Sales and Use Taxation of Internet Sales

By Amy Cobb

I. Introduction

From Amazon.com to Zfurniture.com, the e-commerce industry is booming. E-commerce, generally defined as transactions that involve the exchange of goods and services by electronic means [1], is most commonly transacted via the Internet, a worldwide network of computers and other communications equipment linked by high-speed data lines and wireless systems. [2] The Internet and the World Wide Web enable millions of computers and other communication equipment using “different hardware, operating systems, and software application programs to link to each other by a common protocol.” [3]

The growth of the Internet in the last six years of the 20th century was staggering. In the United States, the number of households that have access to the Internet increased from 0.2 percent in 1993 to 14 percent in 1996 to 37 percent in 1999. [4] It is estimated that over one half of all households in the United States will have Internet connections by the year 2002. [5] The Internet’s commercial as well as individual consumer use has skyrocketed since 1995. [6] On March 2, 2000, the United States Department of Commerce Census Bureau released its first official estimate of online retail sales. [7] According to this estimate, online retail sales equaled $5.3 billion or 0.64% of total retail sales during the fourth quarter of 1999. [8] Internet purchases are expected to exceed $20 billion per year in the near future. [9] By the year 2003, industry experts predict that Internet purchases by businesses will reach $1.3 trillion and Internet purchases by consumers are expected to reach $144 billion. [10]

In the United States, the discussion of the taxation of e-commerce has centered on state sales and use taxes instead of other methods of taxation for a variety of reasons. First, the United States has no national-level sales tax or other type of consumption tax. Second, transaction taxes
such as the sales and use tax tend to be more complicated to administer than income taxes in relation to e-commerce business activities. Third, the sales tax in the United States is complicated by the large number of state, county, and local jurisdictions that impose sales and use taxes. [11] Fourth, at the state level, the sales and use tax generates more revenue than any other category of tax. [12]

In this paper, I first address the policy considerations surrounding decisions to tax Internet sales and those surrounding decisions not to tax Internet sales. Next, I discuss the current taxation schemes in place regarding brick-and-mortar sales, mail-order sales, and Internet sales. Third, I address the constitutional limitations on proposed solutions to the special problems presented by Internet sales and use taxation. Then, I discuss how the states are currently defining “nexus” and which groups are developing new definitions of “nexus.” Finally, I propose my definition of “nexus” and how and by whom that definition should be implemented.

II. Policy Considerations

Proponents of the taxation of Internet sales argue that the states will lose a substantial amount of tax revenues in the future if Internet sales are not taxed. A study conducted [13] in 2000 estimated that states would lose $2 billion on uncollected taxes in 2001, and more than $5 billion in 2004. [14] Some states have put the expected losses at three times as much. [15] Moody’s Investor Service estimates that states could miss out on $10 billion in sales-tax revenues by 2003. [16] The General Accounting Office (GAO) estimated in June 2000 that state and local revenue losses from remote sales could be as much as $20 billion by 2003. [17]

Second, proponents of Internet sales and use taxation argue that it is unfair to require brick-and-mortar stores to collect and remit taxes for the same goods sold tax-free by Internet companies. According to Peter Lowy, the founding chairman of the e-Fairness Coalition, a
group of brick-and-mortar and online retailers, realtors, retail and real estate associations, and publicly and privately owned shopping centers, “the government should not provide preferential sales tax treatment based solely upon the distribution system used to sell goods. Requiring brick and mortar retailers to collect sales taxes while exempting their online competitors is fundamentally unfair.” [18]

Third, the absence of a sales or use tax on sales conducted over the Internet unfairly benefits higher-income Americans who can afford the personal computers that allow them to take advantage of online shopping. According to United States Senator John Breaux, D-La., “it isn’t fair to residents who must pay the local sales tax because they don’t own a computer.” [19]

Opponents of the taxation of Internet sales, however, argue that sales conducted via the Internet should not be taxed because of their elemental role in the digital age and the new economy. According to Governor Gray Davis of California, in support of his decision to veto an Internet sales and use taxation statute, “in order for the Internet to reach its full potential as a marketing medium and job creator, it must be given time to mature. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California’s international role as the incubator of the dot-com community.”[20] Similarly, according to Massachusetts officials, imposing the burden of collecting sales taxes could hurt the technology industry, which is responsible for 185,000 jobs in Massachusetts. [21] Thus, Massachusetts is one of a few states that have refused to join other states in presenting a united front on the issue of Internet taxation. [22] Three other leading technology states, Colorado, California, and Virginia, agree that taxing Internet commerce would hurt their local economies. [23]

III. Current Taxation Schemes

Currently, states impose both sales and use taxes on brick and mortar sales. A sales tax is a tax on gross receipts from the sale or lease of tangible personal property. [24] The tax is
imposed on the buyer but is collected by the seller. The tax is imposed at the destination point of the sale. The seller is only obligated to collect sales taxes for taxing jurisdictions with which it has nexus, a connection between the seller and the state. A use tax is imposed when the seller has not collected sales tax because the seller does not have nexus with the destination state. This usually occurs when the seller and the buyer are in different states. The buyer must self-assess the use tax; buyers, however, rarely do so.

States also impose both sales and use taxes on mail-order sales. No sales tax is collected, however, from companies that have no nexus with the state. Technically, these mail-order transactions are not tax-free – every state requires consumers to pay a use tax (at the sales tax rate) for any out-of-state catalog. Non-compliance is widespread, however, because states must rely on consumers to volunteer tax payments on their out-of-state transactions.

Existing sales tax law treats goods sold over the Internet the same way it treats goods sold from catalog companies: no sales tax is collected from companies that have no nexus with the state, but states require consumers to pay a use tax. As noted above, however, non-compliance is widespread due to the voluntary nature of the use tax.

E-commerce frequently involves transactions between a consumer and an out-of-state retailer. In addition, many of these out-of-state retailers do not have a physical presence in the customer’s state, sometimes because the retailer does not maintain any brick-and-mortar locations at all. Thus, due to the nature of e-commerce, many sales conducted on the Internet are free from sales taxation, and, because of use tax noncompliance, are free from taxation altogether. For this reason, the concept of nexus for purposes of imposing sales tax on Internet transactions between consumers and out-of-state vendors needs to be redefined. How the nexus concept should be redefined is the dilemma troubling tax experts throughout the nation.

IV. Constitutional Limitations on Redefining Nexus
In the past, courts have deemed many interstate taxation schemes unconstitutional under both the Due Process Clause and the Commerce Clause. Thus, whether the proposed solutions to the problem of Internet taxation are constitutional under the Commerce Clause and the Due Process Clause is an issue that must be addressed. Three Supreme Court cases provide the constitutional framework under which it is necessary to analyze sales and use taxation schemes of remote sellers.

The first of the three cases is *National Bellas Hess, Inc. v. Illinois*, decided by the Supreme Court in 1967. National Bellas Hess, a mail order house with its principal place of business in North Kansas City, Missouri, had neither outlets nor sales representatives within the state of Illinois, but Bellas Hess sent catalogs and flyers to customers residing in Illinois via the United States mail and other common carriers and received orders from Illinois customers in the same manner. In addition, Bellas Hess delivered goods to Illinois customers via the United States mail and other common carriers. Under Illinois law, Bellas Hess was a retailer because it engaged “in soliciting orders within [the] State from users by means of catalogues or other advertising.” Thus, Bellas Hess was subject to the use tax imposed by Illinois upon customers who purchased the company’s goods for use within the state.

The Supreme Court ruled that Bellas Hess could not be required to pay such use taxes. The Court held that, under both the Due Process Clause and Commerce Clause, sellers could be required to pay use taxes only in states where they maintained a certain level of physical presence known as a taxable nexus. Bellas Hess did not maintain such a level of physical presence. The Court recognized and agreed earlier decisions’ distinction between mail order sellers with retail outlets, solicitors, or property within a State and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. Both the Due Process Clause and the Commerce Clause demand “some definite link, some minimum connection, between a State and the person, property or transaction
it seeks to tax.”[46] This nexus generally requires a substantial physical presence, such as substantial property, equipment, or employees located within a state.[47]

In 1977, the Supreme Court decided *Complete Auto Transit, Inc. v. Brady*, a case that has shaped contemporary Commerce Clause jurisprudence with respect to the taxation of interstate commerce.[48] The State of Mississippi attempted to tax an out-of-state carrier that delivered motor vehicles to dealers throughout the state.[49] The taxes in question were sales taxes assessed by the Mississippi State Tax Commission pursuant to a Mississippi statute authorizing “privilege taxes for the privilege of engaging or continuing in business or doing business within [the] state.”[50] The carrier, Complete Auto, argued that the tax on the privilege of doing business within a state’s borders violated the Commerce Clause.[51] The Court held that the privilege tax was constitutional under the Commerce Clause.[52] According to the Court, a tax is constitutional under the Commerce Clause if the tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state.[53] This four-prong test has become the standard for Commerce Clause analysis of state taxation of out-of-state vendors doing business within a state.

The third Supreme Court case dealing with state taxation of out-of-state vendors is *Quill Corporation v. North Dakota*, decided by the Supreme Court in 1992.[54] *Quill* involved a state’s attempt to require an out-of-state mail order house that had neither outlets nor sales representatives in the state to collect and pay a use tax on goods purchased for use within the state.[55] The Quill Corporation had no employees or property in North Dakota.[56] Its only connection with North Dakota was contacts with customers through catalogs and flyers and deliveries of packages through mail.[57] North Dakota requires every retailer maintaining a place of business in the state to collect the tax.[58] The definition of retailer includes every person who engages in regular or systematic solicitation of a consumer market in the state.[59]
In this case, unlike the Court’s previous decisions, the Court considered the nexus question separately under the Commerce and Due Process Clauses. The Court noted that the two doctrines are closely related but have distinct requirements.\[60\] “Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical.”\[61\] The two standards are animated by different constitutional concerns and policies. Due Process concerns the fundamental fairness of governmental activity.\[62\] In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.\[63\]

With regard to the Due Process Clause, the Court recognized that its jurisprudence had evolved since 1967, when the Court decided *National Bellas Hess*.\[64\] The Court concluded that the physical presence of the vendor in the taxing state no longer mattered.\[65\] Instead, the Court should only consider the reasonableness of the vendor’s contacts with the taxing state.\[66\] Thus, the Due Process Clause requires “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”\[67\] Due Process is satisfied when the remote seller’s efforts are “purposefully directed” toward the residents of another state.\[68\] Purposeful direction essentially entails any effort, such as the purchase of advertising in a local newspaper, to solicit orders from the residents of a state.\[69\] According to the majority, “in modern commercial life it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation’s lack of physical presence in the taxing State.”\[70\] To the extent that its previous decisions had required physical presence in a State for the imposition of duty to collect a use tax, the *Quill* case overruled them.\[71\]

With regard to the Commerce Clause, the Supreme Court maintained the physical presence requirement for taxation nexus from the *Bellas Hess* case. According to the Court, *Bellas
Hess created a safe harbor for vendors “whose only connection with customers in the [taxing] State is by common carrier or the United States mail.” Under Bellas Hess such vendors are free from state-imposed duties to collect sales and use taxes. This rule clearly establishes the boundaries of state authority to impose a duty to collect sales and use taxes.

V. How are states currently defining nexus?

Most out-of-state corporations doing business within a state will have the requisite minimum connection to the taxing jurisdiction to satisfy a Due Process challenge. Whether that same out-of-state corporation has a physical presence in the state sufficient to satisfy a Commerce Clause challenge, however, is not as clear. Whether a physical presence exists depends upon the interpretation given to the phrase “physical presence.” State legislatures, to create tax legislation that will withstand court examination, have interpreted this phrase in several different ways, and traditional physical presence nexus test has broadened to the slight physical presence test and the attributional/affiliate nexus test.

A. Slight physical presence

Traditionally, physical presence nexus required the out-of-state vendor to have employees, equipment, or other property within the taxing jurisdiction. It is uncertain, however, how many of these items or persons must be present in the taxing jurisdiction to constitute “physical presence” or how long these items or persons must be present in the taxing jurisdiction to constitute “physical presence.” The only limitation given by the Supreme Court is that a “slight physical presence” does not suffice. According to the Court in Quill, a certain de minimis level of physical presence in a state does not create nexus for an out-of-state corporation. “Although title to a few floppy diskettes present in a State might constitute some minimal nexus, . . . we expressly rejected a slightest physical presence standard of
The Court did not, however, give definitive guidelines as to what constitutes this de minimis safe harbor. Thus, each individual state legislature, when drafting tax legislation, can determine the required amount of employees, equipment, or other property within the state’s borders or the required length of time that the employees, equipment, or other property must be located within the state necessary to satisfy the physical presence nexus test.

Some state courts have determined that an out-of-state vendor has nexus with the state based on a very narrow interpretation of the slight physical presence safe harbor. For example, in a 1995 Texas ruling, a vendor whose presence in the state was limited to three training sessions of two to three days’ duration each was found to have nexus in Texas for sales and use tax purposes. Similarly, the New York Court of Appeals held that sporadic visits by a mail-order company’s sales personnel for the purpose of soliciting orders from retailers was sufficient to constitute nexus.

Other states have taken a broader approach to the interpretation of the slight physical presence safe harbor, allowing states to conduct more activities within a state without triggering nexus. For example, the Florida Supreme Court ruled in 1996 that an ongoing continuous presence in the state is required to constitute nexus; the once-a-year visits to Florida by a corporation’s president and vice president were only a slight physical presence. In addition, the Pennsylvania state court ruled in 1986 that L.L. Bean did not have enough physical presence in the state to constitute nexus, despite that L.L. Bean employees made several trips to Pennsylvania during the year for various reasons.

B. Attributional/affiliate nexus

While the slight physical presence definition of nexus requires a smaller physical presence than the traditional definition of physical presence nexus, it still requires the retailer to have some sort of physical presence in the taxing jurisdiction. Attributional/affiliate nexus,
however, does not require the retailer itself to have any physical presence in the taxing jurisdiction. Instead, attributional nexus exists “between a state and an out-of-state entity when an in-state person or corporation acts as an agent representing the interests of its out-of-state principal.” [81] Thus, even if a corporation itself does not have sufficient presence in a taxing jurisdiction, the jurisdiction may assert nexus over the remote vendor by attributing the presence of activity of another person or entity to the corporation. [82] Similarly, affiliate nexus arises when an out-of-state company has no physical presence in the taxing jurisdiction, but the company does have an affiliate, such as a parent, subsidiary, or sister company with physical presence in the state. [83]

Defining nexus in this manner prevents corporations from setting up Internet subsidiaries to avoid sales and use taxes. Companies such as Barnes and Noble (bn.com), K-Mart (bluelight.com), and Wal-Mart (walmart.com) have established Internet subsidiaries to sell the same products sold by the retail stores owned by the parent company. [84] Since the subsidiary itself does not have a physical presence in any state, it is free from sales and use taxation. Under the affiliate nexus theory, the subsidiary would not be exempt from sales and use taxation because it is affiliated with a company that has a nexus with the taxing jurisdiction.

At least one state legislature has already defined nexus in this manner. The Arkansas state legislature developed Act 922, which was signed into law by Governor Mike Huckabee in March 2001. [85] The Act, which will take effect on January 1, 2002, alters prevailing rules by requiring a retailer to collect taxes in that state if a business related to it by corporate ties conducts taxable commerce in Arkansas, regardless of whether the sale is conducted over the Internet, by telephone, or through the mail. [86] According to the statute, a vendor that is required to collect use taxes under Arkansas law includes a vendor that “holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in
Arkansas, or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof.” [87]

The California legislature passed a bill (AB2412), similar to the Arkansas bill, that would have required California residents to pay California state sales taxes on certain purchases made online. [88] The bill, if signed into law, would have amended the tax code by clarifying that “the processing of orders electronically, by fax, telephone, the Internet, or other electronic ordering process, [did] not relieve a retailer of responsibility for collection of the tax from the purchaser if the retailer is engaged in business in this state.” [89] The bill specified that “a retailer is presumed to have an agent within the state if the retailer is related, as specified, to a retailer maintaining sales locations in this state, provided the retailer sells similar products under a similar name as the California retailer, or facilities or employees of the related California retailer are used to advertise or promote sales by the retailer to California purchasers.” [90] California governor Gray Davis, however, vetoed the bill on September 25, 2000. [91] The author of the bill reintroduced the bill on January 4, 2001, as AB81. [92]

VI. Who is developing new definitions of nexus?

As discussed earlier, most out-of-state corporations doing business within a state will have the requisite minimum connection to the taxing jurisdiction to satisfy a Due Process challenge. Whether that same out-of-state corporation has a physical presence in the state sufficient for a Commerce Clause challenge is not as clear. States are free to establish what constitutes physical presence based on the slight physical presence standard, the attributional/affiliate nexus standard, or any other definition that a state chooses to use. If challenged, however, the state’s definition of physical presence might be found unconstitutional under the Commerce Clause.
Instead of relying on states to implement taxation schemes that could be unconstitutional under the Commerce Clause, Congress should enact legislation establishing, among other things, what definition of nexus will be used for interstate taxation. Congress has this power because of the nature of the Due Process Clause and the Commerce Clause. “While the Due Process Clause is a constitutional limitation on the power of government, the Commerce Clause is an affirmative grant of power to Congress.” [93] Therefore, federal lawmakers may alter Commerce Clause requirements by statute. [94] Under the dormant commerce clause, states cannot burden interstate commerce, but Congress, which has the power to regulate commerce under the Commerce Clause, can enact legislation which burdens interstate commerce. Many observers have thus concluded that the Supreme Court’s decision in *Quill* was an invitation to Congress to exercise its power to clarify the standards for remote commerce taxation. [95] In fact, the Supreme Court in *Quill* stated, “the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.” [96] In addition, the Court noted, “Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.” [97] Based on this reasoning, Congress is free to enact its own definition of nexus, a definition, which, if enacted by an individual state, could be found unconstitutional under the Commerce Clause, but, if enacted by Congress, would be constitutional.

At this time, Congress is attempting to define nexus in legislation such as NET FAIR [98] and S. 288 [99]. However, other groups are attempting to define nexus by pursuing alternative approaches. Some approaches, such as the Internet Tax Freedom Act’s Advisory Commission on Electronic Commerce, consist of local, state, and federal government leaders and industry officials working together to find the best solution. Other approaches, such as the Streamlined Sales Tax Project and the Internet Tax Moratorium and Equity Act’s state compact, are composed of only state leaders attempting to streamline the interstate tax system.
A. Internet Tax Freedom Act

In 1997 the Internet Tax Freedom Act (also known as the Cox-Wyden bill after its chief sponsors) was introduced in Congress. [100] On October 21, 1998, after one-and-a-half years of hearings, negotiations and redrafting, Congress enacted the legislation and the President signed the Act into law. [101] The Act established a three-year moratorium barring state and local governments from taxing Internet access and from imposing other taxes that would subject buyers and sellers of electronic commerce to multiple or discriminatory taxation. Discriminatory taxes encompass taxes that are applied only to e-commerce but not to similarly situated goods or services that are not ordered and/or delivered electronically. [102] Under the ITFA, states are prohibited for the three-year period from imposing new sales or use tax on Internet access. [103] The legislation, however, does not prohibit the imposition of new or preexisting sales or use taxes on other forms of e-commerce including sales of products or services ordered over the Internet but delivered by means of conventional physical delivery or on sales of software, information, music or other products that are delivered electronically [104]. The only protection to businesses under the statute is that multiple or discriminatory taxes are prohibited.

The Internet Tax Freedom Act also created a 19-member Advisory Commission on Electronic Commerce (ACEC). [105] The law authorized Congress to appoint 16 members, 8 from the e-commerce industry (including small businesses), telecommunications carriers, local retail business and consumer groups and 8 from state and local government (including one from a state or local government that does not impose a sales tax and one representative from a state that does not impose an income tax). The remaining three members came from the executive branch (Department of Treasury, Department of Commerce, and the United States Trade Representative). The commission’s duty was to conduct “a thorough study of Federal, State and local and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate, or international sales activities.”
Based on nearly 40 different proposals from government, business, and other interested parties on tax reform related to e-commerce, the Commission developed its report, which it submitted to Congress on April 12, 2000. The Commission’s first recommendation was that the current moratorium barring multiple and discriminatory taxation of e-commerce be extended for a period of five years. Second, the Commission found that the following factors should not, in and of themselves, establish a seller’s physical presence in a state for purposes of determining whether a seller has sufficient nexus with that state to impose collection obligations:

(a) a seller’s use of an Internet service provider (“ISP”) that has physical presence in a state;
(b) the placement of a seller’s digital data on a server located in that particular state;
(c) seller’s use of telecommunications service provided by telecommunications provider that has physical presence in that state;
(d) a seller’s ownership of intangible property that is used or is present in that state;
(e) the presence of a seller’s customers in a state;
(f) a seller’s affiliation with another taxpayer that has physical presence in that state;
(g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state;
(h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller’s Web site or catalogue to be returned to the other party’s physical location within that state; and
(i) the advertisement of a seller’s business location, telephone number, and Web site address.

Third, the Commission proposed that state and local governments should be encouraged to work with and through NCCUSL to draft a uniform sales and use tax act within three years after the expiration of the current Internet Tax Freedom Act moratorium (i.e., by October 21, 2004) that would simplify state and local sales and use taxation policies to create and maintain parity of collection costs between remote sellers and comparable single-jurisdiction vendors that do not offer remote sales.
B. The Streamlined Sales Tax Project

After the Advisory Commission on Electronic Commerce failed to make formal findings regarding the taxation of e-commerce, state governments formed the Streamlined Sales Tax Project (SSTP), which is now composed of representatives from thirty-eight state governments. The purpose of the SSTP was “to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance.” The member states of the SSTP adopted the Streamlined Sales and Use Tax Agreement, whereby they agreed to amend their tax laws to make the collection of sales tax easier for all sellers. By entering into the agreement, states pledged to amend their own laws to conform to the requirements of a 40-page model code that sets out simplified rates and uniform definitions of categories of products and to cooperate with one another. The model code does not establish what constitutes nexus, but it does provide that “the agreement must establish uniform standards for . . . the sourcing of transactions to taxing jurisdictions.” In addition to the SSTP version of the Act, the National Conference of State Legislatures (NCSL) adopted a version of the SSTP’s Uniform Sales and Use Tax Administration Act in January 2001, which differs from the SSTP version in several ways. The differences between the NCSL version and the SSTP version however, are not relevant to a nexus discussion.

Currently, member states of the SSTP are beginning the legislative processes in their respective states necessary to pass a code patterned after either the SSTP version or the NCSL version of the Uniform Sales and Use Tax Administration Act. As of April 25, 2001, the SSTP version has been introduced in eight states and the NCSL version has been introduced in eleven states. Three other states, Kentucky, Utah, and Wyoming, have already enacted the SSTP version.
C. Internet Tax Moratorium and Equity Act

Senator Byron Dorgan of North Dakota introduced the Internet Tax Moratorium and Equity Act (S. 2775) into the Senate on June 22, 2000. Its purpose was “to foster innovation and technological advancement in the development of the Internet and electronic commerce, and to assist the States in simplifying their sales and use taxes.” The bill proposed to extend the Internet Tax Freedom Act Moratorium through 2005. The bill also provided for a Streamlined Sales and Use Tax System to be developed by the states through an Interstate Sales and Use Tax Compact whereby states are authorized to enter into a compact to describe a uniform, streamlined sales and use tax system. States would be required to simplify their taxes in exchange for the ability to collect legally owed taxes on remote sales via an interstate compact of at least 20 states - one which Congress would have 120 days to disapprove following receipt. In addition, the bill contained other provisions including a federally mandated de minimis threshold for retail sales, one rate per state for all remote commerce, and the use of the National Conference of Commissioners on Uniform State Laws to oversee state tax simplification. This version of the Internet Tax Moratorium and Equity Act did not make it out of committee.

Senator Dorgan introduced a new version of the Act (S. 512) into the Senate on March 9, 2001. This version is substantially similar to S. 2775 but the provision mandating one sales tax rate per State has been removed. The National Conference of State Legislatures, the National Governors’ Association, the Council of State Governments, the National Association of Counties, the U.S. Conference of Mayors and International City/County Management Association support this version of the Act. As of April 16, 2001, members of the Senate Commerce Committee were trying to reach a compromise bill combining portions of the Internet Tax Moratorium and Equity Act and the Internet Tax Nondiscrimination Act (discussed infra).
The Internet Tax Moratorium and Equity Act provides that “States and localities should work together to develop a streamlined sales and use tax system that addresses . . . uniform rules for attributing transactions to particular taxing jurisdictions.”[130] The Act, however, does not go further to create such rules. Thus, the Act does not establish what constitutes nexus for an out-of-state vendor with a taxing jurisdiction.

D. New Economy Tax Fairness Act

On March 29, 2001, Senator Judd Gregg, R-N.H., and Senator Herbert H. Kohl, D-Wis., introduced into Congress a bipartisan bill (S. 664) designed to provide one nationwide standard regulating the imposition of state and local tax collection obligations on companies involved in interstate commerce. The proposed New Economy Tax Fairness Act or NET FAIR would clarify the existing law by creating a single nationwide standard governing when states can impose use-tax collection duties on retailers. [131] According to Senator Gregg, “NET FAIR builds upon the Quill decision by extending the same approach that currently governs catalogue sales to the Internet. This legislation would allow States to require a company to collect sales and use tax, or to pay business activity taxes, only if their goods or services are sold to individuals living in states where the company has a substantial physical presence, or ‘nexus.’”[132] According to Senator Kohl, NET FAIR only “codifies the decisions already established by the courts” that clarify what a substantial physical presence is and “restates the principle on which they are all based: State and local taxing authorities do not have jurisdiction over businesses that are not physically located in their borders.”[133]

Thus, under the statute, “a substantial physical presence is not established if the only business activities within such State by or on behalf of such person during such taxable year” consist of, among other activities, the solicitation of orders by such person for sales of property, if the orders are approved or rejected outside the State, and orders are fulfilled by shipment or delivery of such property from a point outside the State; the presence or use of intangible
personal property in such State; the affiliation with a person located in the State, unless the person located in the State is the person’s agent and the activity of the agent in the State constitutes substantial physical presence under this subsection; or the use of an unaffiliated representative or independent contractor in such State for the purpose of performing warranty or repair services with respect to tangible or intangible personal property sold by a person located outside the State. [134]

E. Internet Tax Nondiscrimination Act

Sen. Ron Wyden, D-Ore., and Rep. Christopher Cox, R-Calif. introduced the Internet Tax Nondiscrimination Act (S. 288) into the House and Senate on February 8, 2001. [135] This legislation, if passed, would extend the existing Internet Tax Freedom Act moratorium to December 31, 2006. [136] It would also permanently forbid Internet access taxes, including such taxes already on the books in Connecticut, Montana, New Mexico, Ohio, South Carolina, North Dakota, Tennessee, Texas, Washington, and Wisconsin. [137] In addition, the bill would require a one rate per state rule, as well as uniform rules in taxing jurisdictions, electronic filing and remittance methods. [138] According to Frank Julian, on behalf of the Internet Tax Fairness Coalition (ITFC), an alliance of business, consumer, retail, technology and communications companies and industry groups that promote clear and simple tax rules for the borderless marketplace, the bill “represents a significant first step toward unraveling . . . confusion.” [139]

The Internet Tax Nondiscrimination Act provides that “[t]he rules regarding taxable presence . . . should be made clearer” [140] but it does not explain what those rules should be. Thus, like the Internet Tax Moratorium and Equity Act, the Internet Tax Nondiscrimination Act does not establish what constitutes nexus for an out-of-state vendor with a taxing jurisdiction.

VII. The Best Definition of Nexus and How It Should Be Developed
None of the approaches to Internet sales and use taxation discussed above correctly define what constitutes nexus for out-of-state vendors doing business within a jurisdiction. The Internet Tax Moratorium and Equity Act and the Internet Tax Nondiscrimination Act do not define nexus at all. The Internet Tax Freedom Act lists several factors that do not, by themselves, constitute nexus including “the presence of a seller’s customers in a state” and “a seller’s affiliation with another taxpayer that has physical presence in that state.”[^141] NETFAIR defines nexus as actual physical presence in the taxing jurisdiction.[^142] These definitions of nexus are too broad and allow out-of-state vendors to transact business free from taxation in almost all circumstances.

Nexus should be defined in the broadest terms possible so that an out-of-state vendor with only a slight connection to the taxing jurisdiction is taxed. Thus, nexus should be defined as economic presence within the taxing jurisdiction. Under the economic presence nexus theory, an out-of-state taxpayer may have nexus with a taxing jurisdiction even without actual physical presence. To satisfy nexus requirements under an economic-presence test, it is sufficient that an out-of-state business seeks commercial exploitation of a market state’s consumers through purposeful activities directed toward the market state.[^143] To date, the economic presence test is only used by some states to assert nexus for the purposes of income taxation of financial institutions.[^144]

This definition of nexus is the best solution to the problem for several reasons. First, the loss to states of enormous amounts of tax revenue should be prevented. Second, it is not fair to treat brick and mortar companies differently from Internet companies when they are selling the exact same products to consumers. Third, those with higher incomes who are able to shop online should not be able to benefit by not paying sales and use taxes. Fourth, such a broad definition of nexus will inhibit companies’ ability to get around their tax collection obligations by creating subsidiaries or affiliating themselves with other agents.
In addition to the arguments supporting the imposition of sales and use taxes on e-commerce, the opposing arguments are without merit. The application of a sales and use tax on Internet sales will not stymie the advance of e-commerce. Many individual consumers choose to shop on-line because their purchases are tax-free. [145] If these consumers were to stop shopping on the Internet due to sales and use taxation, some e-commerce revenue would be lost. Their disappearance from the e-commerce marketplace, however, will not be the death knell of the Internet. Also, many other consumers do not consider the absence of sales and use taxes at all in their decision to shop on the Internet; they choose to shop on-line because of the selection and the convenience. Thus, even if sales and use taxes are imposed on Internet sales, companies will continue to utilize the Internet to sell their products to these consumers.

The states should not individually adopt this definition of nexus; Congressional action legislating this definition of nexus is necessary. Under Quill, a taxing jurisdiction cannot impose sales and use taxes upon a company unless that company (a) has minimum contacts with the state (to satisfy Due Process Clause requirements) and (b) some type of physical presence in the state (to satisfy Commerce Clause requirements). Defining nexus as economic presence will likely satisfy the Due Process portion of the Quill analysis but will most certainly not satisfy the Commerce Clause portion. For this reason, Congress must enact the economic presence definition of nexus.

If Congress does define nexus in this manner, it should also incorporate several other provisions into its legislation. First, any legislation should include a revenue threshold such as the one proposed in Senator Dorgan’s Internet Tax Moratorium and Equity Act. No state should be able to require a company to collect sales and use taxes unless that company generates a certain percentage of its revenues from customers in that state. This will ensure that states are not able to require sales and use tax collections from companies with very tenuous connections to the taxing jurisdiction. Second, any legislation, like the Internet Tax Freedom Act, the Streamlined
Sales Tax Project, and the Internet Moratorium Equity Act, should encourage the states to simplify and streamline their taxation schemes to facilitate interstate commerce. The problem of taxing goods and services sold via the Internet is a major issue facing interstate taxation, but it is certainly not the only one. The myriad of complicated and differing taxation schemes facing companies engaged in interstate commerce is an issue about which states should cooperate to develop a solution.

VIII. Conclusion

Redefining nexus for the purpose of taxing Internet sales is an issue that is currently mystifying and frustrating leaders from local, state, and federal government and industry. If Congress acts to define nexus and if the definition of nexus is broad enough to encompass any sort of activity that generates revenue for a company within a taxing jurisdiction, companies engaged in interstate commerce via the Internet will no longer have to agonize over taxation issues and states will benefit from the tax revenue that such sales will generate.

[2] Id. at 5.
[3] Id.
[4] Id. at 3.
[5] Id.

[6] Advisory Commission on Electronic Commerce, REPORT TO CONGRESS, 7 (April 2000). Estimates of commercial use growth vary greatly due to the varying definitions and methods that the research firms utilize to collect and analyze date. Id. at 9.
[7] Id.
For purposes of this estimate, the term retail sales includes only sales of tangible goods and does not include sales of services. Advisory Commission on Electronic Commerce, supra note 6, at 9-10.


Id.

Currently, 45 states and the District of Columbia impose sales or use taxes at the state level. The five states that do not impose sales or use taxes are Delaware, New Hampshire, Montana, Oregon, and Alaska. In addition to the states, approximately 7,500 counties, cities, towns, transportation districts and other special local jurisdictions impose sales or use taxes. FRIEDEN, supra note 1, at 82; Advisory Commission on Electronic Commerce, supra note 6, at 17.

State and local taxes account for over $700 billion in revenues in the United States – about 45% of all tax dollars raised in the country. FRIEDEN, supra note 1, at 57.


Id.

Id.


Id.


Anders, supra note 15.

Id.


Id.

Id.

Id.

Id.


Id.

Id.

Id.

Id.

Id.

Id.

“The Congress shall have Power: To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” U.S. CONST. art. I, § 8, cl. 3. The Commerce Clause is designed to protect against burdens on interstate commerce.

“No State shall . . . deprive any person of life, liberty, or property, without due process of law.” U.S. CONST. amend. XIV, § 1. The Due Process Clause is designed to protect the rights of taxpayers.


Id. at 753-54.

Id. at 755.

Id.

Id.

Id. at 760.

Id. at 758.
[44] Id.

[45] Id.

[46] Id. at 757.

[47] Id.


[49] Id. at 276.

[50] Id. at 275.

[51] Id.

[52] Id. at 289.

[53] Id. at 279.


[55] Id. at 301.

[56] Id. at 302.

[57] Id.

[58] Id.

[59] Id. at 302-03.

[60] Id. at 306.

[61] Id. at 312.

[62] Id.

[63] Id.

[64] Id. at 307.

[65] Id. at 308.

[66] Id.
[73] FRIEDEN, supra note 1, at 272.

[74] Quill Corp., 504 U.S. at 315, n.8.

[75] Id.

[76] Id.


[81] FRIEDEN, supra note 1, at 289.

[82] Id.

[83] FRIEDEN, supra note 1, at 316.


[86] Id.


[88] Bowers, supra note 22.

[90] Id.

[91] Bowers, supra note 22.


[93] Smith, supra note 10, at *77.

[94] Id.

[95] Id.

[96] Quill Corp., 504 U.S. at 318.

[97] Id.


[101] Id.

[102] Id.

[103] Id.


[105] Id.

[106] FRIEDEN, supra note 1, at 56.

[107] The proposals were not formal recommendations of the commission, however, because the commission failed to approve them with the necessary two-thirds endorsement required by its charter. Instead, the recommendations received 11 votes in favor, 1 vote against, and 7 abstentions. Advisory Commission on Electronic Commerce, supra note 6, at 20.


[109] Id.
The proposals of the Advisory Commission on Electronic Commerce were not formal recommendations of the commission because the commission failed to approve them with the necessary two-thirds endorsement required by its charter. See supra note 111.

Thirty-two states are voting participants in the project because their legislatures have enacted enabling legislation or their governors have issued executive orders or a similar authorization. Six states are non-voting participants in the work of the project because they do not have the formal commitment of the state executive or legislative branches. Executive Summary (visited May 14, 2001) <http://www.geocities.com/streamlined 2000>.


The Streamlined Sales Tax Project approved the model code, the Uniform Sales and Use Tax Administration Act, on December 22, 2000.

Caffrey, supra note 25.


Id.

Id.

Id.

Id.

Id.

[128] Dorgan Bill Would Extend Moratorium on Internet Taxes, supra note 130.


[130] Internet Tax Moratorium and Equity Act, S. 512, 107th Cong. (2001);


[143] FRIEDEN, supra note 1, at 338.

[144] For example, Minnesota, Massachusetts, Tennessee, West Virginia, Kentucky, and Indiana have adopted economic-nexus standards with regard to the taxation of financial institutions. Id.