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TOLLING THE INFORMATION SUPERHIGHWAY: STATE SALES AND USE TAXATION OF ELECTRONIC COMMERCE

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I. INTRODUCTION

Sales and gross receipts taxes provide states with forty-eight percent of their tax revenue.[1] Thus, sales tax schemes are essential to states and their fiscal well-being. Because states are not taxing purchases over the Internet, they lost an estimated $525 million in sales taxes in 1999.[2] For calendar year 2003 alone, states are predicted to forego $20 billion due to their inability to collect use taxes from out-of-state sellers conducting business over the Internet.[3] The majority of purchases that occur over the Internet would be subject to sales and use taxation if the purchases transpired in the historical brick-and-mortar, main street store. However, due to constitutional analysis developed and based entirely upon a brick-and-mortar, physical presence conceptualization, state taxation of electronic commerce may be invalid.

The ability to conduct electronic commerce from virtually any location challenges the application of traditional tax schemes. Several characteristics of the Internet contribute to this: its absence of central control, its lack of dependence on physical location, its absence of registration for use, and its lack of proof of identity requirements.[4]

The effect that sales and use taxes will have upon electronic commerce has been hotly debated in recent years. Some commentators argue that imposing sales and use taxes upon online sales will retard the growth of the Internet.[5] Businesses are also concerned that taxation of

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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. *See NGA Online: Overview of Sales and Use Taxes and Electronic Commerce* (visited Mar. 10, 2000) <http://www.nga.org/Internet/Overview.asp> (citing a study by Forrester Research).

3. *See id.* (citing a study by the University of Tennessee).

4. *See* Jeffrey Owens, *The Tax Man Cometh to Cyberspace*, 14 TAX NOTES INT'L 1833, 1835–36 (1997).

5. *See* Dean F. Andal, *Read My E-Mail: No New Taxes*, 12 ST. TAX NOTES 1387, 1388 (1997).

electronic commerce would impose a costly and insurmountable burden upon their operations.[6] In fact, one commentator predicts that state taxation of electronic commerce will cause businesses to relocate their Internet dealings and cause the United States' competitive position with respect to the Internet to deteriorate.[7] However, this fear seems to be refuted by a *CIO* magazine study reporting that seventy-one percent of consumers will not alter their online spending if sales and use taxes are imposed on goods and services purchased over the Internet.[8]

In sum, the benefits of taxing electronic commerce appear to outweigh the concerns expressed by commentators. The tax revenue that could be produced from the collection of sales and use taxes by electronic commerce is significant. Another argument in favor of taxing electronic commerce is that taxes imposed on the Internet should be neutral: all sales should receive identical tax treatment regardless of whether the sale occurs electronically or physically.[9]

This Article addresses the constitutional framework applicable to state sales and use taxation and evaluates the procedure by which states may seek to levy sales and use taxes upon purchases of goods and services over the Internet. Part I of this Article provides an overview of the Internet and sales and use tax schemes. Part II explains the constitutional framework with which a sales and use tax scheme must comply. Part III proposes that Congress enact a law establishing the Commerce Clause analysis to be applied by the states in determining the legitimacy of taxing online transactions.

II. OVERVIEW OF THE INTERNET AND SALES AND USE TAXES

Due to the absence of a face-to-face physical meeting between an online merchant and purchaser, Internet transactions differ from traditional brick-and-mortar sales. This lack of physical presence

6. *See* Nathan Newman, *Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway*, 9 ST. TAX NOTES 927, 930–31 (1995).

7. *See id.*

8. *See* CIO Magazine, Inc., *Technology Execs & Consumers Voice Support for E-Voting, Indifference to Internet Taxes* (Dec. 20, 1999) <http://www.cio.com/info/releases/122099_netreg.html> (citing November 1999 CIO Internet Attitudes Study).

9. *See* DEPARTMENT OF THE TREASURY OFFICE OF TAX POLICY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE ¶ 6.2 (1996); *see also* Walter Hellerstein, *State Taxation of Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation*, 12 ST. TAX NOTES 1315, 1315 (1997).

challenges the structure upon which state sales and use taxes are premised. Therefore, a greater understanding of the Internet illustrates the antiquity of the present sales and use tax scheme.

A. The Internet

The Internet is a global network which connects groups of linked computer networks.[10] This network may be accessed from a personal computer anywhere in the world by using a modem and telephone line or by a direct wire connection to a local network.[11] One facet of communication over the Internet is the World Wide Web.[12] The World Wide Web consists of millions of documents; each document (a "Web page") has an address.[13] In addition, "[e]ach host computer providing Internet services ('site') has a unique Internet address. Users seeking to exchange digital information . . . with a particular Internet host require the host's address in order to establish a connection."[14] Once information is posted on the Internet, the provider cannot prevent that content from being accessed by any person in any locality. The Internet, in effect, "gives a speaker a potential worldwide audience."[15] In addition, the Internet permits entities "to conduct business throughout the world entirely from a desktop."[16]

A brief perusal of the Internet demonstrates that practically any product may be purchased online. As a result, the ability to sell products and services globally creates an issue as to which taxing authorities may levy their tax schemes upon the transactions that occur

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10. *See* Stomp, Inc. v. NeatO, LLC, 61 F. Supp. 2d 1074, 1075 n.1 (C.D. Cal. 1999). For a detailed discussion of the Internet and its history, see ACLU v. Reno, 929 F. Supp. 824, 830–48 (E.D. Pa. 1996).

11. *See Stomp*, 61 F. Supp. 2d at 1075 n.1.

12. *See* Hearst Corp. v. Goldberger, No. 96 Civ. 3620, 1997 WL 97097, at *2 (S.D.N.Y. Feb. 26, 1997).

13. *See id.*

14. MTV Networks v. Curry, 867 F. Supp. 202, 203 n.2 (S.D.N.Y. 1994).

> Internet domain names are similar to telephone number mnemonics, but they are of greater importance, since there is no satisfactory equivalent to a telephone company white pages or directory assistance, and domain names can often be guessed. A domain name mirroring a corporate name may be a valuable corporate asset, as it facilitates communication with a customer base.

Id.

15. ACLU v. Reno, 929 F. Supp. 824, 844 (E.D. Pa. 1996).

16. Zippo Mfg. Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119, 1123 (W.D. Pa. 1997).

over the Internet. Specifically, for sales occurring in or concerning an individual or entity within the United States, a determination must be made as to which state may impose its sales or use tax upon the purchase price of the goods or services being proffered.

B. Sales and Use Taxes

States generally employ a bifurcated scheme for the taxation of purchases of goods and services. States levy a sales tax upon purchases that occur in the taxing state.[17] The sales tax is essentially a "tax on the freedom of purchase."[18] On the other hand, states impose a use tax upon purchases that occur outside of the geographic boundaries of the taxing state, and this tax is considered a "tax on enjoyment of that which was purchased."[19]

1. The Sales Tax

Sales tax is imposed upon "retail sales of tangible personal property for use or consumption."[20] The amount of the sales tax is typically a percentage of the purchase price of the goods or services. In effect, the customer pays the sum of the tax and purchase price; then, the seller remits the tax it has collected to the appropriate taxing authority.[21] The state sales tax generally is levied upon consumers in the state in which their purchases of goods and services are made.[22] In fact, the Commerce Clause excludes a state from levying its sales tax scheme upon goods and services which are purchased outside its geographic boundaries.[23]

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17. *See* PRENTICE-HALL, INC., PRENTICE HALL'S GUIDE TO SALES AND USE TAXES 57 (1988).

18. McLeod v. J.E. Dilworth Co., 322 U.S. 327, 330 (1944).

19. *Id.*

20. PRENTICE-HALL, INC., *supra* note 17, at 57.

21. *See* Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171, 176–77 (1997).

22. *See* JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 5 (2d ed. 1994).

23. *See McLeod*, 322 U.S. at 330–31.

2. The Use Tax

To satisfy the mandate of the Commerce Clause and still be able to tax the out-of-state purchase of goods and services, states impose the use tax, which is seen as a complementary tax to the sales tax. States levy use taxes as an "impos[ition] on the privilege of ownership or possession, storage, use or consumption of goods in the state."[24] Whereas the sales tax is imposed upon purchases within a state, the use tax is levied upon tangible, personal property that is brought into the taxing state or is acquired within the taxing state under a presumption of nontaxability.[25] The imposition of use taxes protects against sales tax evasion by out-of-state buyers,[26] adjusts for any tax savings a purchaser may gain by transacting with an out-of-state business rather than an in-state business,[27] and prevents against interstate discrimination.[28]

In most states a purchaser who has already paid sales tax upon his purchase in another state receives a credit against any use tax he might owe in the taxing state for the amount of sales tax he has already paid. Thus, if the use tax rate in the taxing state exceeds the sales tax rate previously paid to the state in which such goods were purchased, the purchaser shall pay only the amount of the use tax due on the full purchase price less the sales tax previously paid.[29]

The purchaser of goods typically has the burden of paying the pertinent use tax to the state in which he resides or uses the goods.[30] Since consumers are generally unaware of their obligation to pay use taxes, compliance with this obligation is sporadic at best.[31] As a result, many states are developing interstate and multistate agreements to assist in the enforcement and collection of sales and use taxes.[32] In addition, states are developing voluntary registration programs in the hopes that out-of-state sellers who otherwise would not be required to collect and remit sales and use taxes for the taxing state will choose to do so.[33]

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24. PRENTICE-HALL, INC., *supra* note 17, at 51.

25. *See* ROBERT J. FIELDS, UNDERSTANDING AND MANAGING SALES AND USE TAX 47 (4th ed. 1998).

26. *See, e.g.*, Nelson v. Sears, Roebuck & Co., 312 U.S. 359, 363 (1941) (citing Henneford v. Silas Mason Co., 300 U.S. 577, 581 (1937)).

27. *See* PRENTICE-HALL, INC., *supra* note 17, at 51; *see also* PAUL J. HARTMAN, STATE TAXATION OF INTERSTATE COMMERCE 161 (1953).

28. *See* PRENTICE-HALL, INC., *supra* note 17, at 51.

29. *See* FIELDS, *supra* note 25, at 65–66.

30. *See* DUE & MIKESELL, *supra* note 22, at 250.

31. *See id.* at 262–64.

32. *See* FIELDS, *supra* note 25, at 124–30.

33. *See* DUE & MIKESELL, *supra* note 22, at 261 (describing incentive systems

III. PERTINENT CONSTITUTIONAL FRAMEWORK

The application of sales and use taxes has been challenged on two separate fronts. In order to levy a tax upon the sale of goods or services, a state must satisfy the minimum contacts, or "nexus," requirement as set forth by the Supreme Court. "Nexus describes the degree of business activity that must be present before a taxing jurisdiction has the right to impose a tax, or an obligation to collect a tax, on an entity."[34] The Court has developed a bifurcated analysis to determine the constitutionality of a state sales or use tax statute; as a result, a state taxing scheme must overcome scrutiny under both the Due Process Clause and the Commerce Clause.

A. Due Process

Under the Fourteenth Amendment of the Constitution of the United States, no state shall "deprive any person of life, liberty, or property, without due process of law . . . ."[35] To evaluate whether a scheme of taxation satisfies the requirements of the Due Process Clause, courts have imported the analysis applied in personal jurisdiction jurisprudence.[36]

A court may assert personal jurisdiction only in cases where the party has certain minimum contacts with a forum "such that the maintenance of [a] suit does not offend 'traditional notions of fair play and substantial justice.'"[37] Courts have generally interpreted the Due Process Clause to require that a defendant in a lawsuit be able to foresee that his "conduct and connection with the forum State are such that he should reasonably anticipate being haled into court there."[38] This test is a flexible inquiry into whether a defendant's contacts with the forum state make it reasonable to require the defendant to defend a suit in that particular state.[39]

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offered by states to encourage voluntary registration).

34. Karl A. Frieden & Michael E. Porter, *State Taxation of Cyberspace*, TAX ADVISER, Nov. 1996, at 674.

35. U.S. CONST. amend. XIV, § 1 [hereinafter, the Due Process Clause].

36. *See* Edward A. Morse, *State Taxation of Internet Commerce: Something New Under the Sun?*, 30 CREIGHTON L. REV. 1113, 1143 (1997).

37. Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (citing Milliken v. Meyer, 311 U.S. 457, 463 (1940)).

38. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980).

39. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992).

The Supreme Court "has held that 'state taxation falling on interstate commerce . . . can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys.'"[40] Thus, the controlling issue "'is whether the [taxing state] has given anything for which it can ask return.'"[41] As a result, this overriding issue does not necessitate a finding of physical presence within a state. Instead, the Court has found that "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted."[42] Therefore, to assert jurisdiction over an out-of-state person, a court must find that such person has "purposefully directed" his activities towards residents of the forum state.[43]

In *Quill Corp. v. North Dakota*, the State of North Dakota sought to levy its use tax upon an out-of-state retailer (a mail-order house) that had no physical presence within the State. Quill solicited sales nationally using catalogs, flyers, advertisements, and telephone calls and delivered all of its merchandise via mail or common carrier to its customers. The Supreme Court found that Quill purposefully directed its activities toward residents of North Dakota, that the magnitude of such activities fulfilled the requisite level, and that the benefits Quill received from its access to the state allowed North Dakota to impose its use tax upon any sales to residents of North Dakota.[44]

Applying the traditional analysis for the Due Process Clause to electronic commerce has challenged many lower courts. In *Inset Systems, Inc. v. Instruction Set, Inc.*,[45] the defendant had no offices or employees within the State of Connecticut. However, the court determined that, because of its advertising activities on the Internet and its toll-free telephone number, both of which were available continuously to any resident of Connecticut in addition to residents of every other state, the defendant had purposefully availed itself of the

40. National Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753, 756 (1967) (quoting Freeman v. Hewit, 329 U.S. 249, 253 (1946)).

41. *National Bellas Hess*, 386 U.S. at 756 (quoting Wisconsin v. J. C. Penney Co., 311 U.S. 435, 444 (1940)).

42. Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985).

43. *Id.* at 472.

44. *See Quill*, 504 U.S. at 308.

45. 937 F. Supp. 161, 162–63 (D. Conn. 1996).

privilege of doing business within Connecticut. Thus, a Connecticut court could properly assert personal jurisdiction over the defendant.[46]

The Sixth Circuit Court of Appeals determined that personal jurisdiction could be asserted over a defendant who had entered into a Shareware Registration Agreement that was governed by Ohio law with an Ohio corporation under which he loaded his software onto the CompuServe system for use and purchase by others.[47] The defendant used CompuServe's system to advertise his software. The court found that the defendant purposefully availed himself of the opportunity to act in Ohio because upon contracting with the Ohio-based CompuServe, the defendant should have reasonably foreseen that his ongoing relationship with CompuServe would have consequences within Ohio.[48]

On the other hand, it appears that merely placing a Web page on the Internet without any acts to encourage others to access the Web page is not sufficient to satisfy the requirements of the Due Process Clause.[49] In *Bensusan Restaurant Corp. v. King*, the defendant, the owner of a small night club in Columbia, Missouri, created a website which listed general information about the night club and telephone numbers by which it could be contacted. The court found that the defendant was not subject to personal jurisdiction in a New York court because "[t]he mere fact that a person can gain information on the . . . product is not the equivalent of a person advertising, promoting, selling or otherwise making an effort to target its product in New York."[50] Additionally, "[c]reating a site, like placing a product into the stream of commerce, may be felt nationwide — or even worldwide — but, without more, it is not an act purposefully directed toward the forum state."[51]

In its analysis of the Due Process Clause in connection with the Internet, the court in *Zippo Manufacturing Co. v. Zippo Dot Com, Inc.* determined that "[t]he likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet."[52] The court divided websites into three distinct categories.[53]

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46. *See id.* at 165.

47. *See* CompuServe, Inc. v. Patterson, 89 F.3d 1257, 1260–61 (6th Cir. 1996).

48. *See id.* at 1263–64.

49. *See* Bensusan Restaurant Corp. v. King, 937 F. Supp. 295, 301 (S.D.N.Y. 1996), *aff'd*, 126 F.3d 25 (2d Cir. 1997).

50. *Id.* at 299.

51. *Id.* at 301.

52. Zippo Mfg. Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119, 1124 (W.D. Pa. 1997).

53. *See id.*

The first category is "where a defendant clearly does business over the Internet. If the defendant enters into contracts with residents of a foreign jurisdiction that involve the knowing and repeated transmission of computer files over the Internet, personal jurisdiction is proper."[54] At the other end of the scale is "where a defendant has simply posted information on an Internet site which is accessible to users in foreign jurisdictions. A passive Web site that does little more than make information available to those who are interested in it is not grounds for the exercise [sic] personal jurisdiction."[55] Between these two extremes is a middle ground that "is occupied by interactive Web sites where a user can exchange information with the host computer. In these cases, the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the Web site."[56]

In *Zippo Manufacturing Co.*, the defendant had contacts with Pennsylvania that consisted almost entirely of the posting of information about its services on the Internet, its dissemination of information to its subscribers (two percent of which resided in Pennsylvania), and its contractual arrangements with seven Internet access providers in Pennsylvania to establish the subscribers' access to the defendant's news service. The defendant had no offices, employees, or agents in Pennsylvania. The court determined that the defendant was conducting electronic commerce with Pennsylvania residents such that it had purposefully availed itself of doing business in Pennsylvania. According to the court, when a person or entity chooses to conduct business with the residents of a state, "it has clear notice that it is subject to suit there."[57] Thus, if a corporation evaluates the risk of being subject to personal jurisdiction in a particular forum and determines that the risk is too great, the corporation can sever its connection to the state.[58]

Lastly, a California appellate court has also applied the *Zippo Manufacturing Co.* three-category evaluation of the Internet.[59] The court ruled that personal jurisdiction could not be properly asserted over a New York resident with no physical presence in California who had

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54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at 1126 (quoting World-Wide Volkswagen v. Woodson, 444 U.S. 286, 297 (1980)).

58. *See Zippo Mfg. Co.*, 952 F. Supp. at 1126.

59. *See* Jewish Defense Org., Inc. v. Superior Court, 85 Cal. Rptr. 2d 611, 620–21 (1999).

merely created a "passive" website that conveyed information to the Internet users who sought access to it.[60]

B. Commerce Clause

In addition to satisfying the Due Process Clause, a taxing jurisdiction must also ensure that its sales or use tax imposition does not violate the Commerce Clause of the Constitution of the United States. The Constitution grants to Congress the power to regulate commerce "with foreign Nations, and among the several States."[61] The Commerce Clause empowers Congress to regulate interstate commerce and to restrict the states' ability to enact laws that affect interstate commerce.[62]

This power to restrict the states is a negative grant of power that prohibits a state from burdening or interfering with interstate commerce.[63] This Dormant Commerce Clause bars a state law from discriminating against interstate commerce on its face or in its effect and bars the imposition of an incidental burden on interstate commerce that is excessive when compared to the local benefits.[64]

The Supreme Court ruled that the Dormant Commerce Clause prohibited the imposition of the Illinois use tax on a Missouri mail-order business that had neither assets nor employees in Illinois.[65] Citing that the business' only connection with Illinois was the delivery of its goods to its Illinois customers by mail and common carrier, the Court determined that the tax could not constitutionally be levied because the Constitution of the United States requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[66] The holding of the Court required the actual presence of the business within Illinois and, therefore, created a "physical presence" requirement.[67]

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60. *See id.* at 622.

61. U.S. CONST. art. I, § 8, cl. 3.

62. *See* Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 571–72 (1997) (citing Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 224 (1824)).

63. *See* Freeman v. Hewit, 329 U.S. 249, 252 (1946).

64. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992); Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970); National Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753, 756 (1967)

65. *See National Bellas Hess*, 386 U.S. at 754, *overruled by Quill*, 504 U.S. at 308.

66. *National Bellas Hess*, 386 U.S. at 756–57 (quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344–45 (1954)); *see also* Scripto, Inc. v. Carson, 362 U.S. 207, 210–11 (1960).

67. *See National Bellas Hess*, 386 U.S. at 756–57; *see also* Orvis Co., Inc. v. Tax

The Court added an additional layer of analysis in a challenge to the levy of the Mississippi sales tax upon automobiles which were manufactured outside of Mississippi.[68] The Court developed a four-part test that evaluates: (i) whether the tax is applied to an interstate activity with a substantial nexus with the taxing state; (ii) whether the tax is fairly apportioned; (iii) whether it discriminates against interstate commerce; and (iv) whether it is fairly related to the services provided by the state.[69]

Attempting to provide greater clarity to the notion of substantial nexus, the Supreme Court has ruled that an out-of-state merchant must have a physical presence in the taxing state which exceeds a "slightest presence."[70] This concept is nebulous and is evaluated on a case-by-case basis.[71]

Further developing the physical presence requirement developed in *National Bellas Hess* and the meaning of substantial nexus within the four-prong test of *Complete Auto*, the Supreme Court has ruled that the substantial nexus requirement is not fulfilled by an out-of-state seller "whose only connection with customers in the [taxing] state is by common carrier or the United States mail."[72] Thus, traditional notions of nexus necessitate actual physical presence within the taxing state, including maintaining an office[73] or having employees,[74] agents,[75]

Appeals Tribunal, 654 N.E.2d 954, 957 (N.Y. 1995).

68. *See* Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 276 (1977).

69. *See id.* at 279.

70. National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 556 (1977).

71. *See* Gen. Ltr. Rul. IT 99-0057-GIL (Ill. Dep't. Rev. May 24, 1999), *available at* 1999 WL 628693 (stating that Illinois has not addressed the issue of nexus by statute or regulation and that determinations of nexus are made on an individual basis where all relevant facts and circumstances of a taxpayer's activities in Illinois can be evaluated); *see also* B.L. Key, Inc. v. Utah State Tax Comm'n, 934 P.2d 1164, 1167 (Utah Ct. App. 1997).

72. Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992) (quoting *National Bellas Hess*, 386 U.S. at 758) (alteration in original).

73. *See National Geographic Soc'y*, 430 U.S. at 556 (maintaining two offices within the taxing state, albeit unrelated to the business activities being taxed, is sufficient to constitute nexus).

74. *See* Standard Pressed Steel Co. v. Washington Dep't of Revenue, 419 U.S. 560, 562 (1975) (holding that one employee within the taxing state is sufficient to constitute substantial nexus).

75. *See, e.g.*, Scripto, Inc. v. Carson, 362 U.S. 207, 211 (1960) (finding substantial nexus where an entity had ten independent contractors who continually solicited business for the company).

inventory,[76] or equipment.[77] In addition, courts will also evaluate whether an out-of-state seller owns property within the taxing state,[78] maintains a local telephone listing within the taxing state,[79] or engages regularly in delivering or servicing property within the taxing state.[80] Courts may also weigh other factors. For example, courts may evaluate whether a business has published or printed catalogs in the taxing state, advertised using local media within the taxing state, kept a security interest in any goods sold in the taxing state, been qualified or licensed to do business within the taxing state, established a bank account in the taxing state, or sought the aid of a collection agency within the taxing state.[81]

In *Quill*, the Court's opinion exudes an air of discontent. The Court explains its reliance upon the physical presence, substantial nexus test as set forth in *National Bellas Hess* as resulting from the "doctrine and principles of stare decisis . . . ."[82] Nevertheless, the Supreme Court specifically invited Congress to determine

> whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes. . . . Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. In this situation, it may be that the better part of both wisdom and valor is to respect

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76. *See* David C. Blum, Comment, *State and Local Taxing Authorities: Taking More Than Their Fair Share of the Electronic Information Age*, 14 J. MARSHALL J. COMPUTER & INFO. L. 493, 509 (1996).

77. *See* Quotron Sys., Inc. v. Comptroller of the Treasury, 411 A.2d 439, 441 (Md. 1980) (establishing sufficient nexus where a company retained ownership and control over the equipment it provided to its customers).

78. *See Quill Corp.*, 504 U.S. at 315; *cf.* Cally Curtis Co. v. Groppo, 572 A.2d 302, 306 (Conn. 1990).

79. *See* Goldberg v. Sweet, 488 U.S. 252, 263 (1989) (holding that for an interstate telecommunications excise tax, a telephone call either initiated or terminated in a state and paid by a service address within that state or paid within the state fulfills the nexus requirement); SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666, 671 (Conn. 1991) (establishing that sufficient nexus does not exist when an out-of-state company uses a toll-free telephone number for the benefit of its customers).

80. *See* B.L. Key, Inc. v. Utah State Tax Comm'n, 934 P.2d 1164, 1168 (Utah Ct. App. 1997) (finding that repeated visits by a company's agents to the taxing state to deliver or service products, when combined with significant business activities within the state, constitutes sufficient nexus).

81. *See SFA Folio Collections*, 585 A.2d at 669–70; L.L. Bean, Inc. v. Pennsylvania Dep't Revenue, 516 A.2d 820, 822–26 (Pa. Commw. Ct. 1986).

82. *Quill Corp.*, 504 U.S. at 317.

> the judgment of the other branches of the Government.[83]

The Court of Appeals of New York has rejected the requirement of substantial nexus and has substituted the "more than a 'slightest presence' test" in its place. In *Orvis Co. v. Tax Appeals Tribunal*, the out-of-state retailer and mail-order house challenged the imposition of the New York use tax upon orders placed through its mail-order catalog.[84] The court reviewed the history of nexus and determined that prior to *Quill* the standard of nexus required under the Due Process Clause and the Commerce Clause had historically been "indistinguishabl[e]."[85] According to this court, the Supreme Court had reluctantly retained the physical presence requirement in *Quill*, and the history of Commerce Clause jurisprudence does not support the retention of this physical presence requirement.[86]

Following the lead of the New York court, the Illinois Supreme Court found that Illinois had substantial nexus with a company with no assets, offices, or employees within Illinois because the business conducted extensive advertising within Illinois and made regular deliveries to Illinois.[87] The court held that the Commerce Clause does not require a substantial physical presence but instead requires a physical presence that is more than a slightest presence.[88] A Michigan appellate court has also found that by establishing more than a slightest presence, the mandates of the Commerce Clause are satisfied.[89] The denial of certiorari in both the New York and Illinois cases also indicates that the weight accorded to the *Quill* bright-line, physical presence standard has diminished.

In order to withstand Commerce Clause scrutiny, a tax must be fairly apportioned. Two requirements must be satisfied for a state tax to be deemed fairly apportioned.[90] The taxing scheme must be both

83. *Id.* at 318–19 (internal quotations and citation omitted) (quoting Commonwealth Edison Co. v. Montana, 453 U.S. 609, 637–38 (1981) (White, J., concurring)).

84. *See* Orvis Co. v. Tax Appeals Tribunal, 654 N.E.2d 954, 955 (N.Y. 1995).

85. *Id.* at 956.

86. *See id.* at 960.

87. *See* Brown's Furniture, Inc. v. Wagner, 665 N.E.2d 795, 803–04 (Ill. 1996).

88. *See id.* at 802.

89. *See* Magnetek Controls, Inc. v. Revenue Div., Dep't of Treasury, 562 N.W.2d 219, 223–24 (Mich. Ct. App. 1997).

90. *See* Goldberg v. Sweet, 488 U.S. 252, 261 (1989).

internally and externally consistent.[91] For internal consistency, a tax levy "must be structured so that if every State were to impose an identical tax, no multiple taxation would result."[92] However, a tax levy will not be invalidated solely because of a limited possibility of multiple taxation.[93] For external consistency, a state tax imposition may "tax[] only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."[94] The Supreme Court has applied this test and has "examine[d] the in-state business activity which triggers the taxable event and the practical or economic effect of the tax on that interstate activity."[95]

Therefore, as Commerce Clause scrutiny currently stands, a tax must have substantial nexus with the taxing state, and the tax must be fairly apportioned. In addition, interstate and out-of-state interests may not be more heavily burdened by the taxing scheme than intrastate interests, and the benefits bestowed upon the taxpayer by the State must be fairly related to the tax imposed.[96]

IV. CODIFICATION OF A CLEAR CUT NEXUS STANDARD

After *Quill*, many commentators have expressed concern as to how a state may levy its sales and use tax scheme upon businesses that lack physical presence within the state.[97] In order to compel out-of-state merchants to collect such taxes, state and local governments should lobby Congress for the codification of a Commerce Clause standard that modifies the *Quill* standard to address situations in which a physical presence exists in no state and provides a practical solution as to which state is the appropriate taxing jurisdiction. Various schemes

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91. *See id.*

92. *Id.*

93. *See id.* at 263–64.

94. *Id.* at 262.

95. *Id.*

96. *See* Arthur R. Rosen & Richard A. Leavy, *State Taxation of Electronic Commerce and Other Nexus Issues: Where Are We and Where Are We Going?*, 570 PLI/PAT 1209, 1218–19 (August/September 1999).

97. This concern arises from the difficulties a state may incur in successfully asserting that the taxation of an out-of-state merchant with no assets, employees, or other physical presence within the state satisfies the requirements of the Commerce Clause. States should not encounter any difficulty in establishing the minimum contacts standard required under the Due Process Clause. *See, e.g.*, Saba Ashraf, *Virtual Taxation: State Taxation of Internet and On-line Sales*, 24 FLA. ST. U. L. REV. 605, 628–29 (1997).

for taxing electronic commerce have been proposed by commentators, legislators, and policy organizations.[98]

Congressional action to address the issues posed by state sales and use tax systems may be imminent. Congress may follow the recommendation submitted by the Advisory Commission on Electronic Commerce in April, 2000 and may choose to provide guidance on this issue to the states.[99] Since the Supreme Court explicitly invited Congress to discard the bright-line physical presence test set forth in *Quill*,[100] the report by the Advisory Commission on Electronic Commerce may be the prompting necessary to initiate Congressional action.

A. Application of Due Process Clause Scrutiny

To accept the challenge by the Supreme Court to establish a more practical standard by which courts may exercise Commerce Clause scrutiny, Congress need only enact a law resembling the following:

> In the levying [of] sales and use taxes, an entity, whether a person or business, must purposefully direct his/her activities within the taxing state and must avail him/herself of the benefits of the jurisdiction. These benefits include the provision of a market in which to conduct business, of police services, and of a tribunal in which [he/she has] the

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98. *See, e.g.*, Advisory Commission on Electronic Commerce, *Issues and Policy Options Paper* (Dec. 3, 1999) <http://www.ecommercecommission.org/document/issuesPO.pdf>; S. 2028, 106th Cong. § 2 (2000); S. 2036, 106th Cong. § 1 (2000); S. 1611, 106th Cong. § 1 (1999); H.R. 3252, 106th Cong. § 2 (1999); National Tax Association, *Communications and Electronic Commerce Tax Project* (Sept. 7, 1999) <http://www.ntanet.org/ecommerce/final_report_cover.htm>; NGA Online, *Streamlined Sales Tax System for the 21st Century* (visited Apr. 30, 2000) <http://www.nga.org/Internet/Proposal.asp>.

99. On October 21, 1998, the Internet Tax Freedom Act was signed as public law. The Internet Tax Freedom Act prohibits the enactment of new, multiple, or discriminatory taxes on electronic commerce for a three year period. The Act did not impair the imposition of any state law concerning taxation that is permissible under the Constitution of the United States and in effect on the date of the enactment of the Act. The Internet Tax Freedom Act established the Advisory Commission on Electronic Commerce (the "ACEC") and provided that the ACEC should thoroughly examine taxation of Internet commerce and issue a report no later than eighteen months after the enactment of the Act. The report by the ACEC was issued in April, 2000. *See* Internet Tax Freedom Act, Pub. L. No. 105–277, 112 Stat. 2681 (1998).

100. *See* Part III.B, *supra*, for a discussion of this invitation.

> ability to state his/her claims. This Act shall hereby repudiate any requirement of physical presence within the taxing state.[101]

In effect, this proposed law would create a Commerce Clause standard identical to the standard applicable to the Due Process Clause.[102] As Justice White argued in his dissent in *Quill,* the standard exacted under the Commerce Clause should be no more stringent than that under the Due Process Clause. In fact, Justice White stated that the Court's holding in *Complete Auto* and the cases upon which the *Complete Auto* holding was premised were founded upon the minimum contacts nexus requirement; thus, the bifurcation of analysis created by the Court in *Quill* was, according to Justice White, inconsistent with stare decisis.[103]

Congress could further set a general framework for the taxation of electronic commerce. On a fundamental level, Congress should specify, for purposes of determining into which jurisdiction a merchant has purposefully directed its activities, whether the source or the destination state is deemed to be the default taxing state, or Congress could develop any other method of determining the appropriate taxing jurisdiction that could sufficiently avoid the threat of multiple taxation.

B. Adoption of the International Taxation Concept of Permanent Establishment

Alternatively, Congress could enact a law that incorporates the concept of permanent establishment from international tax analysis. Under the U.S. model income tax treaty, a permanent establishment is "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[104] Although the precise definition of the term "permanent establishment" varies among international tax treaties, the term traditionally has taken the form of a facility, construction site, or an agency relationship.[105] In the brick-and-mortar context, the meaning of "facility" includes a place of business or management, a

101. Megan E. Groves, *Where There's a Will, There's a Way: State Sales and Use Taxation of Electronic Commerce*, 74 IND. L. J. 293, 312 (1998).

102. *See* Part III.A, *supra*, for a discussion of the applicable Due Process standard.

103. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 325–28 (White, J., concurring in part and dissenting in part).

104. *See* United States Model Income Tax Convention (Sept. 20, 1996) art. 5.

105. *See* RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL 116 (3d ed. 1997).

branch, an office, or a factory; and the meaning of a "construction site permanent establishment" includes a building site or construction or installation project which lasts for more than twelve months. An "agency relationship permanent establishment" exists where a dependent agent of the business has the authority to enter into contracts on behalf of the business and "habitually exercises" such authority.[106]

The concept of permanent establishment was developed in the brick-and-mortar economy. Just as the state and local tax concept of substantial nexus must be revised because it is based upon traditional face-to-face retail sales, this international taxation concept must be revised so that it includes electronic commerce transactions within its parameters. The international organization entrusted with setting the standard for international tax treaties, the Organisation for Economic Co-Operation and Development (the "OECD"), has drafted language amending the provision in its Model Tax Convention on Income and on Capital concerning its conceptualization of a permanent establishment.[107]

The OECD proposal concedes that a website alone is not a permanent establishment. However, the server through which a website is accessed, if it is fixed (e.g., on a server located at a particular venue that is rented to or owned by the business that conducts activities through the website), may be deemed a permanent establishment. A website which is hosted by an Internet Service Provider ("ISP") would not constitute a permanent establishment because the ISP is an independent agent and would not have authority to execute contracts on behalf of the business.[108] In addition, human maintenance or operation of the website would not be necessary to establish a fixed place of business; equipment alone, as long as it is located at the particular venue for a "sufficient" period of time and performs "activities that form in themselves an essential and significant part of the commercial activity

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106. *Id.*

107. *See* Organisation for Economic Co-operation and Development Committee on Fiscal Affairs, *Progress Report: Taxation and Electronic Commerce* (visited Apr. 30, 2000) <http://www.oecd.org//daf/FSM/tagprogress99fsmke_en.html> [hereinafter *Progress Report*]. For the current text of the model, see ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL art. 5 (1997).

108. *See Progress Report*, *supra* note 107, Annex I at ¶¶ 2–3 (Proposed Clarification of the Commentary on Article 5 of the OECD Model Convention, Draft for Comments); *OECD Working Party Releases Draft Proposal on Defining PEs in E-commerce Context*, WORLDWIDE TAX DAILY, Sept. 30, 1999, *available in* 1999 WTD 189-16.

of an enterprise as a whole," may be deemed to be a permanent establishment.[109]

By adopting the proposed amendment to the OECD Model Tax Convention as the standard by which states determine the taxability of online transactions, Congress could minimize the burden of analysis for all merchants, both Internet and brick-and-mortar. A seller would first determine the country in which it has a permanent establishment; then, if the country in which the seller has a permanent establishment is the United States, the merchant would continue to apply the permanent establishment analysis to determine the state for which it must collect use tax. In addition, the adoption of the amended concept of permanent establishment would accomplish neutrality by ensuring that business occurring electronically is subjected to the same schemes of taxation as business occurring in more traditional ways.

V. CONCLUSION

With the explosive growth of revenues generated by electronic commerce, states are eager to gain access to this tax base. With uncertainty looming regarding the weight that should be accorded to the *Quill* physical presence nexus standard under the Commerce Clause, a state is unable to determine with exactitude its ability to compel out-of-state merchants to collect use taxes on purchases that will be delivered or used within the state. The nexus standard set by the Supreme Court in *Quill* has become impractical in this age of the information superhighway; as transactions increasingly occur over the Internet, the sales tax revenue lost by states will grow exponentially.

The most practical solution to the sales and use tax issues posed by electronic commerce is for Congress first to determine whether online sales should be subject to such taxes. If Congress decides to allow states to tax Internet purchases as if they had occurred in a face-to-face retail transaction, Congress could accept the Supreme Court's invitation in *Quill* to author a practical nexus standard for the Commerce Clause; then, Congress could attempt to satisfy the objectives of neutrality in the taxation of Internet and physical purchases as set forth by the Department of the Treasury and of non-discriminatory taxes as set forth in the Internet Tax Freedom Act. A tax policy based upon either minimum contacts or upon the international tax concept of permanent

109. *See Progress Report*, *supra* note 107, Annex 1 at ¶¶ 4, 7 (Proposed Clarification of the Commentary on Article 5 of the OECD Model Convention, Draft for Comments);.

establishments would accomplish these objectives and ensure that out-of-state merchants financially support the markets in which they derive their profits.