines, newspapers, newsletters, music, videos, maps, and other information-laden products can be delivered instantaneously over the Internet from remote locations. The emergence of digital products presents a number of challenges to traditional sales and use tax systems.

The interchangeability of digital products and tangible goods results in discriminatory tax treatment of transactions, which are substantively identical. Intangible property is generally not subject to sales taxation, whereas the tangible counterparts of such products are taxed. It is not definitionally or administratively practical, however, to extend the sales tax only to those intangible products which are similar in substance to tangible goods.

The use tax is designed as a consumption tax, which is sitused, or sourced, to the destination where the consumer receives and uses the purchased goods. Consumers of digital products, however, can download their purchases anywhere they can plug in a computer. Digital products are sent to URLs and e-mail addresses, not to street addresses. A seller of digital products does not necessarily know, or need to know, the physical location of its customers. Indeed, as to corporate purchasers, multiple employees located in various states may access products. Consequently, a destination-based transaction tax, such as the state use tax, is ill-suited to electronic commerce transactions where the destination of the product being delivered may be unknown at the time of sale.

Anonymity is a key characteristic of the Internet, and privacy concerns are a high priority for both consumers and government agencies. Sales and use tax collection becomes extremely difficult, however, if the identity and state of residence of the purchaser is not disclosed as part of the sales transactions. New forms of electronic payment require neither customer billing addresses nor credit card information. Cyber cash and other "electronic wallets" store monetary value on computer chips or magnetic strips, and that value can be electronically debited and transferred to another party without going through an intermediary bank. Consequently, an electronic sales transaction can be completed with no personally identifiable information having been provided by the purchaser to the retailer, and none of the conventional audit trails of credit card or check payment are available.

¶ 1004.2 Use Tax Collection Compliance Burdens For Electronic Merchants

Even the sale of non-digital products, *i.e.*, tangible personal property, via the Internet is not well-suited to sales and use taxes. The sheer complexity of the current tax system, with its 7,500 tax jurisdictions, and the attendant variety of tax bases and administrative requirements, makes tax collection and remittance extremely difficult, especially for smaller merchants. The Internet holds great promise for small retailers. It affords them access to a national and international marketplace never before imagined. It allows them to develop niche markets which large retail chains may ignore. But if access to on-line selling requires registration with tax jurisdictions in every state, most small retailers will have to forego the opportunity, because the compliance burden of use tax collection will simply be too great. The Internet will become an arena in which only large companies can play.

The complexity and non-uniformity of state tax systems makes tax collection expensive for all multistate retailers, but especially for low volume merchants. A recent study reported that for firms selling nationally with collection responsibilities in all of the 45 states that have sales and use taxes, the costs of compliance ranged from 14 percent of the sales taxes collected for large retailers, to 48 percent for medium-sized retailers, to 87 percent for small retailers.[68] States and municipalities do not reimburse multistate retailers for their real costs incurred in collecting use taxes. Indeed, in most states, reimbursement rates, in the form of vendor discounts, are either non-existent or nominal.

Electronic commerce is global in scope. Internet ordering, combined with international airfreight delivery systems, makes it possible for a retailer in almost any country to sell to customers throughout the world. This trend will accelerate rapidly. In this global marketplace, it is unrealistic for states and their political subdivisions to expect that tax collection

[68] Cline and Neubig, "Masters Of Complexity And Bearers Of Great Burden: The Sales Tax System and Compliance Costs For Multistate Retailers," Ernst & Young Economics Consulting and Quantitative Analysis, September 1999.

responsibilities can be imposed on foreign merchants. Indeed, any effort by the states or Congress to impose such duties on foreign companies would likely meet with retaliatory restraints on U.S.-based electronic merchants seeking to sell digital and non-digital products via the Internet in overseas markets. The confusing variety of state and local taxes makes negotiation of international transaction tax treaties extremely difficult for the United States government.

¶ 1004.3 Efforts to Address the Problem

Government and industry leaders have recognized the problems associated with applying state sales and use taxes to electronic commerce. To be sure, these individuals approach the issue from very different perspectives. State, county and municipal officials fear that the growth of electronic commerce will erode their sales and use tax revenues for two reasons. First, most electronic transactions involve either interstate or international commerce, and states lack the constitutional authority to impose tax collection obligations on most remote sellers. Second, electronic commerce facilitates the sale of digital products, and such intangibles are not included in most states' sales and use tax bases. From the other direction, industry leaders are concerned that an antiquated transaction tax system will stunt the growth of electronic commerce and make transactions more burdensome for both business and consumers.

Under the auspices of the National Tax Association, government and industry leaders spent over two years examining whether and how state and local taxes, particularly state and local sales and use taxes, should be applied to electronic commerce. The members of the Steering Committee for this project were drawn from the principal associations representing state and local governments and industries involved with electronic commerce. The Final Report of the National Tax Association Communications and Electronic Commerce Tax Project was issued in September of 1999. All of the Project participants recognized the incompatibility of current sales and use tax systems with an electronic commerce environment:

> The complexity within states and the inconsistency among states in the existing state and local sales tax structure has been a major concern with respect to the ability of this structure to accommodate the world of electronic commerce. Although this is not a novel concern to state taxpayers and state tax administrators, it is one that is exacerbated in the context of electronic commerce because of the expectation that more vendors will be selling more products (digital and non-digital) into more states with less contact and less familiarity with the states and their tax systems than ever before. Consequently, the need for simplification of the sales and use tax system is apparent if it is to be a viable and administrable mechanism for raising revenue in the electronic environment.[69]

Among the sources of complexity the Project identified as being associated with the current sales and use tax system were "tax rates, the tax base, and tax administration."[70] Although the members of the Steering Committee agreed that no tentative recommendation adopted by the Steering Committee would be deemed final unless a total package of recommendations was ultimately agreed upon (which never occurred), the interim votes of the Steering Committee evidenced the need for radical reform of state sales and use tax systems. For example, one such resolution of the Steering Committee called for one rate per state for all commerce, whether transactions occurred within the state or originated outside the state.[71] The Project participants agreed that it would be impractical, discriminatory and probably unconstitutional to discriminate in tax rates between electronic commerce and non-electronic commerce or between in-state and interstate sellers.

The complexity and non-uniformity of the current system of state sales and use taxes were repeatedly referenced in the Project's Final Report. The need to simplify state sales and use taxes, and to make administration of those taxes more

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[69] National Tax Association Communications and Electronic Commerce Tax Project Final Report (1999) "NTA Final Report" Introduction, p.7.

[70] NTA Final Report, Introduction, p. 8.

[71] NTA Final Report, p. 13.

uniform among the states, was widely viewed as a necessary reform. In the end, however, the members of the Steering Committee were not able to agree on the details of such reform measures or even the extent of reform that is necessary. The participants were also not able to agree on how to deal with the impact of expanded use tax collection obligations on the international competitiveness of U.S. companies or on the appropriate standards for imposing state business activity taxes on remote companies.

Congress has recently shown a serious concern over the potential danger which state sales and use taxes pose to the continued growth and vitality of electronic commerce. The Internet Tax Freedom Act (P.L. 105-227), enacted in October, 1998, is an important expression of such concerns. The Act provides for a three-year moratorium on any new state Internet access taxes and bars for that same period "multiple or discriminatory taxes on electronic commerce." It calls for the Internet to be free of any new federal taxes and also declares that the Internet should be free of foreign tariffs and other trade restrictions.[72] The Act also established an Advisory Commission on Electronic Commerce to study and report to Congress on electronic commerce tax issues, including whether such commerce should be taxed, and, if so, how electronic commerce can be protected from special, multiple or discriminatory taxes. The Commission also looked at international tax issues affecting electronic commerce and the impact on U.S. companies and consumers.

Significantly, the Chair of the Commission, Governor James Gilmore of Virginia, has submitted a proposal that would make all remote business-to-consumer purchases over the Internet free of sales and use tax. Senator John McCain has proposed a bill, S.B. 1611, which would also make all Internet-based sales tax free, and Congressman John Kasich has offered a similar bill in the House of Representatives.

[72] Concern over the possibility of foreign governments' imposing direct taxes on the Internet is real. For example, the United Nations' 1999 Human Development Report suggested imposing a "bit tax" to "fund the global communications revolution--to ensure that it is truly global." A "bit tax" is a tax on the amount of data sent through the Internet. United Nations Human Development Report, Chapter 2.

These proposals to protect Internet sales from state taxation reflect the anxiety of some political leaders that state tax policies are not only incompatible in structure with electronic commerce, but that state efforts to impose their sales taxes on electronic commerce will undermine the leading role which American companies have played in developing the commercial potential of the Internet.

These proposals and the rationales which support them, while viewed as radical by some tax policy analysts, are fair in their criticism of current state tax structures. Indeed, it would be difficult to design a system of taxation which is less accommodating to electronic commerce than the existing array of state and local sales and use taxes. The very features that made sales tax systems efficient when applied to face-to-face transactions make for an awkward fit when applied to global, cyberspace transactions. Tax administrators suggest that existing problems can be easily remedied through the development of tax compliance software. These officials fail to recognize that the real problem is more fundamental and goes to the essence of a transaction tax system, *i.e.*, the necessity to identify the precise geographic location where a purchaser is located and where a product is destined for use. In a global, mobile, and electronic environment, this notion of "place" becomes both less important to the transaction and less determinable.

¶ 1004.4 The Internet's Challenge To Traditional Notions of Sovereignty and Jurisdiction

The issue of technological developments challenging traditional models of government regulation is not unique to tax systems. Indeed, the Internet is challenging the very concept of "jurisdiction". For centuries, the right of governments to impose taxes and regulations on persons and companies located within their borders was an essential attribute of national or state sovereignty. The exercise of sovereign power was limited, however, by political borders. In other words, a sovereign may have had absolute political authority within its own clearly defined geographic boundaries, but the prerogatives of the sovereign abruptly ended at the frontier with

another sovereign's territory. Applied to taxes, in a world of bricks, mortars, and sales counters, the ability of governments to assert their authority (*i.e.*, jurisdiction) over property, people and transactions was unquestioned. A transaction tax, even one that was administered at the most local of levels (*e.g.*, the municipality) presented few legal or logistical problems. In a less physically tangible electronic environment, the landscape is entirely different. Information moves instantaneously and anonymously across vast distances, and commerce may involve participants in multiple jurisdictions. In this environment, the ability of governments to exercise their traditional prerogatives of sovereignty is limited.

On a global scale, the Internet poses a challenge to the traditional authority of sovereign nations on matters ranging from intellectual property rights to criminal law enforcement. The Internet undermines the significance of political borders and erodes long-established principles of jurisdiction. In the area of sales and use tax administration, the enormous number of different tax jurisdictions compounds this phenomenon, each one insisting upon its exclusive authority over transactions occurring within its territory.

The open-borders aspect of the Internet is a powerful and defining feature of electronic commerce. The states could, of course, try to buck this trend. They could attempt to saddle electronic commerce with tax and regulatory burdens designed for another era. One can imagine an epic struggle between state tax systems, fighting for their survival, and electronic commerce, striving to achieve its full potential. Such a battle would be tragic, as the U.S. economy has been the single greatest beneficiary of electronic commerce. Information technology has fueled the largest and longest economic boom in the nation's history. The result has been a rising tide of prosperity that has raised all ships. Unemployment is at historic lows and personal income at historic highs. Significantly, state tax revenues, including sales tax revenues, are also at all time highs.[73]

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[73] In fiscal year 1998, total state sales tax collection reached an historic high of $155,300,000,000. The annual growth rate in sales taxes in 1998 was 5.6 percent, almost three times the rate of inflation. Cline & Neubig, "The Sky Is Not Falling," *supra*, Table 2.

In 1998, states are reported to have had collectively over $33 billion in unspent surpluses, and that is after the states had cut taxes by $5.5 billion from the previous year. It would be self-defeating for the states to attack the engine of economic prosperity by encumbering electronic commerce with an outdated tax system.

An expansion of state jurisdiction to impose use tax collection obligations on electronic merchants would likely also have the unfortunate effect of driving emerging Internet businesses to offshore locations, or alternatively, of advantaging their foreign competitors. In the last decade, American companies have dominated the fields of information technology and electronic commerce. Parochial state and local tax systems should not be permitted to hinder the continued leadership of the United States in the future.

Governor Gilmore, Senator McCain, and Congressman Kasich have apparently weighed the competing needs of the Internet economy and state governments, and they have concluded that America's long-term best interests are served by keeping the Internet unencumbered by domestic and international taxes. If sales and use taxes are to have a major role in state tax systems in the 21st century, then it is incumbent upon the states to reform their tax systems to accommodate the needs of an electronic environment. Commerce should not have to be retrofitted to match the antiquated structure of state tax systems, nor should Congress throw a wet blanket on the growth of electronic commerce by expanding the jurisdictional reach of state tax systems. It is the responsibility of the states to design their tax structures in a manner suitable to the new millennium.