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The Taxing Issue of E-Commerce

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ABSTRACT

Should e-commerce transactions be taxed? The answer to this question is not straight-forward. Within the United States, federal, state, and local governments continue to struggle with the significant challenges e-commerce presents to systems of taxation. The loss of tax revenue is now becoming a critical concern because of the increasing market share of remote vendors engaged in e-commerce. This paper first identifies the trends contributing to the increasing complexity of e-commerce taxation. The issue of whether e-commerce should or should not be taxed is then examined. The legal considerations of imposing and collecting state sales and use taxes on remote vendor e-commerce transactions are discussed, including federal legislative activity and the "Streamlined Sales Tax Agreement," a judicially invited legislative solution.

Keywords

Internet taxation, Consumption tax, Sales tax, Use tax, E-commerce taxation.

INTRODUCTION

The nature of the marketplace has been changed by E-commerce, a significant source of business revenue. Online retail sales in the United States (U.S.) reached about $96 billion in 2003, up 52% from $78 billion in 2002, according to Forrester Research (Hansen, 2003). This online sales volume represents 4.5% of total retail sales in 2003, up from 3.6 percent in 2002. A growth of 19% is expected over the next five years, reaching almost $230 billion and accounting for about 10% of total U.S. retail sales by 2008. This growth is primarily attributable to a steady increase in online shoppers, new product category sales, more effective use of digital marketing and multichannel by retailers, and more effective analysis of data collected over the web (Hansen, 2003). An estimated 40% of online customers are completely new to any given retailer's entire business.

Significant revenue for national and local governments could be provided from the taxation of e-commerce transactions. For example, an estimated US$13.3 billion in sales and use taxes could have been collected in 2001 in the U.S. (Bruce and Fox, 2001). As business to business (B2B) e-commerce continues to increase, this uncollected revenue is projected to rise to US$45.2 billion by 2006 and US$54.8 billion in 2011, resulting in a cumulative decade loss of US$439 billion in total state and local government revenue between 2001 and 2011.

Should e-commerce transactions be taxed? The answer to this question is not straight-forward. Within the U.S., federal, state, and local governments have been, and continue to struggle with the significant challenges e-commerce presents to systems of taxation. The obligation of remote vendors to collect and remit state and local sales and use taxes is a difficult, but not a new issue. Initially, the issue focused on mail order transactions, but has become more salient with the increase in sales through e-commerce. For state and local governments, the loss of tax revenue is now becoming a critical concern because of the increasing market share of remote vendors engaged in e-commerce. The issue is not just about tax collection. Remote vendors have legitimate concerns about excessive compliance costs if the obligation to collect and remit sales and use taxes from multiple jurisdictions requiring different tax bases, rates, forms, and procedures is imposed.

This paper first identifies the trends contributing to the increasing complexity of e-commerce taxation. The issue of whether e-commerce should or should not be taxed is then examined. Proponents of a tax free internet argue that internet taxes and fees result in rate hikes making access more expensive for the consumer and thus restricting the growth of e-commerce. Further, these proponents argue against imposing the requirement to collect and remit transactional taxes on remote e-commerce vendors because of the cost of compliance with multiple taxing jurisdictions. Such cost is viewed as a barrier to market entry for small, start up e-businesses. Proponents of internet taxation focus on the loss of tax revenue and tax neutrality regardless of the business model, i.e., clicks versus bricks. Noncompliance with the payment of transactional taxes has real revenue implications for governmental entities. First, since transactional taxes are a significant revenue source, an increase in nonpayment would result either in an increase in other taxes or a contraction of government functions and/or programs. Second, an increase in the ability to avoid/evade transactional taxes could adversely affect the local tax base. Third, any law imposing the obligation to collect and remit transactional taxes on remote e-commerce vendors must satisfy

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constitutional standards. The legal considerations of imposing and collecting state sales and use taxes on remote vendor e-commerce transactions are discussed. These include federal legislative activity and the "Streamlined Sales Tax Agreement," which is a judicially invited legislative solution.

THE COMPLEXITY OF E-COMMERCE TAXATION

The growth of e-commerce raises complex issues associated with the taxation of multi-jurisdictional transactions and the sourcing of sales of, or income from, services or intangible property transactions. Several trends contribute to the complexity of e-commerce taxation, including borderless commerce, digital convergence, virtual organizations, automated transactions, and new business models.

Borderless Commerce

E-commerce transactions flow seamlessly across states, and even across the globe. The continued growth in borderless commerce will lead to a corresponding increase in both business tax compliance efforts in multiple jurisdictions and jurisdictional disputes over which jurisdiction can impose taxes. The additional burden of tax compliance is a complex economic, political, and constitutional issue.

Digital Convergence

Technological innovations have changed products and services, their delivery, and how processes underlying the completion of a transaction are performed. For example, in 2003, 32% of computer software and hardware was sold online, 17% of tickets for events, and 12% of books (Hansen, 2003). The taxation of such services and intangibles raises complex tax issues such as the characterization of income, the bundling of services and products, sourcing rules, transfer pricing, and the valuation of intangibles. Current tax rules may simply be inapplicable to these digital products and services.

Virtual Organizations

Companies have transformed themselves into virtual organizations by entering into joint ventures, partnerships, outsourcing agreements, and other arrangements. For example, at Cisco Systems, a leader in networking solutions for the internet, over two-thirds of manufacturing is outsourced and over three-quarters of sales occur on-line. The emergence of virtual organizations will put pressure on taxing authorities to develop new rules for apportioning the income of these more mobile and dynamic businesses.

Automated Transactions

A natural extension of transaction automation through e-commerce is to include transactional tax collection and payment compliance capabilities. There are over 7,500 sales and use tax jurisdictions within the U.S. (U.S. Bureau of Census, 1998). Each has its own listing of taxable items, exemptions, and rates. Constitutional issues aside, this multiplicity and diversity of taxing jurisdictions arguably makes tax compliance by the remote e-commerce vendor unduly burdensome. Governmental development of a simplified national system would reduce this burden.

New Business Models

The integration of technological characteristics of e-commerce into business processes has resulted in the emergence of new business models, posing challenging tax issues. For example, gift certificates, traditionally purchased directly at a retail outlet, can now be purchased at Giftcertificates.com. Gift certificates are purchased from various retail establishments at a discount and then are resold over the web. This raises new taxation issues such as the identity of the actual retailer, the sourcing of consumption, the classification of the good or service sold, and the relevant sales price upon which the transactional tax would be based. Additionally, on-line auctions, reverse auctions, virtual communities, infomediaries, aggregators, and brokers all represent new ways of doing business. New tax rules incorporating these new business models must also allow adaptability to future business models which emerge.

THE ISSUE OF E-COMMERCE TAXATION

The taxation of the internet and e-commerce has been a troubling issue both in the U.S. and abroad. Proponents of a tax free internet argue that internet taxes and fees result in rate hikes making access more expensive for the consumer and thus restricting the growth of e-commerce. Further, these proponents argue against imposing the requirement to collect and remit

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transactional taxes on remote e-commerce vendors because of the cost of compliance with multiple taxing jurisdictions. Such cost is viewed as a barrier to market entry for small, start up e-businesses.

Proponents of internet taxation focus on the loss of tax revenue and tax neutrality regardless of the business model, i.e., clicks versus bricks. Non-compliance with the payment of transactional taxes has real revenue implications for governmental entities. First, since transactional taxes are a significant revenue source, an increase in non-payment would result either in an increase in other taxes or a contraction of government functions and/or programs. Secondly, an increase in the ability to avoid/evade transactional taxes could adversely affect the local tax base. What will be the impact on the local tax base and economy of redirecting commerce from local brick and mortar businesses to remote e-commerce businesses because of the perceived tax savings?

EUROPEAN UNION TAXATION OF E-COMMERCE

Since EU member states rely heavily on the value added tax (VAT), a Community wide approach to the issue of taxation was needed. On May 7, 2002 Council Directive 2002/38/EC was adopted, making the EU "the *first* (emphasis added) significant tax jurisdiction in the world to develop and implement a simplified framework for consumption taxes on e-commerce in accordance with the principles agreed within the framework of the Organization for Economic Co-operation and Development (OECD)" (European Commission, 2004). These principles focus on taxation in the jurisdiction of consumption, i.e., destination. The new Council Directive also removes a competitive handicap for EU suppliers by eliminating the obligation to levy the VAT on products sold outside the EU.

UNITED STATES TAXATION OF E-COMMERCE

A temporary moratorium on new state and local internet access taxes and fees was mandated by the Internet tax Freedom Act of 1998. This moratorium was extended to November 1, 2003, by the Internet Tax Freedom Act of 2001. The pending Internet Tax Non Discrimination Act of 2003 seeks to make the moratorium permanent and repeal any existing state and local access taxes and fees by 2006. This act has yet to be enacted leaving this important issue in a legislative limbo.

Some erroneously assume that these acts also protect e-commerce transactions from state and local sales and use taxes. This is a completely false assumption. The Internet Tax Freedom Act is primarily concerned with the cost of internet access by restricting taxation of access to the internet. It is not directly concerned with the taxation of transactions on the internet, i.e., e-commerce taxation.

Sales and Use Taxes within the United States

Although founded on European political philosophy, the governmental structure of the U.S. functions differently than most European states. This difference is based in the Constitution which was, in part, a compromise between national and state sovereignty. Thus, the taxation of borderless e-commerce is subject to constitutional limitations.

Within the U.S., most states rely in part on transaction and consumption based taxes as part of their overall state taxation system. The only states that do not have sales taxes are Alaska, Delaware, Montana, New Hampshire and Oregon. Cities, other municipalities, and counties may also have such taxes. These sales and use taxes are products of an industrial age consumption model that was locally based. Taxable goods and services that are purchased within the state are subject to a sales tax which is collected, reported, and remitted to the state by the vendor. Out of state taxable purchases are subject to a use tax payable by the in-state purchaser.

The Collection of Sales and Use Taxes from Consumers

Often, out of state, or remote purchases remain unreported. A purchaser may purchase goods in a non-tax state either physically or by mail order and fail to pay the use tax when he returns to his home state. E-commerce facilitates transactions between purchasers and remote vendors, thus increasing the likelihood of nonpayment of state sales and use taxes.

Enforcement and collection of use taxes on out of state purchases is made difficult by a number of factors. First, non-business consumers are often unaware of the obligation to pay a use tax on out of state purchases. Second, states generally do not have significant enforcement and collection programs for non-business purchasers. Third, states usually rely on the vendors to collect and remit the tax. For the remote vendor however, this responsibility is often perceived as too burdensome and further may consider itself without a legal obligation to collect the use tax. The burden on the remote mail order or e-commerce vendor is significant because of the incredible multiplicity of taxing jurisdictions. In addition to 45 states and the District of Columbia, there are approximately 7,500 counties, cities, towns, and special districts that also impose sales and use taxes (U.S. Bureau of Census, 1998).

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The Collection of Sales and Use Taxes from Businesses

Enforcement and collection of use taxes is much higher for business purchasers. Businesses tend to recognize use tax compliance as a cost of doing business. As with other business taxes, compliance can be increased by aggressive audit practices by the state. Failure to pay can result in liability for back taxes, interest and other penalties.

Efforts to Reduce the Loss of Sales and Use Tax Revenues

To reduce the loss of tax revenues, some states have increased their efforts to collect use taxes at the consumer, rather than the remote vendor level. In 1999, North Carolina, for example, began including the use tax as a line item on its individual income tax returns. The result was US$4.3 million in use tax collection. Other states are trying a collective approach to combat the avoidance/evasion problem. The Southeastern Association of Tax Administrators developed an information exchange agreement whereby the twelve member states share information regarding sales to buyers from other member states. In ten years, this agreement has resulted in the collection of US$69.8 million of otherwise uncollected use tax revenue (Masterson, 2000). A suggested technological solution is to employ "taxbots" that could seek out taxes due (Dekleva, 2000). Another solution is to require the capability within the browser to recognize and track taxable transactions (Blumenthal and Clark, 2001). These technological solutions are not without their problems.

Digital Products and Services Delivered via the Web

Further complicating the sales and use tax issue is the method of product delivery. Traditionally, sales and use tax cases are concerned with purchases from remote mail order vendors where the goods were either received at the vendor’s place of business or physically shipped to the purchaser. In these cases, the court considers physical, not digital delivery, of tangible goods or specified services to which state sales and use taxes generally apply. An intriguing question is how do these taxes apply to digital products and services delivered via the web? If shrunk-wrapped software or a music CD is taxable, is the same software or music taxable if it is delivered digitally to the purchaser or by allowing the purchaser access to a server of the vendor? Was the Napster craze only about free online music or something more? The online music phenomenon can be viewed as an issue of choice and convenience, not price (Weber, 2001). However, electronic delivery of digital products and services creates additional state tax issues for e-commerce.

As will be discussed, state efforts to collect sales and use taxes are impeded not only by the costs and difficulties associated with enforcement, but by specific requirements and prohibitions contained within the U.S. Constitution. The new business models of e-commerce only complicate the state’s enforcement and collection efforts. The confusion surrounding the sales and use tax issue is not solely a state concern. A remote vendor who refuses to collect and remit this tax is at risk of being held liable for many years’ use taxes, plus interest and penalties, if it is later determined that the vendor was required to collect and remit.

UNITED STATES CONSTITUTIONAL ISSUES

Attempts to tax remote vendors must confront the requirements and prohibitions of the Due Process Clause and the Commerce Clause of the U.S. Constitution. The requirements of these clauses have at times been considered similar or even the same. The U.S. Supreme Court decision in *Quill v. North Dakota* (1992), clearly differentiated these constitutional provisions and, in so doing, may have created the opportunity for a U.S. Congressional solution. Although *Quill* factually deals with a remote mail order vendor, its holdings are equally applicable to a remote e-commerce vendor.

Due Process Clause of the United States Constitution

Due process deals with the concept of the fundamental fairness of government activity. When applied to a state’s power to impose the duty to collect and remit use taxes, the U.S. Supreme Court has consistently held that due process requires some minimum connection between a state and the person, property, or transaction taxed. This was reaffirmed for mail order remote vendors in *National Bellas Hess, Inc. v. Department of Revenue of Illinois* (1967). In *Bellas Hess*, the remote vendor mailed catalogues and advertising flyers to potential customers in Illinois. Orders were accepted at its Missouri plant. The ordered goods were delivered to the customers by mail or common carrier. Despite a lack of physical presence, Illinois maintained that National had a duty to collect and remit use taxes on orders from Illinois. The Court held that to impose this obligation on National would violate the Due Process Clause. The remote vendor must have some physical presence in the taxing state.

This issue of the requisite minimum connection required before a state can constitutionally require a remote vendor to collect and remit use taxes was revisited in *Quill*. Quill Corporation was an out of state mail order supplier with neither sales agents nor outlets within North Dakota. Quill solicited business through catalogues, flyers, advertisements in national periodicals,

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and telephone calls. All deliveries to Quill's North Dakota customers were made by mail or common carrier from out of state locations. North Dakota sought to impose the duty on Quill to collect and remit use taxes based upon its statutory definition of retailer. These facts seem very similar to *Bellas Hess* and to many remote vendor e-commerce transactions.

Although the facts of *Quill* are very similar to *Bellas Hess*, the Court used this case to reaffirm that due process requires some definite link or minimum contact between the state and the person, property, or transaction it seeks to tax. However, it noted that the test of jurisdictional due process had evolved since *Bellas Hess*. The purposeful availing of the benefits of a state's economic market satisfied the due process requirements, without physical presence in the state. In *Burger King v. Rudzewicz*, the Court noted that business can be transacted primarily by mail and wire communications across state lines and held that "[S]so long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there" (*Burger King*,1985).

In *Quill*, the Court used comparable reasoning to establish a due process "purposefully directed" test for imposing the duty to collect and remit use taxes on a remote vendor. Quill had "purposefully directed its mail order activities at North Dakota residents, [that] the magnitude of those contacts is more than sufficient for due process purposes, and the use tax is related to the benefits Quill receives from access to the State" (*Quill*, 1992). Thus it seems that, based on *Quill*, a remote e-commerce vendor, with more than a minimal business presence in a host state, will not be able to avoid the obligation to pay and remit use taxes based upon a lack of physical presence.

Commerce Clause of the United States Constitution

Even if a state's statute requiring a remote vendor to collect and remit use taxes satisfies the requirements of the Due Process Clause, it is still subject to the limitations of a state's power to tax or otherwise burden interstate commerce imposed by the Commerce Clause. Although, a state may, consistent with due process, have the power to tax a remote vendor, the imposition and collection of the tax may still violate the limitations of the Commerce Clause. These constitutional provisions are related, but different. For use taxes, due process requires some minimum connection between the taxpayer and the taxing state, while the Commerce Clause is concerned with the effect of the imposition of the tax on interstate commerce. The use tax analysis focuses on the issue of whether subjecting the remote vendor to taxation in multiple jurisdictions creates an impermissible undue burden on interstate commerce.

Although the Court in *Quill* found that the due process minimum contacts requirement was satisfied without physical presence, it clearly stated that minimum contacts do not of themselves satisfy the requirements of the Commerce Clause. For states, the Commerce Clause prohibits both discrimination against interstate commerce and state actions that unduly burden interstate commerce. The Court reaffirmed the four part test of *Complete Auto Body v. Brady* (1977). Under *Complete Auto's* test, a tax will survive a Commerce Clause challenge 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." For states, the Commerce Clause prohibits both discrimination against interstate commerce and state actions that unduly burden interstate commerce. Applying this analysis to the facts of the *Quill* case, the Court expressly rejected North Dakota's "slightest presence" argument that bare title to a small amount of leased software within the state satisfied the substantial nexus requirement of the Commerce Clause. Thus, even though Quill's purposeful actions directed towards North Dakota's residents was a sufficient minimum contact for due process purposes, it does not satisfy the substantial nexus requirement of the Commerce Clause.

Due Process and Commerce Clauses Applied to E-Commerce

As mail order and e-commerce operations have expanded, states have continued to try to collect use taxes from remote vendors through both legislation and court action. Subsequent to *Quill*, the Court of Appeals of New York and the Illinois Supreme Court seem to have attempted to lessen the physical nexus requirement by substituting a more than slightest presence test (*Orvis*, 1996). However, other courts have strictly adhered to *Quill's* physical nexus requirement. In *America Online, Inc. v. Johnson* (2001), the Tennessee Chancery Court refused to find substantial nexus without a substantial physical presence. America Online (AOL) had done substantial business with its Tennessee customers and the state wanted to impose and collect over US$9 million in sales and use taxes for the period December 1, 1990 to June 30, 1997. This state court strictly followed *Quill*, even though AOL had substantial economic, if not physical presence. The Tennessee Court of Appeals reversed and remanded the case back to the Chancery Court suggesting that a substantial nexus satisfying the Commerce Clause might be established by activities carried on within the state by AOL's affiliates and independent contractors (*America Online, Inc*. 2002).

Does case law signal the possibility that because of its different business model, e-commerce will be able to use the Commerce Clause in reverse, i.e., to in effect cause state taxation to be discriminatory against, and put a discriminatory

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burden on, local commerce? The *Quill* Court seemed concerned with this possibility and made note that while the U.S. Congress, absent a constitutional amendment, could not cure a due process defect, its plenary power for interstate commerce gave it the ultimate power to resolve the Commerce Clause substantial nexus issue. Since the "purposely directed" due process test of *Quill* should not be a difficult standard for a state to meet, the U.S. Congress should focus on the policy issues surrounding the substantial nexus requirement.

CONGRESSIONAL ACTION OR INACTION

The U.S. Supreme Court invited Congress to resolve the Commerce Clause issue as applied to remote vendors in its 1992 *Quill* decision. A decade later, there has been much talk, but little resolution. This issue has been caught up in the original Commerce Clause concern over discriminatory state taxes and the burden of compliance with multiple jurisdictions. Unfortunately, this issue has also been impacted by a political disagreement that goes back to the formation of the U.S., i.e., the size of government and the level of taxation.

Internet Tax Freedom Act

Although the broader issue is the obligation of remote vendors, both mail order and e-commerce, to collect and remit sales and use taxes, the U.S. Congress has focused on e-commerce conducted over the internet. In 1998 the Internet Tax Freedom Act (ITFA) became law. Its purposes were to help economic growth by preventing fledgling e-businesses from being burdened with new taxes and tax compliance, and to create a moratorium on new taxes. As previously stated, *The ITFA does not, as is popularly believed, exempt e-commerce from taxation*.

The ITFA seeks to protect the development of e-commerce and the free flow of information. The ITFA was re-enacted in 2001, but had a sunset date of November 1, 2003. Re-enactment legislation is still pending in Congress. Any state taxes enacted during this limbo period, that would have been prohibited by the ITFA, would most likely be pre-empted when the ITFA is re-enacted.

Streamlined Sales Tax

The recommendation of the Advisory Commission on Electronic Commerce (ACEC), created by the ITFA, was a five year extension of the moratorium. At the same time, other groups combined to develop a proposal that attempted to balance the interests of both e-commerce and state and local government. The resulting proposal, the Streamlined Sales Tax System (SSTS), was studied by various groups, including the U.S. Congress. The SSTS attempts to provide a system for state governments and business that simplifies and modernizes the collection and remission of sales and use taxes. The product of this work is the Streamlined Sales Tax Agreement (SSTA). States are not required to approve the SSTA, but 37, of the 45 states with sales taxes, have approved the Agreement.

Section 102 of the SSTA states that its purpose "is to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance." In other words, the purpose is to provide a tax system that Congress will accept as not unduly burdening interstate commerce. Congress, through its Commerce Clause powers, would then be able to enact legislation permitting member states to collect sales and use taxes from remote vendors following the tax system contained in the SSTA. Non-member states would still be confronted with the substantial nexus requirement of *Quill*. It should be re-emphasised that state participation in the Agreement is voluntary. If a state chooses to participate, it will need to make the necessary statutory changes to comply with the provisions of the Agreement.

Streamlined Sales Tax and Use Tax Act of 2003

Congress has been considering the Streamlined Sales and Use Tax Act (SSUTA). If enacted, Congress will have determined that the SSTA provides sufficient simplification and uniformity to warrant Congressional authorization to states, that are parties to the SSTA, to require remote sellers to collect and remit the sales and use taxes of participating states and their local taxing jurisdictions. This is the type of Congressional action that the Supreme Court alluded to in *Quill*.

CONCLUSION

The attempt by state and local government to impose an obligation on remote vendors to collect and remit state and local sales and use taxes is not a new issue. The issue and case law originated with mail order vendors, but has become more salient with the increase in sales through e-commerce. Because of the increasing market share of the remote vendor engaged in e-commerce, state and local governments have become increasingly concerned about the loss of tax revenues.

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However, the issue is broader than just tax collection. There are constitutional issues that must be addressed. The remote vendor has legitimate concerns about excessive compliance costs if the obligation to collect and remit sales and use taxes from multiple jurisdictions requiring different tax bases, rates, forms and procedures is imposed. Within the U.S. this is a national problem that requires a national solution. The Streamlined Sales and Use Tax Act SSUTA is just such a legislative solution. The authors recommend that a global solution for the appropriate taxation of e-commerce transactions be negotiated between the EU, NAFTA, and other industrialized nations.

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