

Where There's a Will, There's a Way: State Sales and Use Taxation of Electronic Commerce

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INTRODUCTION

With the recent explosion of commercial transactions occurring over the Internet, state and local governments are deciding to tap into the enormous tax revenue potential that accompanies these transactions. State and local governments are considering levying and enacting sales and use taxes on the revenues collected from these sales. As a relatively new concept, commerce over the Internet poses unique problems that may only partially be answered by existing legal analysis and concepts.

In the majority of transactions, the Internet uses telephone lines to establish a connection to the World Wide Web. Maneuvering through the various web sites, the Internet user may locate a commercial web site that offers to sell him an item in which he is interested. Typically using a credit card, the user may purchase this item and will either receive it physically or receive it in the form of a downloaded file. This transaction partially resembles a mail-order transaction in which a customer telephones the mail-order catalog and places his order. However, this analogy does not fully resolve all issues predicated by Internet transactions.

This Note will discuss the present laws applicable to an on-line transaction involving downloaded software and will propose modifications that may need to be made to enable state and local governments to levy sales and use taxes upon electronic commerce. In addition, in its analysis, this Note considers only state taxation of Internet transactions. Part I of this Note details the growth of the Internet and the considerations both for and against its taxation while Part II discusses the limitations upon states' power to levy taxes. Part III will explain the fundamentals of the traditional sales and use tax scheme and, then, Part IV will apply these fundamentals to Internet transactions and conclude that state taxation of electronic commerce is both permissible and achievable.

I. THE ATMOSPHERE OF ELECTRONIC COMMERCE

The Internet is in the midst of a considerable growth period. As a result, the number of electronic commerce transactions also demonstrates growth. The potential for states to impose sales and use taxes on this tax base creates more tax revenue for state governments. However, the benefits to states also have their costs. The projected growth of the Internet must be balanced against the costs of

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taxing Internet transactions. In order to understand this balance, both the benefits and costs of the potential tax levy must be evaluated.

A. *The Growth of Electronic Commerce*

As a testament to the continued growth of electronic commerce, on-line purchases during the fourth quarter of 1997 were expected to surpass market analysts' loftiest projections by \$250 million.¹ In addition, this growth is projected to continue at an unprecedented rate² and is expected to begin to eat away at in-store retail sales.³

Perhaps this enormous growth rate partially reflects the increasing number of Internet users. In 1995, Cyber Dialogue estimated that there were eight million active Internet users; it also reports that in 1997 there were more than thirty-six million active users.⁴ As Internet usage becomes even more commonplace and accessible through equipment that does not even require the user to own a computer, it is logical to infer that the number of web surfers will continue to grow. As the number of Internet users increases, the number of purchasers is also expected to increase.⁵ As a testament to the increasing number of web shoppers, a recent survey concluded that twenty-four percent of active web surfers are Internet shoppers.⁶ Web shopping doubled in nine months from ten million to

1. See, e.g., Barton Crockett, *Holiday 'e-tail' May Exceed Hype* (visited Jan. 6, 1998) <<http://www.msnbc.com/news/12500.asp>> (stating that Kate Delhagen, an analyst at Forrester Research, had originally predicted fourth quarter sales to amount to \$750 million but would not be surprised if sales reach \$1 billion).

2. See Barton Crockett, *E-COMMERCE: Sales Gains Show the Web's Appeal* (visited Jan. 6, 1998) <<http://www.msnbc.com/news/130742.asp>> (reporting that Jupiter Communications and Forrester Research project that for 1997 on-line retail sales were between \$2.4 billion and \$2.6 billion and that for 2002, on-line retail sales will reach between \$17 billion and \$38 billion); see also NUA Internet Surveys, *CNNfn: USD400 Billion Ecommerce by 2002* (visited Oct. 16, 1998) <http://www.nua.ie/surveys/?f=VS&art_id=903540457&rel=true> (stating that the number of people buying on the Web is expected to increase from 18 million in 1997 to 128 million in 2002 and equal \$400 billion).

3. See NUA Internet Surveys, *News.Com: Christmas Shopping Frenzy Online* (visited Oct. 24, 1998) <http://www.nua.ie/surveys/?f=VS&art_id=881845713&rel=true> (reporting that purchases made on the Internet will account for 44% of the holiday season's purchases).

4. See *id.*; see also *CyberStats: Commerce and Advertising on the Web* (visited Jan. 6, 1998) <<http://www8.zdnet.com/zdimag/cyberstats/1997/11/>> (predicting the number of web users in 2002 to be 175 million).

5. See Crockett, *supra* note 1. Crockett reports that in 1995 only 19% of Internet surfers made a purchase on-line, whereas in 1997 this rate was expected to be 27%. See *id.*

6. See NUA Internet Surveys, *@plan: 24 Percent of US Web Users Are Online Shoppers* (visited Oct. 16, 1998) <http://www.nua.ie/surveys/?f=VS&art_id=889187467&rel=true> (reporting on a study conducted by @plan, a company specializing in on-line research, which looked at on-line shopping habits).

twenty million.⁷ Almost one quarter of consumers who connected to the Internet in the first six months of 1998 made an on-line purchase.⁸

The percentage of companies that are offering their products on the Internet is still relatively small but is expected to double in each of the next two years.⁹ Web shopping witnessed a growth of fifty percent in 1997; this growth is attributed to "the industry's technical and marketing initiatives in the past year to build consumer confidence."¹⁰

Another factor that is expected to increase the number of business transactions that transpire over the Internet is the development of encryption systems that customers trust to prevent others to gain access to their financial, or credit card, information.¹¹ As consumer confidence rises, so will sales revenues.¹²

Electronic commerce is also expected to maintain its future growth because of developments in the bandwidth. Bandwidth determines the speed at which data can be transferred over the Internet. Technology in 1997 meant that transferring an entire music compact disc via the Internet takes two days; however, developments in the Internet's bandwidth are expected to reduce this to ten or fifteen minutes.¹³

Lastly, the development of electronic cash will enhance growth of Internet transactions. "E-money" is being developed to enable customers to make on-line purchases without using a credit card.¹⁴ Therefore, each of the aforementioned

7. See Nielsen Media Research, *Number of Internet Users and Shoppers Surges in United States and Canada* (visited Oct. 8, 1998) <<http://www.nielsenmedia.com/news/commnet2.html>>.

8. See Nielsen Media Research, *Shoppers Filling On-line Carts with Books, Computer Stuff* (visited Nov. 3, 1998) <<http://www.nielsenmedia.com/news/onlineshoppers.html>>.

9. See Crockett, *supra* note 2, for IBM's report that 10% of companies sell on-line now, and that it expects this percentage to double in each of the next two years. See also *CyberStats: Commerce and Advertising on the Web*, *supra* note 4 (showing that, according to Computer Sciences, nearly 40% of retailers currently are in the planning stages of offering on-line shopping). But see NUA Internet Surveys, *Techweb: Companies Expect Quick Pay-Offs from E-Commerce* (visited Jan. 6, 1998) <http://www.nua.ie/surveys/index.cg...vice=view_survey&survey_number=515> (stating that 40% of U.S. companies currently conduct business on the Internet and another 23% intend to begin electronic commerce in the next year).

10. NUA Internet Surveys: *CommerceNet: Web Shopping Sees 50 Percent Growth* (visited Jan. 6, 1998) <http://www.nua.ie/surveys/index.cg...vice=view_survey&survey_number=521>.

11. The number one challenge facing e-commerce is the customers' concerns about electronic commerce security and their confusion regarding payment security for on-line purchases. See *Yahoo: Ecommerce Will Flourish When the Web is Made Simple* (visited June 9, 1998) <http://dailynews.yahoo.com/headlines/technology/story.html?s=z/reuters/980528/tech/stories/poll_1.html>.

12. For a discussion of encryption, see Dorothy E. Denning, *America Needs a Secure Computer Encryption System*, in *THE INFORMATION HIGHWAY* 168 (Charles P. Cozic ed., 1996).

13. See Jeffrey Owens, *The Tax Man Cometh to Cyberspace*, 14 *TAX NOTES INT'L* 1833, 1835 (1997).

14. There are three different types of electronic money: the PC-based electronic money, the token based electronic money, and the prepaid electronic money card. Each of these types of electronic money is simply a way to record the electronic set of information created when "e-money" is used. See John L. Douglas, *Electronic Money*, 18 *ANN. INST. ON COMPUTER L.* 1093, 1093 (1998). For a detailed explanation of how CyberCash functions, see Russell B.

developments will contribute to the image of Internet shopping as convenient and secure.¹⁵

In 1994, the median state sales tax rate was five percent.¹⁶ Thus, if a sales tax rate of five percent is imposed upon the projected sales revenues from transactions conducted over the Internet, an estimated \$1.9 billion in tax revenues would be collected from Internet sales alone in 2002 assuming that all Internet sales are subject to the sales tax.¹⁷ Particularly relevant to this Note, on-line sales of software packages are estimated to reach \$5.9 billion by 2001.¹⁸ Therefore, the potential benefit to the states is large, and this benefit will motivate states to attempt to levy sales and use taxes upon Internet transactions in any way possible.

B. The Relevant Characteristics of Electronic Commerce

According to Jeffrey Owens, Head of Fiscal Affairs for the Organisation for Economic Co-operation and Development, the Internet has at least six characteristics that affect how traditional tax schemes may be applied to on-line purchases.¹⁹ In addition, Owens also describes several technical characteristics of the Internet that will frustrate states' attempts to apply these traditional tax systems to the Internet: the Internet lacks central control and has no physical location.²⁰ Also, no central registration to use the Internet is required.²¹ As a result, proof of identity requirements for use of the Internet are virtually

Stevenson, Jr., *Internet Payment Systems and the CyberCash Approach*, 17 ANN. INST. ON COMPUTER L. 441 (1997).

15. See Stevenson, *supra* note 14, at 441.

16. See JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 45 (2d ed. 1994).

17. This revenue figure is determined by using the projected Internet sales for 2002, discussed in Crockett, *supra* note 2, of \$38 billion multiplied by the median sales tax rate of five percent.

18. See International Data Corp., *IDC Study Projects Electronic Software Distribution to Reach \$5.9 Billion in 2001* (visited Oct. 8, 1998) <<http://www.idcresearch.com/Press/091598Apr.htm>>.

19. Owens believes that six characteristics influence the operation of tax systems:

- (1) The ability to establish public and private global communication systems that are secure and inexpensive to operate. . . .
- (2) The process of "disintermediation" whereby the Internet will eliminate or substantially reduce the need for intermediaries in the sale and delivery of goods and services, and in the provision of information. . . .
- (3) The development of encrypted information that protects the confidentiality of the information transmitted on the Internet. . . .
- (4) An increased scope for the "integration of business functions," e.g., design and production. . . .
- (5) The Internet provides greater flexibility in the choice of the organization form by which an enterprise carries out its international activities.
- (6) The Internet has led to a fragmentation of economic activity. The physical location of an activity . . . becomes less important and it becomes more difficult to determine where an activity is carried out.

Owens, *supra* note 13, at 1835-36.

20. See *id.* at 1836.

21. See *id.*

nonexistent or may be circumvented.²² Also, an Internet user can use a web site without being traced.²³ Lastly, the components of an Internet address do not tell the user where the machine that provides the site's information is located.²⁴ Therefore, in evaluating the possibility of levying sales and use taxes upon Internet transactions, states must consider these technical features and incorporate them into the tax scheme.

C. The Arguments Against Taxing Internet Transactions

Critics of state taxation of Internet transactions express several arguments why states should not be allowed to tax on-line transactions. One commentator, Dean Andal, believes that governments do not need the additional revenues from taxing these transactions; instead, he argues, by promoting the growth of electronic commerce, governments will help the United States economy grow and will see increased tax revenues.²⁵ Assuming that taxing the Internet will stifle its growth within the United States, he argues that allowing states to tax Internet commerce will relocate growth and weaken our country's competitive position within the Internet. Lastly, Mr. Andal argues that the nation will benefit from the growth of information technology and on-line commerce.²⁶

Other commentators also feel strongly against state taxation of on-line transactions. For example, both the Senate and the House of Representatives passed different versions of the Internet Tax Freedom Act ("ITFA") during June 1998.²⁷

22. This problem is similar to the problem faced by mail-order catalogs; however, the Internet problem is even more severe because there is the potential that no physical delivery will be made and thus, not even a delivery address will be known. The sheer volume of both mail-order and Internet transactions further complicates the difficulties. The theoretical concerns of how to constitutionally levy mail-order sales and use taxation are also prevalent concerns in Internet taxation; however, Internet transactions pose an even greater challenge for states to be able to satisfy the constitutional limitations. *See infra* Part II.

23. However, see *infra* text accompanying note 147 for a discussion on how "cookies" are used to gather information about an Internet user.

24. *See* Owens, *supra* note 13, at 1836.

25. Dean F. Andal, *Read my E-Mail: No New Taxes*, 12 STATE TAX NOTES 1387, 1388 (1997).

26. *Id.*

27. The House of Representatives voted on June 23, 1998, to approve revised legislation (H.R. 4105) that imposed a three-year moratorium upon the states' ability to impose, assess, collect, or attempt to collect multiple or discriminatory taxes on electronic commerce. *See* Jeremy Holmes, *Electronic Commerce: House Approves Internet Tax Moratorium; Focus Shifts to Companion Bill in Senate*, 1998 Daily Tax Report (BNA) 121 d16 (June 24, 1998), available in LEXIS, FEDTAX Library, BNADTR File. The moratorium does not apply to certain currently existing state taxes. For further information, see H.R. 4105, 105th Cong. (1998). Even according to the bill's author, for a period of three years, the bill preserves the sales tax-free treatment of remote purchases only to the extent present today. *See* U.S. Representative Christopher Cox, *U.S. House Approves Rep. Cox's Internet Tax Freedom Act* (visited Nov. 4, 1998) <<http://cox.house.gov/Press/062398itfa.html>> (explaining the effects of the Internet Tax Freedom Act). In addition, the ITFA "protects the States' legitimate rights to tax Internet sales transactions in the same manner they tax the sale of ordinary goods." 144

D. The Internet Transaction Compared to Other Transactions

Transactions on the Internet differ from traditional transactions because Internet transactions do not require a purchaser to visit the seller's place of business, and they do not require any physical meeting of buyer and seller. In this respect, Internet transactions resemble mail-order transactions. However, mail-order transactions must use the postal service or a common carrier to deliver the purchased goods, whereas on-line purchases do not always require physical delivery. For instance, a purchaser can buy computer software over the Internet and have it downloaded onto his computer without having any disks or CD-ROMs delivered to him. The lack of physical delivery means that a seller could possibly have no knowledge of the location of her purchaser. Nevertheless, in comparison to typical transactions, Internet purchases most resemble mail-order sales.²⁸

II. LIMITATIONS UPON THE STATES' POWER TO LEVY
TAXES

Since its creation in the 1930's to combat the economic effects of the Great Depression,²⁹ the sales tax and its complementary use tax have been challenged on several facets. Sales and use taxes have been attacked as violating the Commerce Clause, the corresponding Dormant Commerce Clause, and the Due Process Clause of the Fourteenth Amendment.³⁰ However, the sales and use taxes have not been eliminated by these challenges, and their applications have instead been only slightly limited.

CONG. REC. H5028, H5032 (daily ed. June 23, 1998) (statement of Rep. Conyers). Therefore, even if this bill ultimately becomes law, because the States still have the ability to tax e-commerce as they do the ordinary sale of goods, the issues presented in this Note will still be relevant both for the present and in the future.

28. See Daniel J. Langin, *The Economics of the Internet: Insurance and Risk Management, Advertising and Other Business Models, Valuation and Tax Issues*, in FIRST ANNUAL INTERNET LAW INSTITUTE 1997, at 447, 461 (PLI Pat., Copyrights, Trademarks, and Literary Prop. Course Handbook Series No. 482, 1997).

29. See DUE & MIKESSELL, *supra* note 16, at 1.

30. See, e.g., ROBERT J. FIELDS, UNDERSTANDING AND MANAGING SALES AND USE TAX §1002, at 93 (1991).

*A. Application of the Commerce Clause and the Dormant
Commerce Clause*

The Constitution of the United States expressly authorizes Congress to “regulate Commerce with foreign Nations, and among the several States.”³¹ The Supreme Court has interpreted this clause to empower Congress to regulate interstate commerce and to restrict the states’ power to enact laws that affect interstate commerce.³² The Court has held:

This principle that our economic unit is the Nation, which alone has the gamut of powers necessary to . . . the vital power of erecting customs barriers against foreign competition, has as its corollary that the states are not separable economic units. . . . “[W]hat is ultimate is the principle that one state in its dealings with another may not place itself in a position of economic isolation.”³³

Thus, the Dormant Commerce Clause is a corollary to the Commerce Clause that prevents state laws from interfering with interstate commerce. The important analysis is to determine if a state’s regulation affects interstate commerce in one of two ways.³⁴ First, the state law cannot “affirmatively” or “clearly” discriminate on its face or in its effect.³⁵ Second, the regulation cannot impose an incidental burden on interstate commerce that is excessive in relation to the local benefits.³⁶ Specifically, the Dormant Commerce Clause has been used to strike down the application of state sales and use tax systems to numerous transactions;³⁷ also, the Court’s interpretation of the clause with respect to tax schemes has developed in a line of cases.³⁸

31. U.S. CONST. art. I, § 8, cl. 3.

32. See *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine*, 117 S. Ct. 1590, 1595-96 (1997) (citing *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824)).

33. *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 537-38 (1949) (quoting *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935)).

34. See H. Joseph Hameline & William Miles, *The Dormant Commerce Clause Meets the Internet*, 41 BOSTON B.J. 8, 9 (1997).

35. *Maine v. Taylor*, 477 U.S. 131, 138 (1986).

36. See *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (stating that the burden test should be applied to Dormant Commerce Clause analysis).

37. See, e.g., *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 (1992); see also *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756 (1967), overruled by *Quill Corp.*, 504 U.S. at 308.

38. The cases discussed in this Note are mostly sales and use tax cases; however, when noted, income tax cases are used to elaborate upon the way in which courts apply the constitutional constraints upon interference with interstate commerce to state taxes. Courts generally apply the same analysis to both income tax and sales and use tax cases. Therefore, the holdings in these income tax cases are also relevant in the electronic commerce and sales and use tax realm.

1. The *National Bellas Hess* Standard

In *National Bellas Hess, Inc. v. Department of Revenue*,³⁹ the Supreme Court addressed a challenge involving the application of the Illinois use tax to a Missouri mail order house that owned no property and had no sales outlets or employees in Illinois. National Bellas Hess simply used the postal system to deliver catalogs to its customers two times a year; to deliver its products, it used either the postal system or a common carrier. The business disputed Illinois's levy of its use tax upon the goods delivered to Illinois customers because its only connection with the state was by common carrier and mail. The Supreme Court held that the levy violated the Dormant Commerce Clause because the "Constitution requires 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'"⁴⁰ Because it required some actual presence of the business within the jurisdiction of the state before Illinois could levy its tax upon the business, *National Bellas Hess* is said to have created a "physical presence" requirement.⁴¹

2. The Four-Part Test Added by *Complete Auto Transit*

The Supreme Court, in *Complete Auto Transit, Inc. v. Brady*,⁴² evaluated a Commerce Clause challenge to a Mississippi sales tax levied upon automobiles that were manufactured outside of the state. In rejecting the challenge, the Court developed a four-part test to examine a Commerce Clause dispute.⁴³ The test assesses (i) whether the tax is applied to an interstate activity with a substantial nexus with the taxing state; (ii) whether the tax is fairly apportioned; (iii) whether it discriminates against interstate commerce; and (iv) whether it is fairly related to the services provided by the state.⁴⁴

More recent Supreme Court cases have developed the meaning of each of the four inquiries.⁴⁵ However, each case has continued to apply the *Complete Auto* four-part test.⁴⁶

39. 386 U.S. 753.

40. *Id.* at 756-57 (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954); *Scripto, Inc. v. Carson*, 362 U.S. 207, 210-II (1960)).

41. *Orvis Co., Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954, 957 (N.Y. 1995).

42. 430 U.S. 274 (1977).

43. *See id.* at 279.

44. *See id.*

45. *See, e.g., Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 620-21 (1981) (developing the fourth prong of the *Complete Auto* test and interpreting it to require only that the measure of the tax be reasonably related to the extent of the taxpayer's contact with the state); *see also Goldberg v. Sweet*, 488 U.S. 252, 257-58 (1989) (applying and explaining each prong of the four-part test).

46. *See, e.g., Goldberg*, 488 U.S. at 257-59; *Commonwealth Edison Co.*, 453 U.S. at 620-21.

3. The Developments of *Quill*

Continuing to apply the *Complete Auto* four-part inquiry, the Supreme Court developed the first prong of the test in a mail-order business's Commerce Clause challenge.⁴⁷ *Quill* argued that because it was only a mail-order business with no physical presence in North Dakota, the State's levy did not fulfill the "substantial nexus" prong of *Complete Auto*. Accepting this argument, the Court upheld the bright-line, physical presence requirement established by *National Bellas Hess* and maintained the "safe harbor for vendors 'whose only connection with customers in the [taxing] State is by common carrier or the United States mail.'"⁴⁸ Therefore, under the traditional requirements of nexus, a business may be subject to a state's sales and use taxes if the business has an office,⁴⁹ employees,⁵⁰ agents,⁵¹ inventory,⁵² or equipment⁵³ within that state.

However, the Court specifically left open an invitation for Congress to decide "whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes" if it disagrees with the Court's conclusions.⁵⁴ Therefore, by inviting Congress to take action, the Supreme Court seemed discontented with its holding in *Quill*.

4. *Orvis*'s Rejection of the Substantial Nexus Requirement

The Court of Appeals of New York rejected the requirement of substantial nexus in *Orvis Co. v. Tax Appeals Tribunal*.⁵⁵ *Orvis*, a retailer and mail-order catalog business, challenged the levy of the compensating use tax upon orders placed through its mail-order catalog. Tracing the development of the level of constitutionally required nexus from its infancy in *National Bellas Hess*, the court

47. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 (1992).

48. *Id.* (quoting *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 758 (1967) (alteration in original)).

49. See *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 556 (1977) (holding that the maintenance of two offices, albeit unrelated to the business activities being taxed, is sufficient to establish nexus).

50. See, e.g., *Standard Pressed Steel Co. v. Washington Dep't of Revenue*, 419 U.S. 560, 562 (1975) (stating that employing one person within Washington to conduct business is sufficient to establish substantial nexus).

51. See, e.g., *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960) (establishing sufficient nexus with a company that had ten independent contractors who solicited business continually for Scripto).

52. See David C. Blum, Comment, *State and Local Taxing Authorities: Taking More Than Their Fair Share of the Electronic Information Age*, 14 J. MARSHALL J. COMPUTER & INFO. L. 493, 509 (1996).

53. See *Quotron Sys., Inc. v. Comptroller of the Treasury*, 411 A.2d 439, 441 (Md. 1980) (holding that because the equipment Quotron provided to its clients was still owned and controlled by Quotron, a sufficient nexus existed).

54. *Quill Corp. v. North Dakota*, 504 U.S. 298, 317-18 (1992).

55. 654 N.E.2d 954 (N.Y. 1995).

found that the level of nexus required by both the Due Process Clause and the Commerce Clause was "indistinguishabl[e]."⁵⁶ The court reasoned that the different standards of nexus imposed by *Quill Corp. v. North Dakota* for the Due Process Clause and the Commerce Clause were adopted with reluctance.⁵⁷

The court reasoned that the Supreme Court begrudgingly retained the *National Bellas Hess, Inc.* physical presence requirement and that the evolution of Commerce Clause jurisprudence does not support its retention.⁵⁸ Thus, the Court of Appeals of New York found that the physical presence of a vendor within a state must be more than a "slightest presence. And it may be manifested by the presence in the taxing state of the vendor's property or the conduct of economic activities in the taxing state performed by the vendor's personnel or on its behalf."⁵⁹ Thus, the court rejected the requirement of substantial nexus in favor of a standard that requires only more than a slight presence;⁶⁰ this standard should be more favorable to states in their sales and use tax systems.

Orvis is not the only case that ignores the Supreme Court's decision in *Quill*. The Illinois Supreme Court, using rationale almost identical to *Orvis*, found that Brown's Furniture had a substantial nexus with Illinois although Brown's Furniture had no property, offices, or employees within the state.⁶¹ Brown's Furniture conducted extensive advertising using television, radio, and print media in Illinois and made deliveries to Illinois on a regular basis.⁶² These periodic deliveries were found to be neither occasional nor sporadic, and thus, the sales revenues gained from transactions with Illinois customers were subject to Illinois income tax. In levying the income tax, the court found an adequate nexus even though Brown's Furniture had no physical presence. The court asserted that a substantial physical presence of a vendor is not required but that only a physical presence that is more than a "slightest" presence is necessary.⁶³ Other courts are adopting the rationale and holdings of *Orvis* and *Brown's Furniture*.⁶⁴

5. The Requirements of Internal and External Consistency

In addition to the "bright-line, physical presence" test, the Supreme Court has added two other requirements that a state tax levy must pass to withstand

56. *Id.* at 956.

57. *See id.* at 959 (citing the Supreme Court's statement that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today" *Quill*, 504 U.S. at 314 (emphasis omitted)).

58. *See Orvis Co.*, 654 N.E.2d at 960.

59. *Id.* at 961 (citation omitted).

60. *See id.*

61. *See Brown's Furniture, Inc. v. Wagner*, 665 N.E.2d 795, 804 (Ill. 1996).

62. *See id.* at 798.

63. *See id.* at 802.

64. *See infra* note 71.

Commerce Clause scrutiny.⁶⁵ The tax must be both internally and externally consistent.⁶⁶

The Supreme Court has defined the inquiry of internal consistency to mean that "a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result."⁶⁷ Therefore, the Court does not want to subject multi-jurisdictional businesses to double taxation. However, the Court recognized that a limited possibility of multiple taxation is not sufficient to invalidate a state sales and use tax scheme.⁶⁸

In addition, the Court, in applying the external consistency test, requires that a state "tax[] only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."⁶⁹ The Court will "examine the in-state business activity which triggers the taxable event and the practical or economic effect of the tax on that interstate activity."⁷⁰ Therefore, states may reach only the part of the transaction that is related to their jurisdiction.

6. The Standard Applied to Commerce Clause Challenges Today

Combining the external and internal consistency tests that are applied to Commerce Clause challenges with the four-part test laid out in *Complete Auto*, the Supreme Court has created a workable test. However, the nexus standard as applied to Commerce Clause challenges is in doubt.⁷¹ Because the Supreme Court invited Congress to address the proper nexus standard, the strength of the substantial nexus standard developed in *Quill* is in doubt. In addition, the denials of certiorari in the *Orvis* and *Brown's Furniture* cases also signify the possibility that the requirement of physical presence for substantial nexus will not be applied in the future.⁷²

65. See *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989). This case is applicable even though the state tax challenged as affecting interstate commerce was the Illinois Telecommunications Excise Tax Act. The Court's holding is relevant because all of the state taxes are judged by the same constitutional constraints.

66. See *id.*

67. *Id.*

68. See *id.* at 263-64 (holding that the possibility of a taxpayer having a different service address and billing location may subject some interstate telephone calls to multiple taxation but that this possibility is not sufficient to invalidate a state's taxation of the calls).

69. *Id.* at 262.

70. *Id.*

71. See *Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954, 956 (N.Y.), *cert. denied*, 516 U.S. 989 (1995) and *Brown's Furniture, Inc. v. Wagner*, 665 N.E.2d 795, 804 (Ill. 1996), *cert. denied*, 117 S. Ct. 175 (1996) for cases that ignore the holding in *Quill* and hold that a sufficient nexus exists.

72. See *Orvis Co.*, 516 U.S. 989; *Brown's Furniture, Inc.*, 117 S. Ct. 175. Other state courts are beginning to use *Orvis*'s holding to find that their states meet the constitutional constraints necessary to tax a transaction. See, e.g., *Magnetek Controls, Inc. v. Revenue Div., Dep't of Treasury*, 562 N.W.2d 219, 223-24 (Mich. Ct. App. 1997).

B. Due Process Clause Considerations

In tax schemes, the Due Process Clause analysis uses personal jurisdiction principles. "Generally, the power of a state to subject someone to personal jurisdiction turns on 'traditional notions of fair play and substantial justice.' Typically, this has been interpreted to mean that a defendant in a lawsuit must receive notice and fair warning of the likelihood of being hailed into court."⁷³ For tax systems, this means that two competing interests must be balanced; the maintenance of a free national economy must be balanced against the countervailing needs of states for tax revenues and the needs of businesses.⁷⁴

1. The *National Bellas Hess* Standard

Not only did the Supreme Court, in *National Bellas Hess*, consider the Commerce Clause challenge discussed earlier,⁷⁵ but it also addressed the Due Process Clause challenge to the taxation of mail-order businesses with no contacts in the taxing state except delivery by common carrier or United States mail.⁷⁶ The Court stated that the essential inquiry in determining whether a state tax scheme passes Due Process attack is "whether the state has given anything for which it can ask in return."⁷⁷ Further applying this requirement, the Court imposed a physical presence requirement.⁷⁸

2. *Quill* Overrules *National Bellas Hess* and Imposes a New Standard

In the twenty-five years following *National Bellas Hess*, the Supreme Court altered its interpretation of the contacts necessary to establish the minimum contacts required to fulfill the Due Process Clause. As a result, in *Quill*, the Court overruled *National Bellas Hess* and held that economic presence within a state may be sufficient to meet the requirements of Due Process. Therefore, the Court purged the physical presence requirement from consideration and stated that "[s]o long as a commercial actor's efforts are 'purposely directed' towards residents of another State," the requirements of Due Process are satisfied.⁷⁹

73. Edward A. Morse, *State Taxation of Internet Commerce: Something New Under the Sun?*, 30 CREIGHTON L. REV. 1113, 1143 (1997).

74. *See id.* at 1143-44.

75. *See supra* Part II.A.1.

76. *See National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756 (1967), overruled by *Quill Corp. v. North Dakota*, 504 U.S. 298, 308 (1992). The Commerce Clause challenge is discussed *supra* Part II.A.1.

77. *National Bellas Hess*, 386 U.S. at 756 (quoting *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940)).

78. *See id.* at 759.

79. *Quill Corp. v. North Dakota*, 504 U.S. 298, 308 (1992) (quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985)).

3. Application of *Quill*

The South Carolina Supreme Court considered the application of *Quill* to the levy of income taxes upon Geoffery, Inc., a subsidiary of Toys R Us.⁸⁰ Geoffery, Inc., was the owner of the trademark and trade name of Toys R Us. In exchange for paying a royalty of one percent of net sales to Geoffery, Inc., Toys R Us was able to use its trade name and trademark; part of the net sales upon which the royalty was paid occurred in South Carolina. The South Carolina Supreme Court held that because Geoffery, Inc. had consented to, and had control over, Toys R Us's use of the trade rights within the state, Geoffery, Inc. had "purposely directed" its business activities into the state. The use of the intangibles transferred to Toys R Us acquired business situs within the state because it had become part of local business conducted within South Carolina.⁸¹ Therefore, at least according to the South Carolina Supreme Court, mere transfer of the right to use intangibles within a state is sufficient to satisfy the requirements of the Due Process Clause.⁸²

III. TRADITIONAL SALES AND USE TAX SYSTEMS

The sales tax is of utmost importance to states; using the sales tax, states receive thirty-four percent of their state tax revenue.⁸³ This importance is reflected in the fact that forty-four states currently levy a sales tax.⁸⁴ As a general rule, a state retail sales tax is levied upon consumers in the state in which the purchases are made in proportion to their purchases. However, this assumption is not entirely accurate. The burden is borne by both the seller and the purchaser.⁸⁵

A. General Definition of the State Sales Tax

The state sales tax is generally imposed upon "retail sales of tangible personal property for use or consumption."⁸⁶ In addition, states usually include specified services to be within the reach of their sales tax.⁸⁷ States typically define sales or

80. See *Geoffery, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d. 13 (S.C. 1993).

81. See *id.* at 17 (citing *Southern Express Co. v. Spigener*, 110 S.E. 403 (S.C. 1920)).

82. Although this case was an income tax case, the same constitutional tests are applicable, and thus, the court's holding is relevant to sales tax analysis. In addition, this case is applicable to the Commerce Clause analysis discussed *supra* Part II.A.

83. See *DUE & MIKESELL*, *supra* note 16, at 1.

84. See *Vertex Inc., Tax Cybrary Internet Taxation Table* (last modified Sept. 18, 1998) <http://www.vertexinc.com/taxcybrary20/CyberTax_Channel/taxtable_72.html>.

85. See *DUE & MIKESELL*, *supra* note 16, at 5.

86. PRENTICE-HALL, INC., PRENTICE HALL'S GUIDE TO SALES AND USE TAXES 57 (1988).

87. In an effort to increase their sales tax revenues, states are including taxable services within their definition of gross receipts. Typically taxable services are distinguished from nontaxable by determining whether the services provided are a part of the sale or whether they involve transfer of the title or possession of tangible personal property. See *FIELDS*, *supra* note 30, at 47.

purchases to include any transfer of title or possession, exchange or barter, license to use, or license to consume for consideration.⁸⁸ After determining that the sale or purchase falls within the state sales tax, a flat tax rate is applied to the transaction.⁸⁹

B. Types and Characteristics of State Sales Tax Schemes

There are four different types of sales tax systems imposed by the states: privilege tax, consumer levy, transaction tax, and gross receipts tax. The types are differentiated by three characteristics: shifting, absorption, and separation.⁹⁰ By first understanding the meaning of each of these characteristics, it is possible to recognize the differences between the tax systems. This understanding enables a state to determine which tax system best serves its needs; specifically, how to best develop a tax system by which Internet commerce may most effectively and efficiently be subjected to state sales tax.

Three economic concepts are used by states in designing their sales tax schemes; as a result, these economic concepts acquire a legal significance and distinguish between the four different types of sales tax schemes. Shifting, the first economic characteristic, concerns the ability of the seller to transfer his obligation to collect the tax to the purchaser.⁹¹ Absorption "refers to the extent the tax may be fully borne by the party upon whom the payment or collection responsibility is placed, thereby making the tax a competitive tool of price negotiation."⁹² Separation, the last economic characteristic, is determined by looking to see if the seller is required to state the sales tax as an independent line item on the invoice or receipt of sale.⁹³

The four different types of state sales tax systems incorporate each of the three characteristics in a unique manner. For instance, the privilege tax system imposes liability upon the seller to collect the tax, but it does not always mandate that the seller shift the burden of payment to the purchaser. The vendor may also be allowed to absorb the burden of payment; he usually is not required to separate the tax as an independent line item on the sales receipt.⁹⁴

In contrast, the consumer levy sales tax system imposes liability upon the purchaser but requires the seller to act as trustee for the tax payment. The seller's role as trustee prohibits the seller from absorbing the tax and requires the seller

88. See PRENTICE-HALL, INC., *supra* note 86, at 58.

89. See FIELDS, *supra* note 30, at 19. The flat tax rate applied is statutorily defined and may vary according to what type of good or service the transaction entails. For example, in Alabama, a sale of an automobile is taxed at two percent, a sale of food from a coin-operated vending machine is taxed at three percent, and other transactions are taxed at four percent of the gross proceeds of the sale or the sale price. *Id.*

90. See *id.* at 29.

91. See *id.*

92. *Id.*

93. See *id.*

94. See *id.* at 29-30.

to separate the tax from the purchase price. The consumer levy is the most used form of state sales tax systems.⁹⁵

The transaction tax system combines aspects of the privilege tax and consumer levy systems. Although the purchaser is liable for payment, the seller and purchaser are jointly liable if the seller fails to collect the sales tax. Thus, the seller is liable for collection, but the purchaser is liable to the seller for the amount of the tax. Shifting is prevalent while absorption is prohibited; and separation is required.⁹⁶

Lastly, in the gross receipts tax system, the seller has full liability for payment. The seller may choose to shift, absorb, and separate the tax.⁹⁷ Thus, depending upon which sales tax system a state enacts, the seller and purchaser have different responsibilities and liabilities.

C. Measuring the Sales Tax

States levy their sales tax upon the gross receipts of a vendor. "Gross receipts are defined in almost every sales tax statute as the total receipts from all sales, or the total receipts from each and every transaction."⁹⁸ States typically want sellers to report all of their receipts before making any exclusions or exemptions, and states base the concept of total receipts upon the total selling price of tangible, personal property. However, many states also include taxable services and rental receipts in their concept of gross receipts.⁹⁹ In addition, in mail-order transactions, the state that imposes its sales tax (subject to the relevant constitutional constraints) upon a transaction is the ship-to state.¹⁰⁰

D. Exemptions from the Sales Tax¹⁰¹

Exemptions from state sales taxes typically fall into three groups: persons or businesses exemptions, specific transaction exemptions, and subjects of sales and use exemptions.¹⁰² States vary on the types of exemptions that fall within the first and third categories. However, states generally exempt similar transactions that fall within the second category of exemptions.¹⁰³

In addition, states exempt casual or occasional sales. Generally, a state defines casual sales to be less than three sales within its jurisdiction during a taxable

95. *See id.* at 30-31.

96. *See id.* at 31.

97. *See id.* at 32.

98. *Id.* at 45.

99. *See id.* at 46-48.

100. *See id.* at 39.

101. An explanation of sales tax exemptions is necessary to develop an understanding of how states may statutorily exempt favored Internet transactions from sales tax.

102. *See* PRENTICE-HALL, INC., *supra* note 86, at 61.

103. *See, e.g.,* DUE & MIKESSELL, *supra* note 16, at 75 (listing such exemptions as food, medicines, clothing, and electricity for residential use); *see also* FIELDS, *supra* note 30, at 49-52 (indicating that separately stated transportation, returns, restocking fees and repossession, and interest and finance charges are often excluded).

year; thus, people who engage in less than three sales a year within a particular state are considered to not be in the business of selling within that state.¹⁰⁴

E. General Definition of the Use Tax

Use taxes are "imposed on the privilege of ownership or possession, storage, use or consumption of goods in the state."¹⁰⁵ Typically, use taxes are levied upon tangible, personal property that is brought into the taxing state or acquired within that state under a presumption of nontaxability.¹⁰⁶ Often, use taxes are deemed compensating taxes because they supplement the sales tax. Collection of use taxes serves to prevent sales tax evasion by out-of-state buyers, to adjust between local and interstate businesses, and to prevent interstate discrimination.¹⁰⁷ The Supreme Court has upheld the validity of the use tax;¹⁰⁸ the collection of a use tax does not violate the Commerce Clause because the tax is not imposed upon interstate commerce, but instead is levied upon the privilege of use after interstate commerce has been completed.¹⁰⁹

Several generalizations are essential to understanding the use tax and its relationship with the state sales tax. First, the use tax exists because of the Commerce Clause's prohibition against states taxing outside of their jurisdiction.¹¹⁰ In addition, states assume that purchasers will self-impose the use tax, and states will levy a use tax rate that is the same as their sales tax.¹¹¹ Lastly, to protect against multiple taxation of the same transaction, states generally provide a use tax credit for sales taxes paid in other states.¹¹²

F. Measuring the Use Tax

In determining the amount of the use tax liability, two questions must be addressed: (1) Did an action trigger a taxable event?; and (2) Are there any parts of the purchase price that are excluded from the tax base? Generally, the tax base is the sale or purchase price of the property.¹¹³

Next, after determining which of the prices serves as the tax base under the state statute, several adjustments must be made. Two adjustments possibly should be made; the tax base should include neither amounts upon which sales tax has already been paid to the taxing state nor amounts upon which sales tax was

104. See PRENTICE-HALL, INC., *supra* note 86, at 107, for a discussion about Alabama's exemption for casual or occasional sales.

105. *Id.* at 51.

106. See FIELDS, *supra* note 30, at 41.

107. See PRENTICE-HALL, INC., *supra* note 86, at 51.

108. See, e.g., *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937).

109. See DUE & MIKESELL, *supra* note 16, at 245.

110. See FIELDS, *supra* note 30, at 41.

111. See *id.*

112. See DUE & MIKESELL, *supra* note 16, at 248.

113. See FIELDS, *supra* note 30, at 55. Both the sales price and the purchase price will be statutorily defined. The amounts calculated under the definitions may differ due to the determination of what is or is not subject to use tax measure under the state statute. *Id.*

previously paid to another state if the sales tax percent was greater than or equal to the use tax rate. If the use tax rate in the taxing state is greater than the sales tax rate already paid to another state, then the purchaser will be liable for the difference between the use tax calculated without adjustment and the sales tax already paid.¹¹⁴

Two categories of exemptions generally exist in state use tax systems: governmental exemptions and interest group/politico-economic exemptions.¹¹⁵ Governmental exemptions reflect the prohibitions in the Constitution against states levying taxes upon the federal government, its agencies, institutions, and instrumentalities. Interest group exemptions are adopted because of pressure lobbyists place upon state legislatures. These exemptions often favor developing economies and businesses, public benefit, humanitarian goals, and nonprofit and service organizations.¹¹⁶

G. Collection of Sales and Use Taxes

Enforcing the sales and use tax schemes enacted by states requires that a system of collection and enforcement be developed. Although the procedure varies among states, most states require that vendors conducting business within their jurisdiction file an application for registration with the state tax administration.¹¹⁷ Vendors who fail to register face the risk that states will conduct random checks to find unregistered businesses. As a result of this practice, most states experience little to no problems with evasion through failure to register.¹¹⁸

Businesses that are required to register are those that meet both the Due Process Clause and Commerce Clause nexus standards. For example, a business which has a place of business;¹¹⁹ solicits business using employees, independent contractors,¹²⁰ or advertising;¹²¹ makes deliveries using its own vehicles on a regular basis;¹²² or has unrelated activities within the state will be required to register.¹²³ Therefore, many businesses will be required to register and collect sales and use taxes simply because they have a nexus with the state through one

114. *See id.* at 55. These deductions reflect the credits for sales tax already paid that were discussed in this Part.

115. *See* FIELDS, *supra* note 30, at 61.

116. *See id.*

117. *See* DUE & MIKESELL, *supra* note 16, at 133.

118. *See id.* at 139 (listing examples of states that conduct random inspections of vendors to ensure their registration).

119. *See* Nelson v. Sears, Roebuck & Co., 312 U.S. 359, 364 (1941); *see also* Nelson v. Montgomery Ward & Co., 312 U.S. 373, 375 (1941).

120. *See* General Trading Co. v. State Tax Commissioner, 322 U.S. 335, 337-38 (1944) and *Scripto, Inc. v. Carson*, 362 U.S. 207, 211-12 (1960) for discussions of adequate nexus for solicitation by employees and independent contractors.

121. *See, e.g.*, D.H. Holmes Co. v. McNamara, 486 U.S. 24, 26 (1988) (discussing the sufficiency of an economic presence).

122. *See* Brown's Furniture, Inc., v. Wagner, 665 N.E.2d 795, 804 (Ill. 1996).

123. *See, e.g.*, National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 556 (1977).

of these factors. Some of the businesses that are required to register will be out-of-state businesses.¹²⁴

However, not all out-of-state businesses that sell their wares to in-state purchasers will be required to register. This is not to say that these businesses will refuse to collect use taxes for the taxing state. Some vendors choose to voluntarily register with the taxing state and submit the use taxes they collect from the taxing state's residents. Usually, these businesses are supply firms and department stores in nearby states.¹²⁵

In addition, states have enacted statutes requiring mail-order companies to collect sales and use taxes on purchases sent to addresses within their jurisdiction. The enforceability of these statutes is questionable,¹²⁶ but their effects are being felt. In response to these statutes, a group of mail-order companies reportedly entered into an agreement in which the companies would collect sales taxes on orders placed and shipped to states that levy sales taxes; however, this agreement has not materialized.¹²⁷

Individual purchasers are also required to submit use taxes for purchases on which they have paid inadequate or no sales taxes. States generally do not attempt to catch purchasers who fail to report use tax liabilities. However, some states make limited attempts to catch use tax evasion.¹²⁸ Some states also provide a line on their state income tax returns on which purchasers are to report their use tax liabilities. As a result, these taxpayers may pay their use tax liability when they file their income tax returns.¹²⁹

Lastly, states have begun to enter into interstate compacts to aid in the enforcement of their sales and use tax systems. These compacts enable member states to gain registrants which leads to additional sales and use tax revenue.¹³⁰ Thus, by working together and sharing information, states are able to enforce their sales and use tax systems.¹³¹

The federal government may lend its hand to states to enable them to collect use taxes from out-of-state sellers. In the Senate, a regulation was proposed that would codify federal jurisdiction ground rules requiring out-of-state sellers to

124. See DUE & MIKESELL, *supra* note 16, at 250.

125. See generally *id.* at 261, for a discussion of the incentives states offer to businesses that voluntarily register to collect use taxes.

126. See *id.* at 260.

127. See David C. Johnston, *Mail-Order Group Agrees to Collect State Sales Taxes*, N.Y. TIMES, Nov. 6, 1997, at A1. *But see* Guy Boulton, *Mail-order Sales Tax Eludes States Again*, CINCINNATI ENQUIRER, Nov. 8, 1997, at B20 (discussing that the agreement will not be signed because of the pressures from angry customers and that these customers do not realize that even though the agreement will not be signed, the customers are still liable for tax under the states' use tax statutes).

128. See DUE & MIKESELL, *supra* note 16, at 262 (discussing state attempts to catch unreported tax liabilities).

129. See *id.* at 264 (discussing the different techniques states employ to link income and use tax reporting at the purchaser level).

130. For example, New York and New Jersey entered into a state sales tax compact under which New York claimed to have increased its sales tax revenue by \$25 million in its first year alone. See FIELDS, *supra* note 30, at 87.

131. See DUE & MIKESELL, *supra* note 16, at 266.

collect use taxes for state and local jurisdictions on interstate sales of tangible, personal property.¹³² In addition, at the beginning of this year a bill was proposed in the Senate that would give states the authority to require a person or corporation that is subject to the personal jurisdiction of the state to collect and remit the state sales tax on tangible personal property if three conditions are met: if the destination (the location to which the seller ships or delivers or causes to be shipped or delivered) of the tangible personal property is in the state; if during the previous year, the person had gross receipts from sales of such tangible personal property in the United States exceeding \$3 million or within the state exceeding \$100,000; and the state collects state and local sales taxes.¹³³

IV. SALES AND USE TAXES IMPOSED UPON INTERNET TRANSACTIONS

Having gained an understanding of the basic state sales and use tax schemes that apply to purchases of tangible, personal property, it is now possible to evaluate the application of such schemes to on-line purchases of property that will not be physically delivered, such as purchases of software that are downloaded over the Internet. States must first classify this property so that it may fall within the scope of the sales and use tax systems. The next hurdle that states must pass is satisfying the nexus requirements of the Due Process Clause and the Commerce Clause. Then, states must determine how to measure the tax base of the transaction and decide how transactions will be reported. Lastly, states must examine how to enforce the sales and use tax systems on this new technology.

A. Classifying as Tangible or Intangible Property

The distinction between tangible and intangible assets often is cited as a method of avoiding computer software tax whether the software was physically delivered or electronically transmitted. Recently states have held that canned software is a tangible good because in its ultimate form it is stored upon tangible property (diskettes or CDS).¹³⁴

However, a regulation proposed by the Treasury Department would end this classification problem if the states use the rule proposed as the federal income tax

132. See AMERICAN ENTER. INST. FOR PUB. POLICY, PROPOSALS TO REGULATE STATE AND LOCAL TAXATION OF MULTIJURISDICTIONAL CORPORATIONS 18 (1981).

133. See Consumer and Main Street Protection Act of 1997, S. 1586, 105th Cong. § 3 (1998).

134. See Michael E. Brownell, California Income and Franchise Tax Issues, Paper prepared for Harvard Law School's Spring Symposium on Multi-Jurisdictional Taxation of Electronic Commerce 14 (Apr. 5, 1997) (unpublished article on file with the *Indiana Law Journal*) (stating that it is generally held that canned computer software is tangible personal property). Canned software is computer software that is purchased ready-to-use and is not adapted to the specific needs of the purchaser. See *Unicorn System Associates Is Custom Programming* (visited Nov. 3, 1998) <http://www.ncinter.net/~unicorn/uni_cp.htm> (comparing purchasing canned software to buying a suit "right off the rack").

rule. The regulation directs the Internal Revenue Service to look at the rights transferred in the transaction involving the computer program. The rights exchanged in the purchase fall into four categories: "the transfer of a copyright right, the transfer of a copyrighted article, the provision of services relating to the development of a computer program, or the provision of know-how."¹³⁵

Because the vendor keeps the ownership rights, the sale of downloaded software will typically fall within the second category, the transfer of a copyrighted article. The Proposed Regulation would treat the transfer of the copyrighted article the same regardless of the method of transfer—whether physical or electronic.¹³⁶ Therefore, because sales of canned software are subject to sales and use taxes, sales of electronically transmitted software should also fall within the reach of sales and use tax statutes.

B. Satisfying the Constitutional Requirement of Nexus

After the Supreme Court's decision in *Quill*, most analysts of state sales and use taxes have expressed their doubt as to the authority with which a state may tax businesses that lack a physical presence within the taxing state.¹³⁷ However, the strength of the holding in *Quill* that retained the physical presence requirement is undermined by several important factors.

First, the Supreme Court left an explicit invitation to Congress to discard this bright-line test if it disagreed with the result.¹³⁸ Although no legislation has been enacted to date,¹³⁹ it may only be a matter of time before state governments begin to lobby Congress in an attempt to spur congressional action. If state governments are successful in these efforts, a federal law may be passed that would purge the physical presence requirement from the Commerce Clause substantial nexus requirement and would instead substitute a requirement of a lesser degree of contact between the taxing state and the business. The law enacted by Congress could state as follows:

In the levying sales and use taxes, an entity, whether a person or business, must purposefully direct his/her activities within the taxing state and must avail him/herself of the benefits of the jurisdiction. These benefits include the provision of a market in which to conduct business, of police services, and of a tribunal in which to have the ability to state his/her claims. This Act shall hereby repudiate any requirement of physical presence within the taxing state.

135. Classification of Certain Transactions Involving Computer Programs, Prop. Treas. Reg. § 1.861-18, 61 Fed. Reg. 58,152, 58,155 (1996). As of July 11, 1998, this proposed regulation had yet to be finalized and was awaiting a final action deadline of December 1998.

136. *See id.*

137. Although the taxation of transactions from vendors lacking physical presence faces a potential problem under the Commerce Clause because of *Quill*'s retention of the physical presence requirement for substantial nexus, the taxing state should not have any difficulties satisfying the nexus requirements of the Due Process Clause. All that is required is that a vendor has purposefully directed his business into the state for a sufficient nexus to exist. *See, e.g., Saba Ashraf, Virtual Taxation: State Taxation of Internet and On-line Sales*, 24 FLA. ST. U. L. REV. 605, 628-29 (1997).

138. *See* discussion *supra* Part II.A.3.

139. *See* Ashraf, *supra* note 137, at 618-19.

By continuing to require the vendor to have at least minimum contacts with the taxing state, the statute should satisfy the Commerce Clause requirement of nexus.

However, in the event that states are unable to inspire congressional action, the states have other possible avenues of hope. Both *Orvis* and *Brown's Furniture* demonstrate the willingness of lower courts to discard *Quill's* physical presence requirement and to substitute in its place a less stringent requirement of nexus.¹⁴⁰ In addition, three recent cases also show the application of this less demanding nexus to the electronic delivery of digital goods.¹⁴¹ Thus, the trend in lower courts appears to be the application of a lower standard of nexus. The Supreme Court's denial of certiorari in both *Orvis* and *Brown's Furniture* suggests that the Court does not want to overturn the judgments of the lower court cases. Perhaps this is attributable to the Court's unhappiness with its decision in *Quill*. It may also be in part an attempt to force Congress' hand.

A last option in the attempt to have the physical presence test erased as a requirement for the Commerce Clause nexus is for an in-state vendor to bring an Equal Protection case against the state for disparate treatment between two vendors that enter into agreements with purchasers inside the jurisdiction of the state. Arguing that by serving the same market the vendors are similarly situated, the in-state vendor could assert that if he is subject to the sales and use tax statutes then the out-of-state vendor who also participates in the market within the state should also be subject to the statutes.¹⁴² Failure to hold both vendors liable, the seller would argue, would be a violation of the Equal Protection Clause. The Equal Protection Clause requires that states treat similarly situated companies in the same manner. Depending upon how the court that hears this case defines the market and the concept of similarly situated and whether the government advances a rational basis, this case may have some chance of success.¹⁴³ Therefore, a taxpayer may be able to eliminate the application of the physical presence test because it creates this unequal treatment.

Policy reasons also abound to support the states' case. The Department of Treasury issued a statement in which it advocated "neutrality"; by this term it meant that a transaction should be taxed the same whether it is conducted

140. See *supra* Part II.A.4.

141. See *CompuServe, Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996); *Zippo Mfg. Co. v. Zippo Dot Com*, 952 F. Supp 1119 (W.D. Pa. 1997); *Maritz, Inc. v. Cybergold*, 947 F. Supp. 1328 (E.D. Mo. 1996). These cases suggest that an agency-based nexus may be sufficient to satisfy a requirement of a substantial nexus. If this is so, analysts have suggested that using agency principles, vendors may be trapped into sales and use tax liability by "own[ing] or leas[ing] equipment or transmission lines . . . [or through] the activities of local telecommunications companies providing dial-up access." Morse, *supra* note 73, at 1160.

142. Even a critique of imposing state taxes on Internet transactions agrees that all taxes should treat similarly situated competitors the same. See *Andal*, *supra* note 25, at 3.

143. See *Commonwealth Edison Co. v. Montana*, where the Supreme Court stated that the "'exploitation by foreign [(meaning out-of-state)] corporations [or consumers] of intrastate opportunities under the protection and encouragement of local government offers a basis for taxation as unrestricted as that for domestic corporations.'" 453 U.S. 609, 623 (1981) (quoting *Ford Motor Co. v. Beauchamp*, 308 U.S. 331, 334-35 (1939) (first alteration added) (second alteration in original)).

electronically or physically.¹⁴⁴ Thus, to apply this concept, states should be given the ability to comply with this idea. The only way for transactions to be treated equally without regard to their form is for the physical presence test to be removed as a constitutional requirement.

States can also allege that changes in the economic marketplace make the application of the physical presence test unfeasible. In addition, in order to prevent tax evasion, states should be able to tax vendors who sell within their borders. Without this ability, the sales dollars that these vendors receive may go untaxed and, thus, would be "no-where" income.¹⁴⁵ Thus, as a policy matter, states can campaign for the repeal of this bright-line test.

C. Measuring and Reporting for Sales and Use Taxation of On-line Purchases

Before determining the appropriate taxing state, it is necessary to determine which of the four types of sales taxes should be enacted for the taxation of Internet transactions. The gross receipts tax will best serve the needs of both the vendor and the purchaser. By allowing the vendor the flexibility of determining whether to shift, absorb, or separate, the gross receipts tax will best answer the criticisms of those who are against imposing any taxes upon the Internet.¹⁴⁶

Because of the similarity between on-line sales and mail-order sales, the two should be treated similarly. As discussed earlier, mail-order sales are taxed by the ship-to location. However, because many Internet transactions involve no physical delivery, this custom cannot prevail for all on-line sales but instead may only apply to on-line sales that arrange physical delivery; nevertheless, states may, on the whole, agree to impose sales and use taxes in the jurisdiction in which the purchased property is to be used. With respect to the transfer of software, this may be difficult to enforce. But, with advances in technology, it may be possible that during the downloading process, an electronic mail message may be transmitted from the vendor to the ship-to state's reporting agency notifying the state that a transaction has occurred in which the copyright of software or the use of copyrighted software has exchanged hands. Currently, "cookies" are transmitted every time a user visits a web site. The "cookie" provides such information as the organization with which the user is affiliated, the user's geographical location, the type of computer and operating system the user is using, the Internet address of the computer the user is using, the exact time and

144. See DEPARTMENT OF THE TREASURY OFFICE OF TAX POLICY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE § 6.2 (1996); see also Walter Hellerstein, *State Taxation of Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation*, 12 STATE TAX NOTES 1315, 1315 (1997) (stating that businesses and their customers who conduct business over the Internet should be subject to the same taxes as those who purchase products that are tangibly sold).

145. Brownell, *supra* note 134, at 11.

146. A person who sides against imposing Internet taxes may expect that taxing Internet sales will decrease the number of purchasers because people will lose the incentive of not having to pay tax on their on-line purchases. By allowing vendors to absorb this cost if they so choose, the gross receipts tax attempts to avoid this hypothesis.

date of the visit, the specific pages the user looked at, and the length of time the user looked at the pages.¹⁴⁷

There is, however, an alternative solution. Until electronic money is created and widely used, the seller will usually receive payment from the purchaser through a credit card. Using this credit card, the vendor could easily verify the billing address and know the applicable taxing locality. This, again, could possibly be facilitated by technology so that the burden upon the sellers is not too large. However, regardless of which method of determining the taxing state is used, the risk of double taxation should be minimal, and as discussed earlier, the minimal likelihood of multiple taxation cannot be grounds upon which to strike down the levying of a sales or use tax.¹⁴⁸

After determining the taxing state, the tax base must be calculated. Using the traditional sales and use tax scheme, it is reasonable to use the selling or purchase price as the tax base.¹⁴⁹ States should also provide for the same exemptions as they do under their traditional sales and use tax systems.¹⁵⁰

If the less stringent nexus requirement is enacted, then the vendors that satisfy it will be required to register with the state and will have to collect the appropriate sales and use taxes. However, even if registration is not mandatory for all vendors doing business within the state, the state can hope to become a member of an interstate compact in which the members cooperate and share information to increase registration and the amounts collected in sales and use tax revenues.¹⁵¹ In addition, states can include a specific line on their income tax returns for the reporting of Internet purchases, can specifically instruct taxpayers to include Internet purchases in the total amount of purchases upon which sales or use tax is due, or can create forms for Internet purchasers to voluntarily complete.¹⁵² Lastly, states may want to strongly encourage on-line vendors to sign voluntary agreements to collect sales and use taxes.¹⁵³

D. Enforcing the Levying of Internet Sales and Use Taxes

By encouraging the payment of sales and use taxes by voluntary reporting, the state can attempt to enforce the taxes upon vendors or purchasers that are not required to report their transactions. However, in order to strong-arm the vendors who are required to report their sales, states should levy penalties and fines that will discourage those who may otherwise have the incentive to evade taxes. Thus, states will want to develop a tax system in which those who are caught failing to file, report, or remit sales and use taxes will face serious repercussions.

147. See BRYAN PFAFFENBERGER, OFFICIAL MICROSOFT INTERNET EXPLORER 4 BOOK 130-31 (1997).

148. See *supra* text accompanying note 67.

149. The statutory distinctions between the selling and purchase price were discussed *supra* Part III.F.

150. See *supra* Part III.F.

151. See discussion *supra* Part III.G.

152. See discussion *supra* Part III.G.

153. See discussion *supra* Part III.G.

CONCLUSION

Despite other analyses to the contrary, states hoping to capture a portion of the sales receipts exchanging hands over the Internet each year may not be completely helpless or hopeless. The most realistic possibilities for states to satisfy the nexus requirement of the Commerce Clause of the Federal Constitution are two-fold: Congress could authorize the states to tax out-of-state vendors who lack physical presence within their state, *or* states could strongly encourage and entice vendors into voluntary agreements in which they register, report, and remit sales and use taxes to the jurisdiction in which the purchaser uses the downloaded software or in which the purchaser's billing address is located. Thus, states are likely to be able to constitutionally collect sales and use taxes from out-of-state Internet vendors.