Dr. Dave: Congress has prohibited state and local governments from taxing the internet. What effect will this have on local economies and local and state tax revenue? Is there anything state or local governments can do or are doing?

A. We need to be precise about what Congress did, and didn't do. In 1998, Congress did impose what has become a 9-year moratorium on state and local taxes on internet *access* fees (the $15-20 or so a month people pay to their internet service provider).[1]

Congress did not prohibit state and local governments from taxing internet sales.[2] On the other hand, it did not permit them to tax such sales either. And therein lies the rub, because until Congress acts, two U.S. Supreme Court decisions make it difficult if not impossible to force most internet and mail-order customers to pay sales taxes.

Here's the history.

Back in 1967, when mail order was still a small-potatoes industry, the U.S. Supreme Court voided an Illinois statute that required mail order firms selling to Illinois customers to collect a sales tax on their orders. The Court ruled that the seller could be forced to collect a sales tax only if it had a physical presence (nexus) in the state in which its sales took place. A "seller whose only connection with customers in the State is by common carrier or the United States mail" lacked the requisite minimum contacts with the State, the Court pronounced.[3]

The Court's decision was based, in large part, on the significant burden of having to deal with the complexity of, potentially, as many as 30,000 different taxing jurisdictions. "[M]any variations in rates of tax, in allowable exemptions and in administrative and recordkeeping requirements could entangle [a mail order house] in a virtual welter of complicated obligations".[4]

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[1] Except for states or localities that already had imposed taxes at the time of the legislation. The Internet Tax Freedom Act, PL 105-277, imposed a three-year moratorium that was extended for two more years in November 1, 2001 (P.L. 197-85). At the end of 2003, Congress extended the moratorium until November 1, 2007. P.L. 197-75 passed 97-3 in the U.S. Senate.

[2] It also did not prohibit states from taxing internet phone service (voice over internet protocol, or VOIP).

[3] National Bellas Hess v. Department of Revenue. 1967. In its 6-3 decision, the Court actually ruled that Illinois' sales tax statute had violated two provisions of the U.S. Constitution: the due process clause of the Fourteenth Amendment and the interstate commerce clause. The violation of due process occurred because the business was being forced to pay taxes when its lack of physical presence meant that it was receiving no benefits for those taxes. Since the Supreme Court overturned this aspect of its ruling in 1992, I address it only in passing here.

[4] "And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's inter-state business in a virtual welter of complicated obligations to local jurisdictions

In 1992 the Supreme Court revisited its1967 decision. The North Dakota Supreme Court had upheld a state statute similar to the Illinois law overturned by the U.S. Supreme Court.[5]

The North Dakota Court argued that the "tremendous social, economic, commercial, and legal innovations" of the past quarter-century rendered the 1967 holding "obsolete." The principal change was the remarkable growth of the mail-order business "from a relatively inconsequential market niche" in 1967 to a "goliath" with annual sales that reached "the staggering figure of $183.3 billion in 1989."[6]

Technology had also made rapid advances. Fast computers and simplified software made it far less costly to comply with multiple taxing jurisdictions.

The U.S. Supreme Court overruled the North Dakota Court and reaffirmed its 1967 decision. It agreed with North Dakota that technological changes undermined much of its interference-with-interstate-commerce argument. But it noted that a major industry had been built in large part on the basis of that ruling, and it would be unfair to change the rules in midstream.   "[T]he Bellas Hess rule has engendered substantial reliance, and has become part of the basic framework of a sizable industry."

In any event, the Court noted that Congress has the authority to subject interstate mail order (or internet) sales to state sales taxes:

> No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. Indeed, in recent years, Congress has considered legislation that would "overrule" the Bellas Hess rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in Bellas Hess that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, 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.

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with no legitimate claim to impose 'a fair share of the cost of the local government.' The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements."

[5] Quill v. North Dakota. U.S. Supreme Court. 1992. In a 9-0 decision, the Court did overturn one of its rationales in the Bellas Hess case by deciding that the taxation of mail order sales did not violate the Due Process clause of the Constitution because the firm was gaining benefits from the state(e.g. an orderly market) even without having a physical presence there. "In this case, there is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State...."

[6] North Dakota v. Quill. 470 N. W. 2d 203, 208 (1991).

Over the last 12 years Congress has repeatedly debated legislation that would grant states the authority to collect sales taxes on orders taken over the phone or internet. It has yet to act.

State and local governments argue, persuasively to my mind, that the Court decision, in effect, discriminates against local businesses. Out-of-state enterprises receive a 4-9 percent price advantage over local businesses. This leads to at least two pernicious results.

It undermines local economies. And it reduces tax revenue, thus undermining local public services.

The rapid rise of e-commerce in the last decade has greatly exacerbated the problem. Estimates of the current state and local government revenue losses vary widely, from a low of about $3 billion to a high of over $45 billion. Nevertheless, everyone agrees that the amount of lost revenue is increasing.[7]

Some 46 states currently assess sales taxes, from which they receive at least 25 percent of their total revenues each year.[8]

What can be done about this worsening problem?

There are two strategies. One can be done by the states themselves, or by cooperation among the states. Another can be undertaken only by Congress, although state action might enable Congressional action.

<u>It is important to understand that what is at stake here is not the legal requirement to pay sales taxes but the legal requirement for the seller to collect the sales tax</u>.

Customers are required to pay a "use" tax on anything they purchase that is subject to a state or local sales tax, no matter from whom or how they purchase the product or service. Two states, Maine and Connecticut, have a line on their state tax form specifically for use taxes.[9]

In-state stores act as tax collectors, thereby guaranteeing the tax is paid. Under current law, if a vendor has a physical presence in a state, the vendor has to collect the tax. If not, the state has little recourse against the vendor for not collecting the tax.

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[7] The University of Tennessee estimated that states and municipalities lost $13.3 billion in 2001, a loss projected to rise to $45.2 billion in 2006. The Direct Marketing Association (DMA) estimates the 2001 loss at $1.9 billion, rising by 2006 to about $3.2 billion. The DMA uses more conservative Department of Commerce data and argues that the States greatly underestimate the amount of business compliance in tax remittance. See Paul Demery, *Internet Retailer*, April 2003.
[8] Oregon, Montana, Delaware and New Hampshire do not impose a sales tax.
[9] Another 43 states have special forms taxpayers are supposed to submit along with their use payments, generally by the end of the calendar year.

The state does have some recourse, however. Each of the states with a sales tax has the authority to audit companies operating in their state to monitor whether the company is complying with the sales tax collection. States have entered into reciprocity agreements with other states to share this information. In this way a state in which the vendor has a physical presence could inform the state in which the vendor's customers are located whether the vendor's sales are significant. If they are, the state can conduct an audit. In 2001, Connecticut announced that any state that shares sales data with Connecticut will receive 25 percent of all taxes collected.

Some corporations are voluntarily collecting use or sales taxes. Williams-Sonoma has been collecting sales tax on its web sales since it launched its first e-commerce web site in 1999, whether or not the company has a physical presence in customers' states. Apple Computer does this as well for its internet sales, including iTunes.

Most firms without a physical presence in a state do not voluntarily collect the state's use or sales taxes. Some states have amended their laws to broaden the definition of "physical presence" to accommodate sales agents, brokers or other types of modest but real activities by the vendor in a state.[10]

Recently, bricks-and-mortar retailers have established online sales divisions and then contend that their e-commerce operations are distinct legal entities, unrelated to their stores. The practice is known as "entity isolation."

Courts in three states -- Ohio, Pennsylvania and Connecticut -- have upheld entity isolation as a means of avoiding state sales taxes.

On the other hand, by early 2005 at least six states -- Alabama, Arkansas, Kansas, Indiana, Louisiana and Minnesota -- have amended their sales tax nexus laws to clarify that entity isolation does not absolve internet retailers of state sales tax obligations. (See the Internet Taxation section of New Rules for a fuller discussion of this and model ordinances on all subjects discussed here).

The U.S. Supreme Court has never heard a case on the issue. It denied review of the Pennsylvania and Connecticut cases without comments on merit.

With regard to so-called "clicks-and-mortar" operations, the California Board of Equalization has ruled that online book retailers Borders.com and BarnesandNoble.com created a physical nexus (and thus must collect state and local sales taxes) by allowing online shoppers to return books to their physical stores. The Board ruled that Barnes and Noble, by giving customers coupons good for online sales, also established a nexus for its online affiliate.

In 2000, the states launched another cooperative effort, the Streamlined Sales Tax Project (SSTP). To date 42 states have approved a model interstate agreement that establishes uniform sales tax rules and definitions, and 20 state legislatures have enacted

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[10] Michael Mazerov of the Center for Budget and Policy Priorities has designed laws for several states to achieve this objective.

implementing legislation.[11] (For the latest state-by-state information, see the map updated regularly by the NGA.)

Under the SSTP, local governments would retain their authority to determine whether to levy a sales tax and at what rate. But they would lose their ability to have more than one tax rate for different kinds of goods. All jurisdictions must agree to the same definitions, same forms, and the same schedule of when they may make tax changes.[12] The SSTP imposes uniformity internal to each state and then states mutually agree to accept the same uniformity among the states.

The SSTP is developing certified software and systems for collecting the sales tax. Any company that uses the certified software will be granted an amnesty from liability for not paying back use taxes. The granting of amnesty is not an insubstantial concession and has generated significant discussion among the states.

In February 2003, Wal-Mart, Target and other major retailers agreed to start collecting sales taxes for purchases in 37 states and the District of Columbia in return for amnesty on any back taxes that the retailers might owe.[13]

Some states are using the stick as well as the carrot. In 2003, Illinois went to court to force Wal-Mart and Target and Office Depot and two smaller retailers for uncollected back sales taxes.[14]

The states hope that by streamlining and simplifying their sales tax systems, they will facilitate passage of a Federal Sales Tax Fairness bill requiring out-of-state companies to collect sales tax.

Two states -- North Carolina and South Dakota – are employing a different strategy to encourage companies to collect the sales tax. They require state agencies to purchase goods and services only from companies that collect sales tax on all sales in the state. This option may be available to local governments, as well.

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[11] States would agree to levy a single in-state general sales tax for all but exempted products such as food and drugs, which would carry a separate rate or no rate at all depending on the state. States can set rates but on fewer categories. Also common definition of products if state wanted to exempt apparel from its general sales tax rate, it would have to use an agreed upon definition of apparel, which could state whether apparel includes accessories such as belts and shoes. A retailer that sells a gift package that includes cheese, a knife and cutting board, might have to collect tax on only the cutting board sold to a customer in one state but on all three pieces to a customer in another state.

[12] Home rule cities will no longer actually collect the tax. Businesses will file everything with the states, which will then distribute the taxes to localities, as they now do with non-home rule cities.

[13] The remaining states that have a sales tax are either still considering whether to grant amnesty or -- like Arizona, California, Nevada and South Carolina -- have refused grant amnesty as part of the SSTP plan.

[14] In January 2005, WalMart.com, Target.Direct LLC and Office Deport avoided a trial by agreeing to pay the state of Illinois more than $2.4 million to compensate for sales tax they failed to collect on transactions made on the internet. The suit was initiated in September 2003 and in February 2004 the three retailers began collecting sales tax for on line sales.