THE EFFECTS OF INTERNET COMMERCE ON THE REVENUE BASE OF STATE AND LOCAL GOVERNMENTS

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ABSTRACT

Internet sales for 2000 are projected to be $850 billion. This explosion in growth of sales on the Internet has not been all good news to the U.S. business community. Both business and government have taken notice of taxation issues related to these electronically generated revenues. Sales taxes have been the primary focus of this attention. Many issues have been raised but the primary one is whether or not sales taxes should be collected from "cyberspace" customers.

The issue of whether a business has the requisite legal nexus in a tax jurisdiction is a key issue. Where there is nexus, sales taxes are required to be charged and remitted to the appropriate tax jurisdiction. In addition, where there is nexus, the same sales that are subject to sales tax would be includable in the income tax calculation in jurisdictions that have an income tax.

Many difficult questions have been raised and remain to be solved. One federally appointed commission has been formed, submitted recommendations to Congress and has dissolved. A National Governors' Association committee is currently in place to study the issues and provide suggestions to state legislatures in 2001 and 2002.

When flying, don't you just hate it when you find out that the person next to you paid less than you did for the flight? Well, your neighbors may not be paying as much for products and services as you. Or, are you the one paying less? This possibility exists because you or your neighbor may **not** have been charged a sales tax on an item ordered over the Internet. Beware, the taxing authorities do not intend for this disparity to continue. An ongoing controversy is taking place on whether, or how, to tax the Internet.

The General Accounting Office (GAO) documented state and local governmental sales tax revenues collected as $203 billion in 1999, accounting for 33 percent of state and 11 percent of local tax revenues. Furthermore, the GAO report estimates sales tax losses on E-commerce related sales might be as high as $20 billion by the year 2003. See Table 1 on the GAO estimates of the size of sales tax losses from Internet sales.[i] [Table 1 about here]

In a different study on E-commerce, the Center for Research in Electronic Commerce (CREC) at the University of Texas estimated that revenue from the Internet economy in 1999 exceeded $500 billion.[ii] According to CREC, this represented a 62% growth from 1998, which was a growth rate approximating 15 times that of the U.S. economy as a whole. In addition, the CREC estimates Internet economy revenue will reach $850 billion in 2000. There is no denying that there has been phenomenal growth in recent years in Internet revenues, and no matter which projections turn out to be most accurate, it is a certainty that more and more revenues will be generated from transactions consummated on the Internet.

Many businesses are riding the cutting edge of this new method for selling goods and services. Many others are positioning themselves to get involved. In general, many businesses see the Internet as a valuable tool to reach current and prospective customers. In many cases, the revenues generated are from customers in states where the companies had not previously conducted business. This seamless entry, via the Internet, into interstate commerce is quite different than what a similar excursion into new states would have looked like just a few years ago. Many other modes of expanding into new states were prevalent in the past. These might have included those necessitating a minimal physical presence, such as catalog distributions. The opposite extreme might have been a decision to acquire a physical operations base, such as a factory or office building. Of course, entry into a new state might have been accomplished via a method somewhere between these two extremes, perhaps by covering the state with travelling sales people.

As will become evident, physical presence in a state, or lack thereof, is a vital aspect of how taxing authorities in many states view revenue transactions. Numerous issues can impact how a transaction is treated for tax purposes. However, in relation to Internet revenues, the most important issue to address is the concept of *nexus*. The dictionary defines *nexus* in relatively succinct terms as a connection or link.[iii] As can often be the case, the words used in a definition may themselves need defining or clarification. In tax law, the practical meaning of nexus has proven to be elusive. The definition and proper application of *nexus* are considered further in the following discussion.

This article considers the impact E-commerce is having on state and local taxation. Specifically, the early portion of the article focuses primarily on the issue of *nexus*. The focus on nexus is not intended to undermine the potential relevance of other issues.

First, the legal background of the tax issues related to interstate commerce is covered. Secondly, state and local income and sales tax implications are reviewed. After reviewing the general issue of taxing the Internet, specific ongoing projects related to Internet taxes are discussed.

LEGAL BACKGROUND

The U.S. constitution authorizes Congress to “regulate commerce with foreign nations, and among the several States …”[iv] The application of what is referred to as the *Commerce Clause* has proven to be difficult over the years, often resulting in litigation to determine what is and is not covered by the wording of this clause. Courts, including the Supreme Court, have delivered decisions both allowing and disallowing taxation of interstate commerce during the past 170 plus years.[v]

As is often the case with tax issues, a decision based on the facts and circumstances in any particular court case is difficult to extrapolate to future cases. However, two decisions in more recent history have provided the most current authority regarding the Commerce Clause. The Supreme Court, in *Complete Auto Transit, Inc. v. Brady,*[vi] acknowledged states’ rights to impose a direct tax on interstate commerce. In the decision, the Court formulated a four-prong test to determine if a state tax violates the Commerce Clause. In order to apply a state tax to an interstate transaction, the tax must: (1) apply to an activity with a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to services provided by the state.

The "substantial *nexus*" portion of the test in *Complete Auto* became the key issue in a recent Supreme Court decision. In *Quill Corp. v. North Dakota,*[vii] the Court ruled that a North Dakota law was in violation of the Commerce Clause. The North Dakota law required out-of-state mail-order sellers to collect North Dakota tax on its in-state sales. In the decision, the Court ruled in favor of Quill by indicating that "substantial *nexus*" requires a physical presence by the vendor.

What still remains to be resolved more fully is what is physical presence? Does the law require an actual physical presence, such as a "brick and mortar" store, often called main street retailers? Or, can a more minimal connection satisfy the physical presence requirement, such as in-state advertisements or travelling sales people? There is no absolute controlling authority, law or court case, that fully addresses these issues.

As the foregoing indicates, determining nexus in relation to a sales transaction can be very elusive and a vexing problem. To date, no court case has specifically addressed *nexus* in relation to Internet sales. The lack of a universal and concise definition of nexus will give the Internet and other remote sales freedom from taxation until either Congress or the courts settle the *nexus* issue.

TAX IMPLICATIONS

Two types of taxes levied by many states, sales and income, will each have varying impacts in relation to the Internet. Although sales taxes have, thus far, been the primary focus of discussions relating to transactions occurring on the Internet, potential state income tax consequences should not be ignored.

The Challenge of Where and When to Tax

Numerous issues need to be considered before the proper tax, sales and/or income, can be applied to Internet transactions. The primary focus of the list that follows is to determine ***where*** an Internet transaction might be deemed to have occurred. It is presumed that the question of ***where*** has some room for doubt based upon the facts (i.e. two or more different tax jurisdictions could be involved). Once the ***where*** question is answered, the question of ***when*** the transaction took place would also be of interest for reporting purposes. The challenge of determining where and when to tax is related to properly defining the *nexus*. Below is a listing of questions related to the ***where*** and ***when*** issues. The list is intended to be illustrative in nature, and not an exhaustive listing of every issue worthy of consideration.

1. **Where was the merchandise or service provided?** In the case of merchandise, will the delivery address control for nexus purposes? What difference, if any, would it make if the merchandise were delivered by common carrier rather than by the vendor's vehicle?
2. **Where is the customer?** Is the delivery point a storage facility serving several tax jurisdictions? Does the customer have a billing address different from the delivery address? Do these things matter?
3. **Where is the seller?** Does the seller have headquarters in one tax jurisdiction, but numerous sales locations from which the customer order might be handled? Could the sales invoice be prepared at one location, but the merchandise actually come from a different location

(perhaps in a different tax jurisdiction)? Is the Internet seller simply a broker representing a seller or sellers? If so, where are these sellers?

The foregoing illustrates the point that electronic commerce presents a new universe of challenges to the business community and taxing authorities alike. The existing legal infrastructure will probably need adjusting in order to properly address these challenges.

INCOME TAXES

In states with an income tax, the base against which the tax rate is applied often times has as a starting point the Federal tax return. The Federal tax return will, presumably, include all revenues generated by the company, Internet sales included. Therefore, for states using the Federal tax return as the starting point for calculating an income tax, the Internet revenues will be included in the tax base.

The calculations necessary to determine what part of the Federal tax base is apportioned to any one state in this situation can become complex. For example, most states add back to the Federal tax base any deductions taken for state and local taxes paid. In addition, most states subtract from the Federal tax base any Federal taxes paid. It is possible that there may be a need to address adjustments, by state, to apportion Internet revenues included in the Federal tax base. If this is done, the questions about where the Internet transaction really took place become applicable for income tax calculations. This will involve a proper *sourcing* of these transactions. In essence, sourcing is the tax terminology used in determining which jurisdiction should get "credit" for a sales transaction.

SALES TAXES

Forty-five states and the District of Columbia have a sales tax. Sales taxes represent a major source of revenues in jurisdictions relying upon it. Most individuals and companies are aware of how a sales tax functions and will normally not be able to avoid paying any sales tax charged by a vendor.

A *use tax* usually appears as a support to the sales tax. The use tax is applied to prevent a taxable sale from escaping taxation in a situation where the consumer was not charged a sales tax. This would normally occur because the vendor did not have nexus in the state where the customer lives and, consequently, was not required to charge the sales tax.

Example – In a tax jurisdiction with an 8% *sales tax*, **Consumer A** buys a new bicycle from a local retailer. The cost of the bicycle is $100. **Consumer A** will pay the vendor a total of $108 for the bicycle, which includes an $8 *sales tax* payable, by the vendor, to the appropriate tax jurisdiction. **Consumer B** buys the same $100 bicycle through a mail-order vendor. Since the mail-order vendor does not have *nexus* in **Consumer B's** tax jurisdiction, **Consumer B** is not charged any *sales tax*. Assuming the taxing jurisdiction has a *use tax* statute, **Consumer B** is *required* by law to remit $8 to the tax jurisdiction.

As the foregoing illustrates, the use tax is an important support for the sales tax. The use tax serves to protect the tax jurisdiction's revenues by requiring non-taxed purchases to be treated exactly the same as those where the vendor charged the appropriate tax.

The application of the use tax is not widely known by most individuals and many companies. Therefore, even though the law may provide for the application of a use tax in situations like the one in the example, compliance is normally minimal at best.

TAXING THE INTERNET

Most major U.S. newspapers during the last couple of years will have had at least one and, more likely, several editorials covering the pros and cons of taxing the Internet. These editorials have discussed widely differing positions. One popular view suggests that **any** taxes on the Internet, taxes on *access charges* **and** retail sales, should be permanently banned. Those forwarding this position feel that taxing the Internet would be akin to killing the goose that is laying the golden egg. Representative Christopher Cox (R-CA) has compared the art of successful taxation to plucking a goose. "The object is to get the greatest amount of feathers with the least amount of squawking and, recognizing that, policymakers will be wise to steer clear of new Internet taxes, if the object is to protect and expand the tax base".[viii]

On the other hand, there are many who believe that allowing Internet sales to escape a sales tax gives an unfair edge to Internet companies as compared to their "bricks and mortar" competitors. Those forwarding this position suggest that state and local governments are losing significant tax dollars, and that the loss will only escalate as Internet sales grow. At a Senate Budget Committee hearing on February 2, 2000, for example, several senators pointedly questioned the impact of the proposed Internet Tax Elimination Act on state and local revenue, and on equity among competing businesses.[ix]

Dr. Charles McLure, a leading tax expert from the Hoover Institution, testified at the February 2, 2000 Senate Hearings in opposition to exemption of E-commerce from state and local taxes. His statement to the Senate included a position statement titled, "Appeal for Fair and Equal Taxation of Electronic Commerce." The statement advocates that:

1. Electronic commerce be taxed the same as other commerce.
2. All remote sales should be taxed by the state of destination.
3. *Sales* and *use taxes* should be simplified to make destination-based taxation of sales feasible.
4. A means must be found to eliminate *sales tax* compliance burdens on businesses making nominal sales in a state.
5.

Furthermore, Dr. McLure noted that over 170 academic tax policy specialists, representing law, accounting and economics (including two winners of the Nobel Prize in Economics), have endorsed this statement.[x]

In response to concerns of constituents on both sides of the Internet tax issue, Congress passed the Internet Tax Freedom Act (ITFA) in 1998.[xi] After its introduction by Rep. Christopher Cox (R-CA) and Sen. Ron Wyden (D-OR), the ITFA underwent a number of changes before its final passage into law on October 21, 1998. Highlights of the ITFA include[xii]:

1. **A 3 – year moratorium on special taxation of the Internet**. This moratorium serves to prevent state or local governments from taxing Internet *access charges*. Certain states that were already

taking steps to tax Internet access prior to October 1, 1998, were "grandfathered" and could proceed with plans to tax Internet access. These states are Connecticut, Wisconsin, Iowa, North Dakota, South Dakota, New Mexico, South Carolina, Tennessee, Texas and Ohio. Not all of those listed will go forward with plans to tax Internet *access charges*. For example, Connecticut and South Carolina have already indicated they intend to honor the national moratorium. The moratorium was to be in effect from October 1, 1998 until October 21, 2001. In October 2001, in recognition that more time was needed to address the difficult issues here, Congress extended the moratorium for another two years.

2. **A 3 – year moratorium on multiple and discriminatory taxes on electronic commerce**. This moratorium serves to prevent local governments from imposing taxes that would subject buyers and sellers of electronic commerce to taxation in multiple states. This moratorium was intended to deflect any attempts to require out-of-state businesses to collect taxes based upon strained interpretations of *nexus*. It also protects, from taxation, for the duration of the moratorium, goods or services that are sold exclusively over the Internet with no comparable offline equivalent.

3. **Establishing a commission to study the question of remote sales**. A temporary Advisory Commission on Electronic Commerce (Advisory Commission) was to study electronic commerce tax issues and report back to Congress after 18 months on whether electronic commerce should be taxed. If the recommendation is to tax E-commerce, the commission will make suggestions about how it can be taxed in a manner to ensure Internet sales transactions would not be subject to special, multiple, or discriminatory taxes.

4. **No federal taxes**. The Congressional sense is there should be no federal taxes on Internet access or electronic commerce.

5. **Declaring that the Internet should be a tariff-free zone**. The ITFA calls on the Clinton Administration to work aggressively through the European Union and the World Trade Organization to keep electronic commerce free from tariffs and discriminatory taxes. The ITFA requests the Commerce Department to report to Congress on barriers hindering the competitiveness of U.S. businesses engaged in electronic commerce abroad.

Nothing in the ITFA specifically prohibits states from taxing sales made over the Internet. If an Internet seller has nexus in a tax jurisdiction, the seller would have to collect a sales tax on its Internet sales related to the jurisdiction. What ITFA really did was prevent states and local governments, during the moratorium, from adopting ***new*** taxes on Internet access charges or applying any other taxes that would have run afoul of item two, on multiple and discriminatory taxes (see above).

The charge of the Advisory Commission, created by the ITFA, was to study "federal, state and local, and international taxation and tariff treatment of transactions using the Internet…" The ITFA required the Advisory Commission to complete its study within eighteen months and provide its findings and legislative recommendations to Congress. The commission held its final meeting by teleconference on March 30, 2000, after which it submitted its report to Congress on April 12, 2000. (Available at the Advisory Commission on Electronic Commerce (ACEC) web site – www.ecommercecommission.org).

Under the statutory guidelines of the ITFA, findings or recommendations of the Advisory Commission required a two-thirds majority. The idea of a supermajority was to try to force various interests to reach a compromise. Since the Advisory Commission was unable to draft significant comprehensive recommendations acceptable to two-thirds of the Advisory Commission, the report only included three formal recommendations to Congress.

1. Reduce the Digital Divide through encouragement of research, clarification of federal welfare guidelines, state and local partnerships with private companies, and federal and state funding.
2. Explore the privacy issues involved in the collection and administration of taxes on E-commerce, and take care in the crafting of any laws pertaining to online privacy
3. Support implementing and making permanent a standstill on tariffs.

The disparity of views within the Advisory Commission and the gamesmanship ensuing during the process may be a precursor to the difficulty that lies ahead as politicians attempt to resolve the issue of Internet taxation. For example, at the final Advisory Commission teleconference on March 30, 2000, Commission Chairman, Virginia Governor James S. Gilmore III, prevented a minority report from even coming to the floor. Furthermore, Gilmore insisted that a simple majority was all that was needed to include additional items in the report. Gilmore relied upon the contention of Advisory Commission general counsel Thomas Griffith who stated, "Findings or recommendations need to have the two-thirds vote of members of the commission, but other than that…the contents of the report are clearly within the discretion of the majority of the commission." Thereafter, many "proposals" opposing taxation of E-commerce were passed on a 10-8 vote. As a result, the final report contained many "proposals" that some members found highly objectionable and that many did not feel reflected all points of view raised.[xiii]

The general feelings of the minority members of the Advisory Commission were reflected in the comments of Gene Lebrun, who after serving on this commission, stated, "In all my years in public service and practicing law, I've never seen a chairman abuse his powers like Governor Gilmore".[xiv] Thus, if the experience of the Advisory Commission is an indicator of things to come, the issue of taxation of the Internet is likely to be a hotly contested political issue.

ONGOING PROJECTS

Approximately 150 participants from state and local governments and the private sector are involved in the *Streamlined Sales Tax Project*.[xv] These participants represent at least 38 states, 3327 of which have formally acted to approve official participation in the project. This project, begun in March 2000, is a comprehensive undertaking that is intended to address the need for a simplified sales tax system. The goal of the project is to design and implement a simplified sales tax collection system that can be used by traditional brick and mortar vendors and vendors involved in E-commerce.[xvi] The participants have met numerous times to date, with the primary focus being a cooperative effort at a revolutionary streamlining of the *sales* and *use tax* system across the U.S.

As an aid in accomplishing its goal, the *Project* has broken its meetings into four Work Groups[xvii]. Each Work Group has been assigned topical areas that need addressing. The Work Groups and topics are:

1. Tax Base and Exemption Work Group – This work group is developing suggestions for a redesigned exemption administration process and a uniform set of definitions. Two essential features related to exemptions will be:
    a. The buyer will claim the exemption by completion of a standard set of information (on paper or electronically) indicating the identity of the buyer and the reason for the exemption.
    b. The seller will not be liable or responsible for verifying the validity of the claimed exemption, or the "good faith" of the buyer providing the exemption. Discovering exemption abuse will be the obligation of the taxing jurisdiction.
    c.

This work group is working on uniform definitions for key aspects of the sales tax. Key terms to be defined include sale, gross receipts, delivery, tangible personal property, etc. A second phase would include developing uniform definitions for commonly exempted items, starting with food and clothing.

2. Tax Rates, Returns, Registration and Remittances – Topics being addressed by this Work Group include:
    a. Basing the appropriate tax rate on the 9-digit Zip Code.
    b. Streamlining the return process by requiring the minimum of information for an accurate reporting (i.e. taxpayer identity, information for proper posting for the state and any local jurisdictions, etc.).
    c. Supporting the one-stop, electronic registration being developed by the Multistate Tax Commission.
    d. Frequencies of filing, possibility of limiting the number of monthly remittances required, uniform electronic filing formats and other uniform rules for remittances.

3. Sourcing and Other Simplification – The three principal products of this Work Group are:
    a. A uniform rounding rule.
    b. A uniform bad debt deduction rule.

c. A uniform sourcing rule.

4. Technology – This Work Group is reviewing various specifications needed in modeling a new sales tax system. This review is being done with input from the private sector.

On December 22, 2000, state representatives to the *Project* voted to approve a Uniform Sales and Use Tax Administration Act and Streamlined Sales and Use Tax Agreement. As of October 2001, 27 states have introduced legislation dealing with simplification. Streamlined legislation has been enacted in 20 states.

CONCLUSION

The Internet and electronic commerce have helped sustain the largest and longest economic boom in America's history. Furthermore, the Internet affords possibilities for small and medium-sized companies, and start-up businesses, to find new markets throughout the world. Yet, state and local governments need tax revenues to build infrastructures and meet local needs such as public school funding, police and fire protection, waste disposal, and road maintenance. While sales taxes account for 33 percent of state and 11 percent of local tax revenues, current tax laws make collection of sales taxes on electronic commerce difficult. As a result, the GAO estimates sales tax losses nationwide may be as high as $9 billion in 2000 and $20 billion in 2003, with the impact greater on some states than others. The difficult problem of whether, or how, to tax E-commerce is one of the most important issues facing the U.S. Congress and state and local governments as the 21st century starts. With business leaders lining up in the camp advocating the permanent prohibition of Internet taxation and the governors of most states firmly committed to protecting one of the most important sources of revenue for state and local governments, the upcoming battle over the issue of Internet taxation is likely to be volatile and intense.

Table 1
Sales Tax Revenue Losses for 2000 and 2003 (Billions of Dollars).*

	Low Estimate	**Percent of Total Tax**	**High Estimate**	**Percent of Total Tax**
Year 2000				
Sales tax losses from:				
All remote sales	$1.6	0.8%	$9.1	4.6%
Internet sales only	$0.3	0.2%	$3.8	1.9%
Year 2003				
Sales tax losses from:				
All remote sales	$2.5	1.0%	$20.4	8%
Internet sales only	$1.0	0.4%	$12.4	5%

*Source of data: U.S. General Accounting Office, "*Sales Taxes*: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain, June 30, 2000, http//www.gao.gov/new.items. Note: The table includes "all remote sales" (e.g., catalog sales) since tax policies made in the future will impact both types of sales. The low estimate for nationwide tax losses in 2000 is $1.6 billion, while the high estimate is $9.1 billion. In 2003, the projected losses range from $2.5 to $20.4 billion.

ENDNOTES

[i] GAO, "Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain," July 2000, www.goa.gov.
[ii] CREC, "Measuring the Internet Economy", June 2000, www.internetindicators.com.
[iii] The Merriam-Webster Dictionary.
[iv] U.S. Constitution, article 1, section 8, clause 3.
[v] Illustrative cases on both sides of the issue, states can tax or not tax interstate commerce, include:
Leloup v. Port of Mobile (1888), Brown v. Maryland (1827), Sanford v. Poe (1895), Adams Express Co. v. Ohio State Auditor (1897), Western Live Stock v. Bureau of Revenue (1938).
[vi] 430 U.S. 274 (1976).
[vii] 504 U.S. 290 (1992).
[viii] http://www.house.gov/chriscox
[ix] "Senators Question Permanent Tax Exemption for E-Commerce," February Tax Analysts, February 3, 2000, Tax Analysts, 2000 TNT 23-6.
[x] "Hoover Institution Testimony at Senate Budget Hearing on Internet Taxation," February 4, 2000, Tax Analysts, 2000 TNT 24-47.
[xi] P.L. 105-277.
[xii] http://www.house.gov/chriscox/nettax/lawsums.html.
[xiii] "Internet Commission Report Lacks Supermajority," March 31, 2000, Tax Analysts, 2000 TNT 63-6.
[xiv] Id.
[xv] http://www.nga.org/106Congress/SalesTax.
[xvi] http://www.geocities.com/streamlined2000.
[xvii] Id.