

NOTE

State Sales & Use Tax on Internet Transactions

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I. INTRODUCTION

With the explosive growth of electronic commerce, the way people do business is dramatically changing. More and more transactions are being conducted electronically, and the geographic boundaries that once played such a significant role in commerce are rapidly disappearing. With this growth and globalization of electronic commerce, state and local taxing authorities have become concerned that the information superhighway bypasses state and local taxation. Since sales and use taxes on transactions are major sources of revenue for state and local governments, erosion of this tax base has serious repercussions for their ability to support local infrastructures. Industry interests, however, express concern that taxation of Internet transactions, both from a financial and administrative perspective, would discourage innovation and investment in the information superhighway and impede its growth.

This Note argues that the existing structure for taxation of physical commerce does not fit the developing reality of an electronic commerce-based economy. The traditional means of taxing the sale of goods and services is based on concepts of physical assets, geographic locations, and face-to-face encounters. Commerce on the Internet is based on technology where there is no locality, no physical presence, and no geographic boundaries. Since Internet transactions do not fit into the traditional physical commerce tax structure, new standards for defining when and how a taxing jurisdiction may tax an Internet transaction must be developed.

Internet transactions have virtually eliminated the geographic boundaries between states and localities that formerly provided the framework for sales and use taxation. As a result, a national tax policy must be developed either through uniform state laws or federal legislation. Any federal legislation or uniform state laws developed to regulate interstate electronic commerce must balance the needs and concerns of state and local taxing authorities with the needs of businesses and consumers. This balance must occur within the framework of basic tax principles of fairness and equality and minimization of administrative and compliance burdens.

Although the taxation of electronic commerce raises issues in several tax areas, including international taxes, federal income taxes, and state and local property taxes, the focus of this Note is on state and local sales and use taxes. The Internet transactions that are discussed are the sale of goods and

services over the Internet, with either physical or on-line delivery to the purchaser from the vendor. This Note does not discuss sales and use tax issues relating to other Internet transactions, such as the sale of Internet access services, Web space, or Web page advertising.

Part II of this Note provides an overview of the traditional sales and use tax structure and discusses why modern electronic commerce does not fit into this traditional structure. Part III discusses some of the challenges of taxation of electronic commerce and the concerns of state and local taxing authorities versus those of businesses and consumers. Part IV provides a review of what guidance is currently available and the constitutional considerations in the taxation of Internet transactions. Part V proposes a national approach, through federal legislation or uniform state laws, to the sales taxation of Internet transactions and offers recommendations, such as a shift of focus from the seller's to the buyer's location, for addressing the taxing challenges of doing business in cyberspace.

II. OVERVIEW

A. *Traditional Sales and Use Tax Structure*

The typical sales tax structure of a state involves a retail sales tax imposed on tangible personal property purchased in the state.¹ A state may also impose a use tax on its residents for tangible personal property acquired in another state but used in their resident state.² Sales and use taxes are typically imposed on purchases by the final consumer, and transactions between businesses are exempt.³ The sales tax has been referred to as a "tax on the freedom of purchase[,]" whereas the use tax is a "tax on the enjoyment of that which was purchased."⁴

Three factors determine whether sales or use tax liability in a particular state exists for a transaction: (1) the type of good being sold, (2) situs, or the location where the transaction takes place, and (3) nexus.⁵ Traditionally, sales tax has been imposed on tangible goods, not on intangible goods or most services, and is assessed and collected at the location where the good is transferred from the seller to the buyer (the situs).⁶ The concept of nexus concerns whether the taxing jurisdiction has sufficient connection to have the

1. *See generally* 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES (1992).

2. *Id.*

3. *Id.*

4. *McLeod v. Dilworth Co.*, 322 U.S. 327, 330 (1944).

5. Sally Adams, *Danger: Internet Taxes Ahead*, TAXES, Sept. 1997, at 495, 501.

6. HELLERSTEIN & HELLERSTEIN, *supra* note 1, ¶ 12.03, at 12-8 to 12-9.

authority to impose taxes on the transaction and collection responsibility on the vendor.⁷ Each of these factors will be explored within the context of the Internet, as opposed to traditional physical, retail transactions.

B. *Shift to Electronic Commerce*

Electronic commerce is defined as “the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and techniques.”⁸ Examples of electronic commerce include on-line catalogs for ordering goods, computer software that can be downloaded, and on-line information, such as LEXIS or WestLaw electronic databases.⁹ Some of the primary growth areas for consumer purchases over the Internet are airline tickets, computer hardware and software, and books, music, and entertainment.¹⁰

In 1997, approximately “100 million people logged onto the Internet, up from 40 million the year before.”¹¹ A recent Forrester Research, Inc. study projects that “electronic commerce will reach about \$350 billion by 2002, from an estimated \$22 billion this year.”¹² Approximately “80% of business on the Net today is conducted between companies,” with the remaining 20 percent involving direct sales to consumers.¹³ The Forrester study estimates that “[n]early one-third of online households made a Net purchase [in the first six months of 1998], up 50% from [1997],” and that “[t]hose who didn’t buy online used the Net to help make a purchase decision.”¹⁴

The shift from physical commerce to electronic commerce has brought about changes in the way businesses market, package, and distribute their products. Traditionally, the purchase of goods by consumers involved either the consumer going to the merchant’s local retail store and buying the good or a representative of the company coming to the consumer’s home. These geographical constraints were first weakened by the advent of catalog shop-

7. Walter Hellerstein, *State Taxation of Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation*, 12 STATE TAX NOTES 1315, 1318 (1997) [hereinafter Hellerstein, *State Taxation: Preliminary Thoughts*].

8. Walter Hellerstein, *Telecommunications and Electronic Commerce: Overview and Appraisal*, 12 STATE TAX NOTES 519, 520 (1997) [hereinafter Hellerstein, *Telecommunications*].

9. *Id.*

10. Robert D. Hof, *The “Click Here” Economy*, BUS. WK., June 22, 1998, at 122, 124.

11. Bruce Ingersoll, *Internet Helps Spur Growth, Cut Inflation*, WALL ST. J., Apr. 16, 1998, at A3 (quoting Commerce Secretary William Daley).

12. Peter Coy, *You Ain’t Seen Nothin’ Yet: The Benefits to the Economy of E-commerce Are Boundless*, BUS. WK., June 22, 1998, at 130, 130.

13. *Id.*

14. Hof, *supra* note 10, at 126.

ping beginning one hundred years ago, which allowed consumers to order goods by mail from other locations.¹⁵ Direct marketing technologies, such as the use of toll-free numbers, computers, and faxes, have further reduced companies' needs for sales personnel or retail stores within states to sell to consumers there. With Internet Web pages increasingly replacing catalogs mailed to people's homes, the physical connection between mail-order sellers and consumers is becoming even weaker.¹⁶ Today, with personal computers and modems, consumers have instantaneous, twenty-four-hour access to a full range of goods and services from all over the world without having to leave their home or office.

The type of goods that consumers purchase is also shifting from tangible to intangible goods and services. Increasingly, it is the packaging, and not the content, of the good that classifies it as tangible. For example, in purchasing a book you physically acquire a tangible item—the book's cover, binding, and pages. However, what you are really purchasing are the contents of the book—the story contained in the words on those pages. As technology improves, there will be greater opportunities for purchasing goods such as books, software, music, and videos electronically by downloading over the Internet, which will allow the purchaser to acquire the content while avoiding the packaging altogether.

To illustrate the evolution of consumer purchases from traditional physical commerce to electronic commerce, assume that you wish to purchase a newspaper. Ten years ago, either you would go to a newsstand or store to purchase the paper or a "paperboy" would come to your home to deliver the paper and collect what you owed. Today, you could order the newspaper directly from the company over the phone or the Internet and have it delivered to your home by a common carrier, such as the postal service. Moreover, you could receive the newspaper in electronic form, either over the Internet or through electronic databases such as LEXIS or WestLaw. The newspaper is displayed on your computer screen rather than on paper, thus eliminating the "packaging" altogether, along with the expense and delay of shipping. As this example shows, the development of electronic commerce has brought about a broader range of choices at potentially lower costs to consumers.

15. Adams, *supra* note 5, at 497.

16. Nathan Newman, *Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway*, 9 STATE TAX NOTES 927, 928 (1995) [hereinafter Newman, *Proposition 13*].

C. *Lack of Fit Between Old Sales Tax System and New Electronic Commerce*

The three factors traditionally used in determining whether sales tax liability exists for a retail transaction present numerous problems in an electronic commerce environment. First, regarding the content or substance of the transaction, most taxing schemes impose a retail sales tax on tangible goods, yet more and more retail transactions involve intangible goods and services. Some intangible goods, like music, which are normally transferred through a tangible medium, such as a compact disc, can now be delivered through an electronic medium and avoid classification as a tangible good. As long as sales taxes are only imposed on tangible goods, this shift in the type of goods being purchased results in an erosion of the sales tax base and a subsequent reduction in sales tax revenues.

The second factor, *situs*, the location of the transaction,¹⁷ is readily determinable in a traditional transaction where a consumer goes to a retail store and purchases a tangible good—the taxing jurisdiction is the state where the vendor's store is located. However, if a resident of one state purchases a tangible good from an on-line catalog on the Internet from a vendor in another state, to be delivered to someone else in still another state, then it becomes unclear in which state the transaction occurred. One of the distinguishing characteristics of doing business in cyberspace is that there are no geographic boundaries because events on the Net occur "everywhere, nowhere in particular, and only on the Net."¹⁸ A physical concept such as *situs* does not adapt easily to a nonphysical environment like the Internet.

The concept of *nexus*¹⁹ deals with whether the taxing jurisdiction has sufficient connection to the transaction to have the power to impose a sales or use tax on the transaction or collection duty on an out-of-state vendor.²⁰ Since the buyer and seller need not have direct contact to engage in a transaction over the Internet, a nexus problem may develop if the buyer and seller reside in different jurisdictions.²¹ The nexus issue can also arise with regular mail-order sales, but the increase in on-line sales further exacerbates the problem. States have the authority to impose a sales tax on goods purchased

17. BLACK'S LAW DICTIONARY 1387 (6th ed. 1990).

18. David R. Johnson & David Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367, 1375 (1996).

19. Nexus is defined as the sufficient presence of an entity with a state so as to apportion the entity's taxable income to the state. BLACK'S LAW DICTIONARY, *supra* note 17, at 1044.

20. Adams, *supra* note 5, at 502-03.

21. *Id.*; See also Matthew N. Murray, *Telecommunication Services and Electronic Commerce: Will Technology Break the Back of the Sales Tax?*, 12 STATE TAX NOTES 272, 274 (1997).

within the state, regardless of who purchases the goods, or to impose a use tax on the purchases their residents make, regardless of where they purchased the goods.²² Even if the state has the authority to impose a sales or use tax on a transaction, it may not have the authority to impose collection responsibility on the vendor.²³

Traditionally, collection responsibility depended upon whether a vendor had physical ties, or “substantial physical presence” in a state.²⁴ Physical presence could be readily determined in an environment where transactions took place at a physical location or with sales representatives of the company within the state.²⁵ But in an electronic commerce environment, as with mail-order, vendors often do not have physical connections with the state, such as a warehouse or retail outlet, and may not even know the physical location of their customers when the customers make purchases via the Internet.

A major issue in the area of state taxation of electronic commerce is the determination of which nexus standard to apply to Internet transactions.²⁶ The nexus issue will be explored more fully in the subsequent discussion of the Supreme Court opinion of *Quill Corp. v. North Dakota*, dealing with sales tax nexus in a mail-order context.²⁷

III. CHALLENGES AND CONCERNS

A. *Concerns of State and Local Taxing Authorities vs. Businesses and Consumers*

While on-line and mail-order commerce has been growing, traditional sources of state sales tax revenue have been dwindling.²⁸ States are concerned that their current sources of sales tax revenue are being shifted to an electronic environment where goods are less tangible, and locations of sellers

22. See discussion in Nathan Newman, *The Great Internet Tax Drain*, TECH. REV., May-June 1996, at 24 [hereinafter Newman, *Tax Drain*].

23. *Id.*

24. See discussion of physical presence *infra* Part IV.

25. Jeanne Goulet, *State Taxation of the Internet*, Paper Presented at the Harvard Spring 1997 Tax Symposium 9 (Apr. 5, 1997) (on file with the *Federal Communications Law Journal*).

26. Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues*, 52 U. MIAMI L. REV. 691, 694 (1998) [hereinafter Hellerstein, *Reflections*].

27. *Quill Corp.*, 504 U.S. 298 (1992).

28. Newman, *Tax Drain*, *supra* note 22, at 26.

and buyers are often unidentifiable.²⁹ As a result, state and local sales tax revenue could plummet.

The United States Advisory Commission on Intergovernmental Relations has estimated that "\$3.3 billion in state and local sales taxes are . . . lost each year due to mail-order sales."³⁰ This represents "approximately 2.4 percent of total state sales tax collections."³¹ While direct Internet sales are not very large (approximately \$2 billion, or 20 percent of total Internet sales, in 1997),³² they are growing dramatically, and an on-line presence makes it easier for companies to expand mail-order operations, resulting in an even greater erosion of sales tax revenue.³³

Loss of this source of revenue could have a serious impact on a state's financial position because "sales taxes generally yield more revenue for state governments than any other tax."³⁴ [Forty-four] states (and the District of Columbia) now impose taxes on retail sales that account for an average of 25 percent of states' annual income."³⁵

Businesses and consumers argue that the Internet has provided new opportunities for entrepreneurs and small businesses, and that the imposition of sales tax liability on transactions over the Internet will serve as a disincentive to explore this new commerce venue and discourage new business.³⁶

Businesses involved in electronic commerce are also concerned that collection responsibility will be shifted their way, which could be a monumental administrative task.³⁷ Some vendors argue that "[W]ith 46 states, Washington, D.C., and more than 6,000 counties, cities, and school districts collecting sales taxes (Delaware, Montana, New Hampshire, and Oregon do not collect state or local sales taxes), the complexity of tracking tax rates in each area and dealing with local government authorities would overwhelm most businesses."³⁸

29. Adams, *supra* note 5, at 497-98.

30. Newman, *Proposition 13*, *supra* note 16, at 927 (citation omitted).

31. *Id.* at 929 (citation omitted).

32. Hof, *supra* note 10, at 124-25 (quoting Forrester Research study that "[b]usiness-to-business [electronic] commerce will account for 78% of the total spent on cyber transactions [in 1998]," and that business-to-business sales totaled approximately \$8 billion in 1997).

33. Newman, *Proposition 13*, *supra* note 16, at 928.

34. Adams, *supra* note 5, at 498.

35. Newman, *Proposition 13*, *supra* note 16, at 928.

36. Dean F. Andal, Read My E-mail, No New Taxes, Paper Presented at the Harvard Spring 1997 Tax Symposium i (Apr. 5, 1997) (on file with the *Federal Communications Law Journal*).

37. See Adams, *supra* note 5, at 500.

38. Newman, *Proposition 13*, *supra* note 16, at 930 (citation omitted).

B. Compliance Challenge

Tax compliance is also complicated in an electronic environment because of the inability to observe electronic transactions.³⁹ This is not an issue with on-line orders for physical goods since the purchaser provides a name and shipping address, although the sales tax on large-ticket items may be high enough to provide an incentive to have the goods shipped to a different location to avoid imposition of a tax. The lack of an audit trail can also be a concern with the purchase of non-physical goods, such as downloading a software program.⁴⁰ It can be difficult to identify the source or the destination of the transaction or determine the location of the taxable event in a transaction that does not involve a physical good without the cooperation of the buyer. “While tax compliance has depended historically on identifying key taxing points, electronic commerce creates a challenge for the identification of such key points[,]” and such transactions may be prime candidates for tax avoidance.⁴¹

C. Collection Concerns

Once tax liability to a particular state is determined, the question remains as to who is responsible for collecting and reporting the tax due. In a traditional physical commerce transaction where a consumer goes to a retail store and purchases a good, the retail store is typically responsible for the collection and reporting of the sales tax on the transaction.⁴² Since the retail store, as the middleman between the consumer and the producer, is the location where the transaction takes place, it is responsible for collecting and remitting the sales tax to the state where the store is located.⁴³

However, one of the characteristics of electronic and mail-order commerce is the change in the role of a middleman in consumer transactions. In electronic commerce, the middleman may not be used at all. Consumers can purchase directly from companies more easily than ever before without having to go to a local intermediary to get the product, which removes the retailer as a means of collecting the sales tax. If a middleman is used, it is no longer used as a means to disseminate a company’s products to retailers, and ultimately to consumers, but as an intermediary to bring buyers and sellers together.⁴⁴ For example, a consumer looking for a particular book can order it through Amazon.com, an on-line bookstore, which will “shop” for the best

39. Murray, *supra* note 21, at 274.

40. See Adams, *supra* note 5, at 499.

41. *Id.* at 498-99.

42. See generally HELLERSTEIN & HELLERSTEIN, *supra* note 1, ch. 19.

43. *Id.*

44. Hof, *supra* note 10, at 125.

bargain and have the book delivered to the consumer.⁴⁵ The role of the new “cyberintermediaries” is to provide a convenient service to consumers, rather than a distribution channel for sellers.⁴⁶

Since the traditional middleman role is disappearing, the issue for states is to determine who or what will now serve this collection function. Although some argue that the Internet Service Provider (ISP) serves such a middleman role, the ISP serves only as a medium for the exchange between the vendor and the consumer.⁴⁷ “Telecommunications service providers are no more the vendor of goods and service delivered using their services than the express delivery company is the vendor of goods carried to purchasers in its trucks.”⁴⁸

If the ISP is not a middleman in the transaction, who will serve the collection function for the taxing jurisdiction? One possibility for collection is the Internet vendor, but in most cases, out-of-state vendors are protected under the U.S. Constitution’s Commerce Clause from state imposition of sales or use tax collection responsibility if they do not meet a “physical presence” test.⁴⁹ Another possible collection mechanism is for the purchaser to directly submit a use tax, but since compliance is voluntary and hard to track, enforcement would be difficult.

D. Need for Predictability

A major concern for all parties with an interest in the sales taxation of Internet transactions is the uncertainty surrounding the imposition and collection of the tax.⁵⁰ The unknowns of whether tax will be collected on a transaction, by whom and from where, “create enormous monetary risks” for “both taxing authorities and taxpayers.”⁵¹ This lack of guidance and predictability regarding the tax liability associated with transactions seriously hampers the development of electronic commerce. Before further progress can reasonably be made in the development of electronic commerce, all the players need to know the rules of the game.⁵²

45. See *Amazon.com* (visited Nov. 8, 1998) <<http://www.amazon.com>>.

46. Hof, *supra* note 10, at 125.

47. Goulet, *supra* note 25, at 9.

48. James R. Eads, Jr., Random Thoughts About a Possible Path, Paper Presented at the Harvard Spring 1997 Tax Symposium 3-4 (Apr. 5, 1997) (on file with the *Federal Communications Law Journal*).

49. *Id.* at 4. See also discussion of constitutional considerations *infra* Part IV.

50. See Murray, *supra* note 21, at 275.

51. See Adams, *supra* note 5, at 501.

52. Murray, *supra* note 21, at 275.

IV. SUPREME COURT GUIDANCE ON THE NEXUS ISSUE

A. *Constitutional Issues*

States are limited by both the Due Process and Commerce Clauses of the U.S. Constitution from imposing a tax liability or collection responsibility on a business unless there is substantial nexus, or in-state contact, established with the state.⁵³ The degree of nexus sufficient to establish taxing jurisdiction is a major issue in dealing with sales taxation of Internet transactions.

Presently, there is no statutory authority or case law addressing nexus matters and the Internet for transactions involving the sale of goods.⁵⁴ There is, however, well-established case law pertaining to out-of-state sellers of tangible personal property that can provide at least some guidance in this area.⁵⁵

B. *Mail-Order Cases*

Three Supreme Court cases dealing with the imposition of sales and use tax on mail-order sales provide guidance on sales tax nexus standards for out-of-state vendors. First, in *National Bellas Hess, Inc. v. Illinois Department of Revenue*,⁵⁶ the Supreme Court held that the state of Illinois was restricted from imposing a use tax collection duty on a Missouri-based mail-order company for sales to Illinois customers. Bellas Hess had neither outlets nor sales representatives in Illinois, and its only contact with the state was via mail or common carrier. The Court held that there was insufficient contact to establish nexus under either the Due Process or the Commerce

53. Walter Hellerstein, *Supreme Court Says No State Use Tax Imposed on Mail-Order Sellers . . . for Now*, 77 J. TAX'N 120, 120 (Aug. 1992) [hereinafter Hellerstein, *Supreme Court*].

54. Bruce J. Reid, On the First Day, the Computer Gods Created Info. Serv. On the Second Day, the Tax Collector Subscribed, Paper Presented at the Harvard Law School 1997 Symposium 1 (Apr. 5, 1997) (on file with the *Federal Communications Law Journal*). There have been several recent cases involving nexus and the Internet in transactions other than the sale of goods over the Internet, but these areas are beyond the scope of this Note. See, e.g., *Bensusan Restaurant Corp. v. King*, 937 F. Supp. 295 (S.D.N.Y. 1996), *aff'd*, 126 F.3d 25 (2d Cir. 1997) (involving trademark infringement and web advertising); *Compuserve, Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996), *reh'g denied*, 514 U.S. 1035 (1996) (basing jurisdictional presence on telecommunications business activities); *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995) (imposing sales tax in state of purchase of bus ticket).

55. Reid, *supra* note 54, at 1.

56. *National Bellas Hess, Inc.*, 386 U.S. 753 (1967), *overruled by* *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Clause and embraced a physical-presence nexus standard for both.⁵⁷ The Due Process Clause relates to the fairness of the tax burden and whether a company has minimum contacts with the taxing jurisdiction.⁵⁸ The concern under the Commerce Clause is the affect of state tax policy on interstate commerce.⁵⁹

In *Complete Auto Transit, Inc. v. Brady*,⁶⁰ the Supreme Court clarified the four-prong test of the Commerce Clause: the state tax must be “applied to an activity with substantial nexus with the taxing state, [must be] fairly apportioned, [must] not discriminate against interstate commerce, and [must be] fairly related to the services provided by the State.”⁶¹ Although *Complete Auto Transit* clarified the nexus standards for the Commerce Clause, it did not address the Due Process Clause.

In its 1992 decision in *Quill Corp. v. North Dakota*,⁶² the Supreme Court revisited *Bellas Hess* and set forth guidelines for determining what constitutes sufficient in-state contact to establish taxing jurisdiction under both the Due Process Clause and the Commerce Clause. The facts in *Quill* were virtually identical to those of *Bellas Hess*: Quill was an Illinois-based vendor with neither outlets nor sales representatives in North Dakota, and all of its contacts with the state were via mail, telephone, or common carrier.⁶³ Once again, the issue before the Court was whether such an out-of-state vendor had sufficient nexus with the state to support the state’s imposition of a duty to collect a use tax on sales to residents of that state (in this case, North Dakota).

In *Quill*, the Court did not review the nexus standards under both clauses together as it had in *Bellas Hess*, but instead considered the nexus question separately under each clause.⁶⁴ Although *Bellas Hess* had suggested that physical presence was a due process requirement, the *Quill* Court concluded that physical presence was not required for nexus under the Due Process Clause.⁶⁵

The Court held that the only due process requirement is that the out-of-state vendor’s efforts are “purposefully directed toward residents of another

57. Hellerstein, *Supreme Court*, *supra* note 53, at 120.

58. *Id.*

59. *Id.*

60. *Complete Auto Transit, Inc.*, 430 U.S. 274 (1977), *reh’g denied*, 430 U.S. 976 (1977).

61. *Id.* at 279.

62. *Quill Corp.*, 504 U.S. 298 (1992).

63. *Id.* at 302.

64. *Id.* at 312.

65. *Id.* at 312-13.

State,”⁶⁶ which for an out-of-state mail-order vendor would involve purposefully directing its solicitation toward residents of the taxing state.⁶⁷ However, even though the Court did not impose a physical-presence standard for due process, the physical-presence standard for the Commerce Clause, which requires a more substantial nexus, was reaffirmed.⁶⁸ So, although the Court held that the Due Process Clause did not bar the state from imposing a use tax collection duty on Quill, the Commerce Clause did.

The physical-presence requirement for imposing a use tax collection obligation on out-of-state sellers provides a large measure of protection for businesses. In the context of electronic merchants, it may be even more difficult to establish nexus since contacts made via electronic commerce may be much less than for mail-order sellers. Under the guidelines that exist from *Quill*, states will often be unable to require the vendor to collect taxes on goods sold over the Internet.

However, the Supreme Court in *Quill* specifically invited Congress to act in the area of interstate sales pursuant to its power to regulate interstate commerce under the dormant Commerce Clause.

By removing any due process objection to the imposition of use tax collection obligations . . . and by resting the physical-presence rule entirely on the Commerce Clause, the Court left the ultimate decision as to state taxation of mail-order sellers in the hands of the Legislative Branch. Because of Congress’ plenary authority under the Commerce Clause to broaden or restrict state taxing powers affecting interstate commerce[,] . . . Congress plainly may authorize the states to require mail-order sellers to collect use taxes.⁶⁹

Although Congress has not chosen to pass such legislation, the sales tax issue should receive increasing attention along with other emerging electronic commerce issues.

C. *Similarities Between Mail-Order and Telephone-Order Sales and Internet Sales*

In sales transactions involving physical goods, the purchase of a product over the Internet is essentially no different from a purchase by mail order or telephone order. The rules pertaining to mail-order and telephone-order sales should also apply to Internet sales. The real issue for the purchase of physical goods becomes whether the current guidelines, as provided in *Quill*, continue to be appropriate for out-of-state sales in light of the dramatic

66. *Id.* at 308 (quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985)).

67. *Quill Corp.*, 504 U.S. 298 (1992).

68. *Id.* at 317.

69. Hellerstein, *Supreme Court*, *supra* note 53, at 123-24 (citation omitted).

change in the way consumers make purchases and the sheer volume of on-line transactions.

Another concern in the electronic commerce area is the elimination of "packaging."⁷⁰ As technology continues to improve, consumers will be able to obtain previously tangible goods in an intangible form by downloading directly.⁷¹ Under the typical state sales tax scheme, intangibles are not subject to sales tax.⁷² With a continued focus on physical presence as a standard for the imposition of sales tax, as provided in *Quill*, fewer transactions will be subject to sales tax.

V. APPROACH TO A POSSIBLE SOLUTION

A. General Guiding Principles

In analyzing possible sales tax schemes for Internet transactions, the following generally recognized tax policy principles should be used as guidelines.⁷³

1. Economic Neutrality

Under the principle of tax neutrality, goods and services provided in electronic commerce should be taxed no differently from goods or services provided in conventional commerce.⁷⁴ A "neutral sales tax would fall on the final sale of goods, . . . regardless of the source of supply."⁷⁵ Consequently, "[i]ntangible products sold and delivered over the Internet should be treated the same way for tax purposes as products purchased off-line in the tangible world."⁷⁶ For example, if states tax software purchased at a retail store but do not tax that software when it is purchased over the Internet, the state violates the principle that "a tax system should treat economically similar transactions the same."⁷⁷

70. Adams, *supra* note 5, at 497.

71. The classification of intangible vs. tangible transactions in the context of international income taxation has recently been addressed in Treas. Reg. § 1.861-18 (1998), dealing with sales or royalty income generated from foreign transactions involving the downloading of computer programs.

72. HELLERSTEIN & HELLERSTEIN, *supra* note 1, ¶ 12.03, at 12-9.

73. See generally Hellerstein, *State Taxation: Preliminary Thoughts*, *supra* note 7; Adams, *supra* note 5; and Murray, *supra* note 21.

74. Hellerstein, *State Taxation: Preliminary Thoughts*, *supra* note 7, at 1315.

75. Murray, *supra* note 21, at 273.

76. Hellerstein, *Reflections*, *supra* note 26, at 697 (quoting Information Technology Association of America (ITAA), *Straight Talk: Internet, Tax & Electronic Commerce: A White Paper on Taxation of Electronic Commerce and the Internet* 10 (undated and unpublished manuscript)).

77. See Hellerstein, *Telecommunications*, *supra* note 8, at 522.

2. Uniformity

State sales taxes on electronic commerce should be uniform ““from state to state and from taxpayer to taxpayer.””⁷⁸ This does not mean that all states need to use the same tax rate, but that uniform standards and definitions should be used in defining the sales tax base. Without a uniform tax system, a state where a seller is located could impose a tax and the home state of the buyer could as well, resulting in double taxation. In addition, the lack of uniform standards could allow a direct seller to be in the position of collecting a sales tax if a product is ordered on its Web site, but not if it is purchased by phone. Uniformity should provide the same tax on a good regardless of the way the consumer buys it or from whom the consumer buys it.

3. Administrability

Another important objective is to minimize administrative costs and compliance burdens for both taxpayers and tax administrators.⁷⁹ “A serious practical complication for tax administrators is the lack of observability of electronic transactions, creating a practical obstacle to administration and enforcement.”⁸⁰ Since the transaction cannot be observed, it can be difficult, and often impossible, to identify the parties in the transaction or their location if they choose to remain anonymous.⁸¹ This translates into higher administrative costs and heavy burdens on the retailers who would be responsible for collection of the tax.

B. National Focus

Since the Internet effectively eliminates geographic borders, taxation of transactions over the Internet cannot be realistically bound by state borders. Due to the importance of electronic commerce for the national economy and the need for uniformity, the issue requires a national focus, rather than allowing each state to address the issue individually.

Several approaches for the development of uniform laws have been proposed, including turning to traditional bodies that have written uniform laws, such as the American Law Institute (ALI) or the National Conference of Commissioners of Uniform State Laws (NCCUSL), or providing a forum for discussion through national tax associations, such as the Multistate Tax

78. Hellerstein, *State Taxation: Preliminary Thoughts*, *supra* note 7, at 1315 (citation omitted).

79. *Id.* at 1316.

80. Murray, *supra* note 21, at 274.

81. *Id.*

Commission.⁸² Federal legislation in the area of electronic commerce is also an alternative. In *Quill*, the Supreme Court invited Congress to act in the area of mail-order sales under its power to regulate interstate commerce.⁸³

Since electronic commerce crosses (or ignores) state lines, it is an area of interstate commerce where federal regulation is appropriate and desirable.

⁸⁴ Since the current guidelines provided by *Quill* protect the vendor from tax collection responsibility, congressional action is required if collection responsibility is to be placed on the seller.

Legislation was proposed, which President Clinton endorsed on February 26, 1998, imposing a moratorium on new taxes on Internet commerce to allow time to study the issue.⁸⁵ Clinton noted that "the moratorium does not prevent state and local governments from applying existing taxes to electronic commerce, as long as there is no discrimination between an Internet sale and a traditional one."⁸⁶ Under this proposed bill, states could still collect taxes on sales of goods to buyers living in the same state as the merchant, but not if the sales are made to buyers in other states—the same rules that apply to mail-order sales.⁸⁷ The legislation was passed by Congress in October 1998, imposing a three-year moratorium on new state and local taxes on Internet commerce, and allowing for a commission to study the type of tax treatment that should be applied to the Internet.⁸⁸

C. *Redefining Nexus*

The first issue that must be resolved in proposing a solution to the sales taxation of Internet transactions is the definition of nexus, or what constitutes "sufficient connection" with the transaction for a state to be able to tax the transaction. Since the traditional definition of nexus is tied to physical location, it is totally inapplicable to electronic commerce. The only physical contact that an on-line vendor might have with a state could be the location of a server, which has nothing to do with the economic substance of the transaction, and could be easily moved to another location to avoid taxation.⁸⁹

82. Adams, *supra* note 5, at 506.

83. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992), *cert. denied*, 510 U.S. 859 (1993).

84. See Adams, *supra* note 5, at 506.

85. Tom Raum, *Clinton Backs Ban on New Internet Taxes, Offers New Disaster Aid*, THE ASSOCIATED PRESS, Feb. 26, 1998.

86. *Id.*

87. *Id.*

88. *Tax Moratorium*, CQ WKLY., Oct. 17, 1998, at 2818.

89. See Hellerstein, *State Taxation: Preliminary Thoughts*, *supra* note 7, at 1318; Adams, *supra* note 5, at 508.

Professor Walter Hellerstein of the University of Georgia, a well-recognized expert in the sales and use tax area, suggests one possibility for redefining nexus as “the establishment of nexus over the out-of-state vendor in the state of the purchaser.”⁹⁰ Congress could require on-line vendors to collect and remit sales/use tax to the state of the purchaser. The state of the purchaser could be based on locational information provided to the vendor by the purchaser, such as the billing address or shipping address.⁹¹ The concern that on-line vendors express about the burden and complexity of such a responsibility is without merit. Basic spreadsheet programs (Excel, Lotus) could easily be developed to calculate the sales tax for a large number of jurisdictions based on the rate of the relevant taxing jurisdiction.

Another alternative to having the on-line vendor collect the taxes is to have states directly tax consumers through a use tax, placing the burden of reporting and remitting on the consumer.⁹² States have the authority to tax their residents, regardless of where or how the residents buy their goods.⁹³ Use taxes, however, are hard to collect. Since use taxes are self-assessed, they require taxpayers to maintain records of their purchases, and reporting is basically done on an honor system.

There are several advantages to a system of taxing transactions based on the location of the purchaser and imposing collection responsibility on the on-line vendor. One is that it is relatively simple and easy to understand for all parties involved: consumers, vendors and state and local governments.⁹⁴

The vendor is also the most logical party to collect the tax since it has access to the relevant information about the transaction. Having the on-line vendor collect the tax and remit it to the appropriate state also helps maximize sales tax revenue for states because it provides states with a mechanism for taxing transactions that they would otherwise have a difficult time capturing.⁹⁵

One of the weaknesses of such a system is the difficulty for the vendor of obtaining locational information without the cooperation of the purchaser since one of the characteristics of the Internet is that the vendor may not know the location, or even the identity, of the party with whom he is dealing.⁹⁶ For all practical purposes, however, the “anonymous purchaser” is by

90. Hellerstein, *State Taxation: Preliminary Thoughts*, *supra* note 7, at 1318.

91. *Id.*

92. A solution involving “enforcement of existing use tax laws on consumers based on information furnished by sellers” was suggested by James Eads, Jr., *Random Thoughts About a Possible Path*, *supra* note 48, at 10.

93. Hellerstein, *State Taxation: Preliminary Thoughts*, *supra* note 7, at 1319.

94. *Id.*

95. *Id.*

96. *Id.*

far the exception in Internet transactions. Locational information generally must be provided for delivery, in the case of tangible goods, or for billing purposes, since at least currently such transactions must be paid for with a credit card. Although a purchaser could avoid taxation by having an item shipped to a fictitious address in a state without a sales tax, this risk of tax avoidance already exists with mail-order sales, and in most cases, the potential tax savings would not be worth the trouble to the taxpayer.

VI. CONCLUSION

Electronic commerce is experiencing rapid growth, and this explosive growth is expected to continue. The economic reality is that the means by which consumers are purchasing goods and services, and the types of goods and services they are purchasing, are changing dramatically and will continue to change. Physical presence, the current standard for establishing nexus in the sales and use tax context, is no longer an appropriate measure of a state's connection to a transaction. Without the ability to impose a tax on these transactions, states will no longer be able to rely on sales tax as a source of revenue.

Reevaluation of the overall sales and use tax structure requires looking at all consumer transactions, including mail-order and telephone-order sales, and not just Internet transactions. New standards for defining when and how a state or local taxing jurisdiction may tax a transaction must be developed. Transactions are no longer bound by state geographic boundaries; therefore, any system for taxing these transactions requires a national, rather than a state or local approach. The Supreme Court's invitation to Congress in *Quill* to act in the area of interstate mail-order sales under its power to regulate interstate commerce also applies in the area of electronic commerce.

In developing new guidelines, whether through federal legislation or uniform state laws, there must be uniformity. The sales and use tax system should impose taxes uniformly on goods and services, regardless of how and from whom they are purchased. If a product is subject to tax, then that tax should be imposed regardless of whether it is purchased in a store, over the telephone, through the mail, or over the Internet.