

IMPLEMENTING E-COMMERCE TAX POLICY

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I. INTRODUCTION

Deliberation begins anew on the application of taxes to e-commerce.¹ The Internet Tax Freedom Act ("ITFA")² imposed a three-year moratorium on the imposition of taxes targeting the Internet. As the expiration of the ITFA approaches,³ legislatures and governmental agencies are formulating plans, the consequence of which will be one or more of three specific governmental actions. These actions will effectively implement both state and federal e-commerce tax policy. As in 1997, businesses, government representatives and others are examining whether and how taxation should be applied to e-commerce. The fact that states cannot legally collect taxes from companies without nexus⁴ and the explosive growth of e-commerce necessitate this assessment.

The growth of e-commerce is reducing the ability of federal, state and local governments to raise revenue from traditional sources in traditional ways. Consequently, legislatures are reassessing specific tax

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1. See *NGA Online: Sources of State Tax Revenue* (visited Mar. 10, 2000) <<http://www.nga.org/Internet/TaxSources.asp>>.

2. Pub. L. No. 105-277, §§ 1101-1104, 112 Stat. 2681-719 to 2681-726 (1998) (prohibiting state and local jurisdictions from imposing taxes on Internet access and multiple or discriminatory taxes on e-commerce from October 1, 1998 through October 21, 2001). A grandfather clause in the ITFA protects taxes imposed and enforced before October 1, 1998; thus, states and localities are only barred from imposing any new types of taxes on e-commerce until late 2001. See *id.* § 1101(a)(1).

3. In addition, a commission created by the ITFA was required to prepare a report to Congress, which may include the possible tax legislation recommendations with respect to e-commerce.

4. Nexus is the connection between an entity and a taxing authority that gives rise to the legal authority to tax. Nexus must be established as a basis for allowing a jurisdiction to apply its tax. Generally, state law bases nexus on some sort of physical presence. International law, as detailed by treaty, bases it on permanent establishment.

policies with respect to e-commerce and asking how such policies may impede or facilitate economic objectives.⁵ To be specific, states have a renewed interest in the possibility of applying existing sales and use tax statutes to the state taxation of e-commerce. Similarly, federal legislators are reevaluating federal income tax statutes with an eye toward their application to e-commerce. This renewed interest and reevaluation has raised such questions as: When do e-transactions constitute taxable sales? What is the tax base for e-transactions, particularly those which involve the sale of services and/or intangible property? Which jurisdictions have the right to impose tax on e-transactions? What happens if more than one jurisdiction imposes a tax on an e-transaction? What are the sales/use tax collection responsibilities for an e-vendor? The answers to such questions will help to determine e-commerce tax policies. They will also determine whether the implementation of such policies will require legislative action, bureaucratic action, both, or neither.

Since most states derive substantial tax revenue from commercial transactions,⁶ e-commerce raises important corporate income tax questions concerning the apportionment of income to the various states, in addition to sales or use tax implications. Typically states have taken the approach of taxing income where income is earned. To this end, most states determine taxable income for corporate income tax purposes by employing an apportionment formula comprised of a payroll factor, a property factor, and a sales factor. This formula is not transparently adaptable to e-commerce. As in the case of sales or use tax, the misclassification of the product and erroneous treatment for tax purposes is a real danger.

In addition, there are several state corporate income tax issues that are relevant to the implementation of taxation to e-commerce. For the most part, these issues involve the different ways in which the types of e-commerce affected by the Internet can be classified by a state. The classification options available to the states are tangible personal property, intangible property, or services.

The classification chosen by a state affects the method of sourcing the income derived from the e-commerce activity. Income derived

5. For a review of the debate of the issues discussed in 1997 regarding the application of tax to e-commerce, see Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269 (1997).

6. See U.S. Census Bureau, *State Tax Collections by State and Type of Tax* (visited June 1, 2000) <<http://www.census.gov/govs/qtax/qtx993t3.txt>>.

from sales of tangible personal property is usually sourced to the state where the customer is located, according to the so-called "destination" rule. Most states source income related to the sale of intangibles to the state in which the vendor is located, assuming that this is the place the income-producing activity is performed. A smaller number of states source such income to the state in which the customer is located, assuming that this is the place in which the benefit of the service or property is received.

Because e-commerce involves significant amounts of income related to intangible personal property, the difference in the approaches is important. For example, if an e-vendor is located in a state that sources such income to the state where the income-producing activity occurred, and sells to a jurisdiction that sources such income to the state where the benefit is received, there is the possibility of double corporate taxation on the transaction.

Double taxation may occur in another way as a result of throwback sales rules. Under throwback sales rules, if an e-vendor sells tangible personal property to a customer in a state in which the vendor is not subject to tax, the income will often be "thrown back" and taxed in the e-vendor's state of domicile. However, e-sales of intangible personal property and services are not subject to these rules. Inconsistent classification of property as tangible or intangible may result in double taxation.

Finally, double taxation may result from inconsistent classification in yet another way. Public Law 86-272⁷ protects solicitations by sales representatives relating to sales of tangible personal property. Such solicitations do not create income tax nexus for the e-vendor in jurisdictions in which it does not otherwise have nexus. Double taxation may result from the fact that the protection of Public Law 86-272 does not apply to sales of intangible property and services.

When Congress enacted its moratorium on new state Internet taxes,⁸ the Treasury Department also announced a policy of neutrality toward Internet commerce.⁹ The Treasury Department stated that income earned through the Internet would be treated in the same manner as income derived from traditional means. It is reasonable to

7. Codified at 15 U.S.C.A. §§ 381–384 (1959).

8. The Internet Tax Freedom Act banned the imposition of new state corporate income taxes on profits from the provision of Internet access and the online sale of goods and services, as well as new sales and use taxes.

9. See Matthew G. McLaughlin, *The Internet Tax Freedom Act: Congress Takes A Byte Out Of The Net*, 48 CATH. U. L. REV. 209, 238 n.216 (1998).

assume from the Treasury position that e-commerce would generally be taxed as either source-based income or residence-based income.

Unfortunately, source and residency principles are equally problematic when applied to e-commerce because they are highly dependent upon factors that may be easily manipulated due to the nature of e-commerce. Consequently, existing starting points for establishing income tax liability are not satisfactory for e-commerce.

Other substantive tax policy questions, including those of tax administration, are likely to arise when e-commerce is used to transfer funds. The Treasury Department's prior action allowing "check the box" proposals, in which entities elect to be taxed either as corporations, which in the U.S. are subject to two levels of taxation, or as pass-through entities, compounds these problems.

United States firms regularly deliberate the benefits and costs of advertising, coordinating, or altering export sales by using the Internet. The Internet allows them to enter international markets for the first time through online sales and realize tax-related cost savings that Internet export sales can produce. These tax savings include the reduction of U.S. federal income tax on export profits, such as the FSC benefit, the reduced possibility of foreign income taxes on Internet export profits, and the probability that the greater utilization of foreign tax credits will offset U.S. federal income tax liability. Consequently, e-commerce will present problems as businesses manipulate e-transactions so that they will be treated as taxable by one jurisdiction and as transparent by another jurisdiction.

Just as in the case of state sales and use taxes, examination of this manipulation of e-commerce will help to determine e-commerce tax policy. The debate, as in the case of state sales and use taxes, will also determine whether the implementation will require legislative action, bureaucratic action, both, or neither. The current e-commerce tax deliberations will result in one or more of three outcomes. Simply put, these include taking no special action, enforcing existing tax statutes, and enacting new legislation.

If no special action is taken to implement the taxation of e-commerce, it is likely that existing tax revenues such as sales tax revenue will decline. However, just as increases in sales tax revenue replaced declines in personal property tax revenue,¹⁰ so too may another

10. By the late nineteenth century most states allowed the taxation of personal property. Despite efforts to reform the system, the revenue generated by the taxation of personal property tax declined in the twentieth century. One reason for this decline was the changing nature of the wealth tax base, from one based on tangible property to

existing tax, such as a telecommunications tax, replace revenue lost from declines in sales tax revenue. The decision to take no action (hereinafter, "Option 1") would thus itself represent a form of e-commerce tax policy.

Bureaucratic action is also an option. Without legislation, state tax departments and others may implement the taxation of e-commerce by enforcing existing laws. For example, use tax statutes could be enforced to tax e-commerce. The decision by state or federal agencies to take administrative action (hereinafter, "Option 2") would therefore also result in the implementation of a form of e-commerce tax policy.

Finally, legislative action offers a wide variety of possibilities. Legislation may be active — transforming tax statutes — or may be passive — maintaining the status quo of existing tax statutes. It is possible that e-commerce will be taxed by taxing Internet service providers ("ISPs") and allowing them to pass the tax along in a manner similar to a value added tax. It is also possible that parties other than the buyer or seller may be made responsible for collecting and remitting taxes, or that some form of federal revenue sharing will be enacted. These are examples of active or transforming legislative action. It is equally possible that one or more legislatures may extend or may make permanent the current moratorium on sales and use taxes on remote sales over the Internet. This is an example of a passive or status quo legislative action. The decision by state or federal legislatures to take active or passive action (hereinafter, "Option 3") would therefore also result in a form of e-commerce tax policy.

II. OPTION 1: NO SPECIAL ACTION

The nature of e-commerce may sufficiently change the economy, such that no special governmental action is necessary to maintain tax revenue. Revenue from an existing tax such as a telecommunications tax may replace the decline in a state's sales tax revenue.

one based on intangible property. Another was the fact that taxpayers realized that personal property was easy to move and conceal, so avoidance of the personal property tax became the norm rather than the exception. *See generally* GLENN W. FISHER, *THE WORST TAX?: A HISTORY OF THE PROPERTY TAX IN AMERICA* (1996). World War II furthered eclipsed the need for personal property tax by requiring different types of taxes to meet the growing demand for increased revenue. *See generally* THE AMERICAN PROPERTY TAX: ITS HISTORY, ADMINISTRATION, AND ECONOMIC IMPACT (George C. S. Benson et al. eds., 1965).

In 1998 sales tax receipts were a hefty source of revenue for state and local governments, raising \$160 to \$189 billion.¹¹ In some states, such as Texas and Tennessee, which have no personal income tax, sales taxes are particularly important. However, while e-commerce grew more than 400% last year, it still represents less than 1% of all sales, so loss of sales tax receipts has not yet created any serious budget problems for these jurisdictions.¹² The dramatic increase in telecommunications tax receipts¹³ most likely has compensated for the sales tax loss.¹⁴

Some jurisdictions have imposed taxes on e-commerce.¹⁵ Generally, they have not done so by imposing a tax on the information content that traverses the Internet; rather, they have imposed a tax on e-commerce transmission channels. Telecommunications via telephone, satellite, or cable are subject to tax in these jurisdictions. Nearly half of the states impose a sales tax or use tax on interstate telecommunications, and most states tax intrastate telecommunications.

Taxes are generally imposed on the telecommunications service, not on the content. However, considerable ambiguity still exists over what constitutes taxable telecommunications services. For example, residential telephone calls and cellular communications uniformly constitute taxable telecommunications, but Internet access, e-mail, e-bulletin boards, e-facsimile services and other added-value or enhanced telecommunications services¹⁶ are taxed in a haphazard

11. See U.S. Census Bureau, *Index of govts/qtax/* (visited June 1, 2000) <<http://www.census.gov/govs/qtax/>>; see also David C. Johnston, *Out on a Limb as Technologies Converge; Republicans Wrangle Over Internet Taxation*, N.Y. TIMES, January 3, 2000, at C3.

12. See Kenneth E. Scott, *Electronic Commerce Revisited*, 51 STAN. L. REV. 1333 (1999).

13. Typically, telecommunications taxes apply to fax machines, pagers, Internet hookups, and local and long distance telephone calls.

14. See David Young, *Utility Tax on Talk Says a Mouthful: Communications is New Gold Mine*, CHI. TRIB., May 31, 1999, at 1.

15. See Vertex Inc., *Internet Taxation: State Summaries* (visited Jan. 12, 2000) <http://www.vertexinc.com/taxcybrary20/cybertax_channel/taxsum_73.asp>, which identifies the nine states which tax access to the Internet, the forty-five states which tax sales of goods over the Internet and the twenty-nine states which tax downloaded information and software. State corporate income taxes on profits from allowing Internet access and the online sale of goods and services are also taxable in most states.

16. Added value and enhanced telecommunications services are defined on a state-by-state basis. Adherence to the federal regulatory distinctions between "basic" telecommunications services and "enhanced" telecommunications services is voluntary. Generally speaking, a "basic" transmission service is a transmission between parties that does not consider the form or content of the information sent and received when

fashion. Services that are similar to traditional telephone company telecommunications (i.e. the connection of two parties) are usually taxed as telecommunications services. Services that involve additional features, such as temporary storage of messages on a computer server or a change in the protocol of the transmitted information, are not uniformly treated as taxable telecommunications services. The novelty of some of these telecommunications services generally accounts for their disparate tax treatment. As states gain better understanding of the nature of these transactions, they have taxed more enhanced communications transactions.

When sales taxes were introduced in the 1930s, property taxes yielded more revenue to state and local tax authorities than did sales taxes.¹⁷ Today sales taxes that are associated with tangible personal property yield more revenue to state and local tax authorities than communications taxes.¹⁸ But just as the American economy eventually invested more in sales transactions than property assessments, so too may the tax revenue value of communications transactions in time surpass the tax revenue value of sales transactions.¹⁹

To be more specific, e-commerce depends on the Internet, which in turn depends on telecommunications services, such as telephone service. For years, numerous state taxes have been imposed on telephone service.²⁰ In addition, there is a three percent federal excise

formulating the charge for the service. These services are simple transmissions such as local exchange and long distance phone calls. Under federal regulatory definitions, an "enhanced service" is any telecommunications service that uses computer processing applications that act on the format, content, code, protocol, or similar aspects of the subscriber's transmitted information and that restructures or stores information.

17. See 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION*, ch. 1, § 1.02 (3d ed. 1999) (indicating that property tax in 1902 produced 50% of total state tax revenues and in 1993 produced only about 2%, whereas the general sales tax produced less than 1% of total state tax revenues in 1932 and produced 33% of total tax revenues in 1993).

18. Note that most statutes tax telecommunications services as part of a retail sales tax. See 2 *id.* § 15.12.

19. See FEDERAL COMMUNICATION COMMISSION, *TRENDS IN THE U.S. INTERNATIONAL TELECOMMUNICATIONS INDUSTRY*, 11-12 (1998), available in 1998 FCC LEXIS 3954 (indicating that in 1986, telephone revenue billed by U.S. carriers was about \$4 billion, but within ten years it was more than \$14 billion).

20. See Federal Communications Commission, *FCC Releases Reference Book of Rates, Price Indices, and Expenditures for Telephone Service* (June 14, 1999), available in 1999 FCC LEXIS 2850 ("State, county, and municipal governments levy a number of charges on telephone service. These charges range from standard sales taxes to the federal excise tax on telephone service, which is levied on all charges, including state taxes and surcharges.").

tax on telephone service. Thus telecommunications taxes are effectively taxes on the use of the Internet and, indirectly, taxes on e-commerce. Telecommunications tax liabilities arise whether through shared dial-up access or direct subscriber lines ("DSL"). E-commerce access via cable or via a wireless modem involving satellite communications is normally subject to a telecommunications tax.

What makes this scenario more plausible is the fact that the average telecommunications tax rate is more than twice that of the average sales tax rate. While the average combined state and local sales tax rate in 1998 was 6.5%,²¹ the average telecommunications tax rate for all states was just over 14%.²² This statistic may not be as telling as the fact that some telecommunications rates are more than three times as great as the highest sales tax rate.²³

In addition, while the normal sales tax statute is full of exemptions and exclusions, the normal telecommunications tax is relatively free of exemptions and exclusions. For example, a cursory review of the New Jersey sales tax statute identifies sixty-four specific goods and services transactions that are exempt from New Jersey sales tax.²⁴ The New Jersey sales tax statute also lists various methods of being exempted from sales tax.²⁵ In contrast with its sales tax, New Jersey's telecommunications utility tax — an excise tax in lieu of all other taxes that would otherwise be imposed on local exchange telephone services²⁶ — enumerates only a handful of exemptions and exclusions.

21. See Robert J. Cline & Thomas S. Neubig, *The Sky Is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*, 17 ST. TAX NOTES 43, 49 (1999) (stating that the average combined state and local sales tax is 6.5%); see also Traci Gleason & Jesse Rothstein, *Taxes and the Internet: Updating Tax Structures for a Wired World*, 17 ST. TAX NOTES 491, 496 (1999) (citing Federation of Tax Administrators statistics showing that the median state sales tax rate was 5%).

22. While the average telecommunications tax is 14% (based on a "weighted average" sample of telecommunications charges reviewed by the author), it is made up of a number of different tax and fee charges. These tax charges include state, local, and federal excise taxes imposed on telecommunications. See Young, *supra* note 14; see also Tuan N. Samahon, *The First Amendment Case Against FCC IP Telephony Regulation*, 51 FED. COMM. L.J. 493, 497 (1999) (stating that \$.05 to \$.06 per minute in federal universal service fees represents approximately half of a caller's costs to communicate).

23. Consider the fact that New York City has a rate of nearly 10% for sales tax but Richmond, Virginia has a telecommunications rate of more than 35%.

24. See N.J. STAT. ANN. § 54:32B-6 (2000).

25. See *id.* § 54:32B-12(b) (identifying numerous forms of exemption certificates as means of being exempted from New Jersey sales tax).

26. See *id.* § 54:30A-18 (repealed 2000) (imposing an excise tax on New Jersey franchises).

A typical sales tax basis is primarily the value of the tangible personal property exchanged. A typical telecommunications tax basis is the value of the telecommunication used. Therefore, the implementation of telecommunications taxes would result in a change in tax basis. Thus, a sales tax basis derives from the exchange of goods, whereas the telecommunications tax basis derives from service. As previously indicated, the United States' economic shift from a tax based on property to one based on sales transactions foreshadowed the shift of state tax revenues from personal property tax to sales tax. The United States economy is now moving from a goods-based economy to a service-based economy.²⁷ It is possible that a similar shift to a service-based tax will accompany this economic change.

1996 sales tax statutes were responsible for approximately \$66 billion of state and local collections, while utility taxes were responsible for approximately \$16 billion of state and local collections.²⁸ The compound growth rate during the period of 1991–1998 for transactions subject to sales tax was 4.9%,²⁹ whereas the compound growth rate for transactions subject to communications tax may be greater than 75%.³⁰

27. See Gov. James S. Gilmore, III., *No Internet Tax, A Proposal Submitted to the "Policies & Options" Paper Of the Advisory Commission on Electronic Commerce* (1999), in Commission on Information Technology, *Virginia Commission on Information Technology Issues Report*, 1999 ST. TAX TODAY 244-30 (1999) [hereinafter Gilmore]. According to Governor Gilmore's proposal:

The entire economy is shifting away from tangible goods to services and information. According to a study conducted by Ernst & Young, consumer spending for services has exceeded the growth rate of spending on durable goods by 35 percent and the growth rate of spending on non-durable goods by 50 percent over the last decade. Ernst & Young estimates that 63 percent of current business-to-consumer Internet sales are intangible services.

Id.

28. See Robert Tannenwald, *Fiscal Disparity Among the States Revisited*, 17 ST. TAX NOTES 969, 973 (1999) (reporting 1996 data).

29. See Cline & Neubig, *supra* note 21.

30. While reliable estimates of the compound growth rate for the telecommunications industry for 1991–99 are difficult to obtain due to the diverse nature of telecommunications services that are subject to tax, Frost & Sullivan projects the compound annual growth rate in the market for the forecast period to be 75.8%. See Press Release, Frost & Sullivan, *Service Bundling The Key to Cash for Cable Operators* (March 1, 1999).

III. OPTION 2: BUREAUCRATIC ACTION

The collection difficulties of a sales tax on e-commerce arise in part from the fact that collection mechanisms were designed for traditional retail transactions and are ill equipped to handle remote e-commerce transactions. The same cannot be said of use tax collections.

Despite the much-publicized suggestion that the e-commerce industry wants a new tax loophole — an exemption from taxes on goods and services sold over the Internet and on fees paid for access to the Internet³¹ — the existing tax moratorium does not provide it. While a tax-free Internet would be a perceived benefit to e-vendors, offsetting the costs of shipping goods, the benefit only results from lack of enforcement, not from legal protection.

Contrary to popular belief, existing federal law does not exempt e-commerce from state taxation. Instead, tax statutes and case law merely proscribe certain collection procedures. For example, state and local tax collection agencies lack the constitutional authority to require out-of-state e-businesses to collect taxes on sales that are delivered into the state. This limitation on *sales* taxes is not a limitation on a state and local tax collector's ability to collect *use* taxes. As a result, while e-commerce sales taxes may go uncollected on remote e-transactions, use taxes need not follow suit. While e-commerce enterprises can easily situate their operations in one or another state to avoid sales tax collection obligations, e-consumers may be required to assess their own taxes and remit them to the state.

Federal restrictions on the authority of state and local jurisdictions to require firms located outside of the jurisdiction to collect sales tax have long resulted in court action between states and mail-order companies. Recently, states have begun to take similar action against e-retailers. In the past it has been more effective for state and local jurisdictions to collect tax from sellers than from buyers. As state and local resources have become more limited, state and local jurisdictions have sought to collect taxes from sellers rather than buyers. Thus, few traditional consumers or e-consumers assess and report their own use tax. Due to the lack of tax enforcement, their risk of being caught and forced to comply is currently negligible.

In the past, the collection of sales taxes was more effective than the collection of use taxes. Consequently, state and local tax officials concentrated on sales tax collections more than use tax collections.

31. See Johnston, *supra* note 11.

This need not be true in the future. The rapid growth of e-commerce gives new incentives to state and local tax authorities to redistribute their collection resources. To this end, enforcing existing use tax statutes may become a higher priority.

Some state tax authorities have started to invest in collecting use taxes. For example, Michigan and North Carolina's 2000 tax forms include a question about out-of-state purchases, including those made via the Internet.³² However, other states have temporarily precluded such action through administrative rulings. For example, the California Franchise Tax Board ruled that a person having a mere electronic presence in a state — for example, through a server — does not have sufficient nexus with the state to be subject to the state's tax laws.³³ This ruling, however, may be later reversed by the Tax Board or by the courts.

The federal bureaucracy also has the ability to take action. A prime example is the telecommunications universal service tax, which is based on the proposition that everyone should have access to affordable telecommunications services. Under the Telecommunications Act of 1996, the Federal Communications Commission ("FCC") has the authority to decide the level of "contributions" taxes that telecommunications providers should have to pay to support universal service.³⁴ The FCC recently doubled that tax to \$2.5 billion per year, and the administration's budget has projected a rise in that tax to \$10 billion per year.

IV. OPTION 3: LEGISLATIVE ACTION

The United States Constitution has accorded substantial freedom to the states and to local jurisdictions as to how they finance activities. While Congress has encouraged cooperation among federal, state, and local tax administrators, the possibility of the taxation of e-commerce by multiple jurisdictions presents complications to the sovereignty of

32. See Jim Kerstetter, *Tracking a Tax Equation: Developer Readies Software to Report Taxes on Web Sales*; *Taxware International's Transaction Tax Server*; *Product Development*, PCWEEK, Jan. 3, 2000, at 1.

33. See Cal. Code Regs. tit. 18, § 1684 (West 1999) (stating that the use of a server on the Internet to create or maintain a website by an out-of-state retailer is not considered as a factor in determining whether the retailer has substantial nexus with California).

34. See generally 47 U.S.C. § 254 (Supp. III 1997). See also Nicole L. Millard, Note, *Universal Service, Section 254 of the Telecommunications Act: A Hidden Tax?*, 50 Fed. Comm. L.J. 255 (1997).

these governments. Differing views about underlying political and budgetary needs can affect the evaluation of competing federal and state e-commerce tax proposals, from the perspectives of both the particular legislature as well as the overall economy. To avoid getting entangled in such debates, it will simply be assumed that federal, state and local interests are in harmony for the purposes of this Article.

Either taxing e-commerce or exempting e-commerce from tax is a policy decision. To the extent that one views tax exemption of e-commerce as preferable, one may argue that public policy should embrace e-commerce for reasons of social and economic benefit. Consider the use of tax law as a social or economic action arm of a governmental unit. For example, it is common to read or hear about the extent of tax help a state or local government provides to a new company or a professional sports franchise in order to encourage it to move into a particular community. This example illustrates certain principles that usually guide the use of tax law as a social or economic tool. These principles include the minimization of the distortion of economic choices, the raising of revenues adequate to finance agreed upon budgetary objectives, the simplification of tax implementation and administration, the assistance for economic stabilization, and the achievement of vertical and horizontal equity.³⁵

In the same way, the enactment of new e-commerce tax laws may also involve the use of tax law for social or economic objectives. This approach involves some form of active legislation, and usually requires new regulations and increases bureaucracy. Another approach, which maintains the status quo, is to close the door to new forms of e-commerce taxation. This approach would represent a form of passive legislation.

A. Option 3A: Taxing E-Commerce Using a Value-Added Tax Model

One transformation approach would tax e-commerce using a Value Added Tax ("VAT") model. A VAT was levied by the member countries of the European Union ("EU"), which together collect most of their operating revenue from this tax. Currently, a VAT must be paid in Great Britain, for example, on computer software that is purchased from outside of the United Kingdom over the Internet.

35. See Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector*, 14 AM. J. TAX POL'Y 361 (1997).

Since most e-commerce is a form of consumption, taxing e-commerce transactions by taxing goods and service providers and allowing such entities to pass the tax seems to be appropriate. At first blush, a VAT appears to be particularly appropriate as it is applied in the EU because the VAT levied in the EU explicitly applies to the provision of services and intangibles. Moreover, in basing the definition of taxable persons — and thus nexus — on the conduct of specified activities in a member state, it essentially adopts an economic concept of nexus, which has particular value to e-commerce. In particular, in individual states within the EU, different rules may govern the place of supply of goods and services and the place of delivery, as may be the case with respect to e-commerce. In order to implement a tax system acceptable to each of the EU states, a destination principle was adopted. Tangible products imported into the EU from outside the Union are taxed at the border while tangible products exported from the Union are zero-rated. Goods shipped across national borders within the EU to registered taxpayers are subject to tax in the country of destination. The VAT is implemented via books of account, not border controls. Goods shipped from one member country of the EU to customers in another member country who are not registered to pay VAT in their home country are generally taxed by the country where the transport begins (the country of origin), unless aggregate shipments into the destination country in a year exceed a de minimis amount. In this case, the shipper must register and pay VAT on such shipments in the country of destination.

VAT systems are defined as general consumption taxes where revenues in principle accrue to the government of the country of consumption. Generally, these taxes should be neutral with no interference on trade. The use of VAT usually does not result in transactions going untaxed or double taxed. Taxation that uses a VAT on consumption of goods and services has largely achieved its objectives for traditional commerce in the EU, so it also has been proposed for e-commerce.

The implementation of e-commerce has had three separate new developments, which have important implications for VAT systems. To be specific, e-commerce has resulted in increases in mail orders, remote service requests, and new types of products to be downloaded. Consumers and businesses using e-commerce have ordered the delivery of goods, placed requests for insurance, financial, advertising and consulting services, as well as downloaded text, images, films, music, and software.

As the use of e-commerce has created international markets, the proximity of the supplier to his or her customer has become increasingly irrelevant. This fact has created additional difficulties. For instance, the rise of e-commerce has increased the number of packages shipped in the mails between countries,³⁶ which has strained the resources of customs authorities and has resulted in reduced VAT enforcement. This increase in international transactions has also led to goods going untaxed and other goods being doubly taxed where VAT and similar tax systems in different countries are inconsistent.

The delivery of e-commerce goods does not give rise to problems if all the countries involved in the transaction have complementary VAT systems; for example, if they all had taxation at importation and the use of zero-rate relief for export (with full deduction of VAT). This tax arrangement always leads to taxation in the country where consumption takes place. However, if a country associated with the transaction does not have a VAT system, there is no taxation.

The application of VAT presents a more complicated model with respect to the supply of services than with respect to the supply of goods. Here, double taxation or the complete lack of taxation occurs more frequently. For example, there is no taxation when the country of the supplier does not have a VAT system. In addition, there is no taxation if the country of the supplier uses the "beneficial enjoyment rule." Double taxation will occur if a service is exported by a European Union supplier to a country with the "beneficial enjoyment rule."

In order to alleviate the instance of double taxation or the complete lack of taxation, two issues related to the application of VAT to e-commerce must be resolved: place-of-supply tax rules and tax-related definitions. Other issues such as reverse charge of taxes³⁷ and mutual assistance may also raise concerns.

Place-of-supply rules, including the rules for fixed establishment for e-commerce, are the most important. These rules must also deal with the identification of a product as a good or a service. Once basic rules for the supply of goods are in place, a VAT system can be enforced. Under existing VAT rules, for example, taxation takes place at the location of the goods at the time of supply or at the start of transport,

36. Third-party contract logistics services grew by 16.5% in 1999 and domestic transportation management and dedicated contract carriage grew by 18%. *See 3PLs Grow by 16.5 Percent in 1999*, J. COM., Jan 11, 2000, at 12.

37. The potential distortion of tax revenue as a result of reverse charges is due to the growth of "call-back" systems in the telecommunications field. These provisions allow a firm without any fixed place of establishment in the European Union to be able to supply services to European Union customers with no VAT charge.

and there is taxation at the border if the good is imported from a third country. Similar rules for e-commerce services must be established. The most frequently suggested starting point for e-commerce services is the place where the supplier has established his business or has his fixed establishment.

Since it is clear that the place of taxation can be changed by changing the place-of-supply rules or by using another definition for a product, to prevent distortion on the national market, supplies of the same kind should be taxed equally. In addition, imports must be taxed at the same level as national supplies and VAT must be reimbursed for export. However, the realization of such international coordination would require a Herculean effort at this time. Consequently, the application of VAT to e-commerce is not likely.

B. Option 3B: Third Parties as Tax Collectors

Those who would make third parties tax collectors also advocate the transformation approach. An example of this approach would be to have ISPs or credit card service providers act as surrogate tax collectors. Alternately, other Internet access providers like IBM, telecommunications service providers such as AT&T, or financial intermediaries like Citibank could be surrogate tax collectors as well. Statutes that call for ISPs or credit card service providers to act as tax collectors could be modeled on existing sales tax statutes. Most states have statutes that require sellers of tangible personal property to act as tax collectors.

Although it is possible to have a direct connection to the Internet, most users gain access to the Internet through ISPs.³⁸ Connections to an ISP are typically made through a local point of presence ("POP"), commonly via a local or toll-free call utilizing telecommunications facilities acquired from other companies. Thus, an ISP is capable of identifying the location of the buyer while he or she is in the process of conducting e-commerce. An ISP's POP is normally in the same taxing jurisdiction as the buyer and because a POP has a physical presence, there is a basis for tax purposes to register the buyers at a particular location.

Since the Internet service provider has detailed knowledge of the buyer's location and the time of an e-commerce transaction, an ISP registered to collect and remit tax in the buyer's jurisdiction would be

38. For the purposes of simplification the term Internet service provider ("ISP") will refer to both the Internet and proprietary networks.

an ideal candidate for the role of tax collector. The characteristic nature of the Internet requires the ISP to copy all Internet communications, including all e-commerce transactions, for subsequent transmission to the user. The ISP could therefore be in good position to prepare tax bills and collect information upon which a tax audit might be conducted.

Making the Internet service provider responsible for tax collection makes more sense than making either the buyer or the seller responsible. The e-commerce communication technology allows a seller to move from place to place; thus, taxes cannot be based on the location of the seller. E-commerce technology is still not capable of allowing a seller to determine the location of the buyer, so taxes cannot be based on the seller's knowledge of the location of the buyer.

The use of ISPs as tax collection agents would allow taxing authorities to continue to base nexus on physical presence. The use of existing nexus concepts and requirements makes sense in the e-commerce environment, because it avoids the necessity of adopting and employing a novel concept of "economic nexus," especially in the case of state sales taxes.

Allowing ISPs to act as tax collection agents would have additional significance under U.S. law. States cannot impose an obligation to collect a tax on interstate sales into the taxing state on sellers of tangible personal property that have no physical presence in the state and ship goods into the state using only common carrier or U.S. mail.³⁹ While some may debate whether and how Internet communications create nexus for e-commerce purposes,⁴⁰ such debate is not necessary if ISPs are designated as tax collectors. While a seller's use of telecommunications facilities in a state, by itself, almost certainly would not constitute taxable nexus, an ISP would have nexus due to its point of presence.

The use of Internet service providers as tax collectors would be consistent with state tax practice limitations set forth primarily by two provisions of the Constitution. First, the Due Process Clause provides: "No person shall . . . be deprived of life, liberty, or property, without due process of law,"⁴¹ and "nor shall any State deprive any person of

39. See, e.g., *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 758 (1967).

40. The debate has resulted from the fact that it is not clear whether the U.S. Supreme Court would apply the same bright-line "physical presence test" as set forth in *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992), in determining nexus for sales of intangible products.

41. U.S. CONST. amend. V.

life, liberty, or property without due process of law.”⁴² Second, the Commerce Clause provides that Congress shall have power “[t]o regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes.”⁴³ Courts have cited both clauses with respect to the taxation of interstate commerce. Both clauses have also been explicitly interpreted (under the “dormant Commerce Clause”) as prohibiting state taxes that would impede interstate commerce.

As an additional benefit of using ISPs as tax collection agents, neither taxpayers nor state taxing authorities would face novel compliance problems. Organizations that have traditionally conducted business in interstate trade have had to deal with the difficulties posed by existing tax statutes, including the complexity created by compliance with many simultaneously taxing jurisdictions. If e-commerce taxation used a novel theory of nexus, then many small businesses might not be able to comply.

Two decisions by the Supreme Court further support the possibility of using ISPs as tax collectors. In *Goldberg v. Sweet*,⁴⁴ the Court upheld the constitutionality of the Illinois Telecommunications Excise Tax Act against a Commerce Clause challenge. The Court noted that for a state to have sufficient nexus to tax an interstate phone call, the call must either originate or terminate in the state and the state must contain either the service address to which the call was charged or the address to which the telephone call was billed or from which it was paid.⁴⁵ Based on that ruling, since service is ordinarily billed and paid for where it is provided, in most cases, nexus will exist in the state where the call either originates or terminates and the service is provided, billed, and paid. In the second case, *Oklahoma Tax Commission v. Jefferson Lines, Inc.*,⁴⁶ the Court upheld a sales tax imposed on the sale of interstate bus transportation by the state where tickets were bought and trips commenced. This ruling suggests that the taxable event inherent in provision of interstate services could be “wholly local.”⁴⁷

Business practices also support the possibility of using ISPs as tax collectors. As Martin Eisenstein has commented, “[a] practical agreement between the Industry and the states to rely upon the subscriber’s billing address as the equivalent of the service address in

42. U.S. CONST. amend. XIV.

43. U.S. CONST. art. I, § 8, cl. 3.

44. 488 U.S. 252 (1989).

45. *See id.* at 263.

46. 514 U.S. 175 (1995).

47. *See id.* at 188.

determining the situs of a sale could solve most problems in this area.”⁴⁸ Needless to say, ISPs have their users’ billing addresses.

The use of ISPs would allow the United States to use existing tax law and regulations that were formulated years ago and were designed for taxing tangible products. This will allow state and local governments to avoid attempting to capture emerging technologies in their tax structures by simply expanding old concepts to new types of businesses. In short, the detailed court-tested tax regulations developed and used for generations can easily apply to e-commerce transactions, and most serious compliance problems for sellers and buyers can be avoided. Such action might also restore fairness to competition between local retail store purchases and out-of-state Internet transactions and provide a means for the states to collect taxes that are owed under existing law. The recent rapid growth of the Internet has underscored the importance of such equitable treatment.

This alternative could successfully address criticisms associated with claims of economic distortion because it provides a common tax treatment to purchases of goods over the Internet and to purchases made through conventional means. It could address criticisms associated with states’ and localities’ abilities to address revenue needs. By maintaining current rules, few could argue that it would be too burdensome for e-merchants to comply.

Alternatively, credit card service providers could also serve as tax collectors for many of the same reasons as ISPs. A credit card service provider, like an ISP, is capable of identifying the location of the buyer while he or she is in the process of conducting e-commerce. However, unlike the ISP’s local POP, the credit card service provider’s location is normally outside of the taxing jurisdiction of the buyer and thus it lacks the physical presence necessary to provide a basis for the registration for tax purposes in the buyer’s location. While the credit card service provider and the ISP share the detailed knowledge of the buyer’s location and time of an e-commerce transaction, a credit card service provider is typically barred from registering for the purpose of collecting and remitting tax in the buyer’s location. Therefore a credit card service provider is a weaker candidate for a tax collection role than an ISP.

Another alternative would be for third parties to create and maintain a tax transaction computation service, which credit card service providers would use. Under such a system, imagine that a buyer places

48. Interactive Servs. Ass’n Task Force, *White Paper: Logging on to Cyberspace Tax Policy*, 12 ST. TAX NOTES 209 (1997).

an order via the Internet using his or her credit card. The credit card service provider, having access to the credit card billing address, would send that the billing address and order information to a tax transaction computation service. The tax transaction computation service would first calculate the tax on the transaction. Second, it would send appropriate tax authorities information regarding the transaction. Third, it would send the buyer information concerning the transaction, including the information sent to the appropriate tax authority.

While software has been developed to allow the operation of tax transaction computation services,⁴⁹ such services suffer from the same shortfalls as the credit card service providers as candidates for the role of tax collector. Specifically, tax transaction computation services are usually located in only a few locations and, having no physical presence in most jurisdictions, would be generally barred from registering for the purpose of collecting and remitting tax in the buyer's location.

C. Option 3C: Sharing Federal Communication Tax Revenue

A proposal that requires both federal and state action would also exemplify the transformation approach. One idea is to make up for potential lost sales tax revenues resulting from untaxed e-commerce by having the federal government redistribute some of its revenues to the states in the form of grants. For example, it has been suggested that Congress allow states that exempted e-commerce from sales tax to receive a portion of the federal telecommunications tax revenue.⁵⁰

General revenue sharing is the least controlled form of federal funding. Revenue sharing funds are usually based on a non-programmatic criterion, such as the amount of a particular tax paid by a particular jurisdiction. For example, federal transportation funding often provides states unrestricted revenue through revenue sharing formulas.⁵¹

Revenue sharing has been used in the past.⁵² Prior to 1972, the federal government traditionally transferred revenue to state and local jurisdictions through categorical grants, which required recipients to

49. See Kerstetter, *supra* note 32.

50. See Doug Sheppard et. al., *California's Andal, CBPP's Mazerov Go Head-to-Head on E-Commerce*, 17 ST. TAX NOTES 1523, 1524 (1999).

51. For a broad discussion of revenue sharing, see RICHARD P. NATHAN ET AL., *REVENUE SHARING: THE SECOND ROUND* (1977).

52. Revenue sharing was first implemented by the Surplus Distribution Act of 1836, ch. 115, 5 Stat. 52. See Jonathon A. Olsoff, Note, *Council of and for the Blind v. Regan: Initiation Rights Under the Revenue Sharing Act*, 33 AM. U.L. REV. 989 (1984).

comply with specific terms of a particular program. In 1972, Congress enacted general revenue sharing programs, which allocated federal funds with few or no conditions. For example, the State and Local Fiscal Assistance Act of 1972⁵³ provided for general revenue sharing payments to 39,000 general purpose governments.⁵⁴

The primary rationale for revenue sharing is to return control of local affairs to the states and municipalities, enabling them to solve their fiscal problems.⁵⁵ At the same time, several commentators have noted that Congress has been reluctant to allow unrestricted revenue to go to state and local jurisdictions directly. Such revenue sharing could allow politicians outside of Congress to take credit for the benefits associated with such revenue,⁵⁶ making revenue sharing an unlikely component of e-commerce tax policy.

D. Option 3D: Continued Tax Moratorium

Those who believe that a state must prevent its businesses and citizens who conduct e-commerce from being at a tax disadvantage advocate a status quo approach. Supporters of this approach argue that government regulation should be limited to the very few instances where global electronic commerce may not fit within traditional commercial rules. For example, one state commission has recommended that, "[t]he General Assembly, regardless of the outcome of the national debate, should make permanent its current moratorium on sales and use taxes on remote sales over the Internet."⁵⁷

Advocates of the status quo approach in the taxation of e-commerce have won a preliminary victory in Congress. In October 1998, Congress enacted the ITFA,⁵⁸ which bars three specifically identified categories of tax: taxes on Internet access, discriminatory taxes on e-commerce, and multiple taxes on e-commerce. More

53. Pub. L. No. 92-512, 86 Stat. 919 (codified as amended at 31 U.S.C. §§ 6701-6724 and in scattered sections in 26 and 31 U.S.C.) (repealed 1986).

54. Strauss, *supra* note 35.

55. See STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, GENERAL EXPLANATION OF THE STATE AND LOCAL FISCAL ASSISTANCE ACT AND THE FEDERAL-STATE TAX COLLECTION ACT OF 1972, H.R. DOC. NO. 14,370 (1973) (discussing the use of revenue sharing funds to resolve unique problems found in specific state and local jurisdictions).

56. See Roderick M. Hills, Jr., *Dissecting the State: The Use of Federal Law to Free State and Local Officials from State Legislatures' Control*, 97 MICH. L. REV. 1201 (1999).

57. See Gilmore, *supra* note 27.

58. Pub. L. No. 105-277, §§ 1101-1104, 112 Stat. 2681-719 to 2681-726 (1998).

specifically, this Act forbids the state taxation of service charges related to enabling users to access information, e-mail, or other services over the Internet. For example, the states could not tax the monthly fee that America Online and other ISPs charge their customers for connecting to the Internet.

The Act also prohibits taxes that result in the discriminatory treatment of e-commerce. Any transaction conducted over the Internet comprising the sale, lease, license, offer, or delivery of property, goods, services or information may not be singled out for disadvantageous taxation.⁵⁹ Finally, the Act prohibits taxes imposed by one state on an e-commerce transaction that is also subject to a tax imposed by another state.

Two conditions must be present for the Internet Tax Freedom Act to allow a state to impose a tax on e-commerce.⁶⁰ These are that the imposition of the tax, and the rate at which it is imposed, must be the same as they would have been had the transaction been conducted via traditional commerce, and the obligation to collect the tax must be imposed on the same entity as if a traditional commercial transaction had occurred.

The motivation for the Internet Tax Freedom Act was threefold, according to Representative Christopher Cox, the original sponsor of the House bill.⁶¹ First, the sentiment was that e-commerce needed time to grow; second, the multi-jurisdictional characteristics of the Internet made e-commerce susceptible to multiple and discriminatory taxation in a way that traditional commerce was not; third, the Act provided assurance that e-commerce would not be subject to unexpected taxes and tax collecting costs from remote governments.⁶²

Since these considerations are still present, the stimulus for maintaining the ITFA moratorium still exists. Nonetheless, further discussion of implementing e-commerce taxation is likely. Critical analysis of e-commerce taxation and the introduction of new proposals are inevitable as e-commerce continues to become a greater part of our economy.

59. *See id.* § 1104(3).

60. *See* Kenneth H. Silverberg & Mark M. Foster, *The Internet Tax Freedom Act: Will It Be a Success or a Failure?*, 9 J. MULTISTATE TAX'N 4, 8 (1999).

61. *See* H. REP NO. 105-570, (1998).

62. *See id.*