

# TAXATION OF ELECTRONIC COMMERCE: AVOIDING AN INROAD UPON FEDERALISM

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## I. INTRODUCTION

From the American Revolution to the Industrial Revolution, the American experience with revolutions shaped the way we govern and conduct business. The Internet revolution is no exception. The explosion of electronic commerce fundamentally changed our economy and behavior.<sup>1</sup> Now is a pivotal time in this revolution as consumers, businesses, and policy makers attempt to manage the continuing changes brought by electronic commerce. The Internet Tax Freedom Act (the Act), enabling state, federal, and corporate policy makers to address these changes, represents the confluence of government and business activity.<sup>2</sup> Policy makers hoped a comprehensive policy relating to taxation of electronic commerce (e-commerce) would emerge from the establishment of the United

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1. See generally United States Department of Commerce, *A Framework for Global Electronic Commerce* <<http://www.ecommerce.gov>> (July 1997) [hereinafter *Framework*] (discussing the emergence of the Internet and the impact on society and commerce).

2. Internet Tax Freedom Act, Pub. L. No. 105-277, 112 Stat. 2681-719 (1998).

States Advisory Commission on Electronic Commerce and a moratorium on Internet taxation.<sup>3</sup> That has proven more difficult than anticipated.

Taxation of e-commerce has pitted the states against the federal government,<sup>4</sup> and online e-tailers against traditional bricks-and-mortar retailers.<sup>5</sup> The individual states, with their political subdivisions of counties and cities, claim they lose sales and use tax revenue from e-commerce.<sup>6</sup> The federal government has taken the position of tax neutrality,<sup>7</sup> and through the Internet Tax Freedom Act established a three-year moratorium, set to expire in 2001, on the taxation of e-commerce.<sup>8</sup> Traditional retailers have complained that their businesses suffer from the advantage online retailers gain through non-taxed e-commerce transactions.<sup>9</sup> Businesses engaged in online sales argue that individualized state taxing systems are too complicated to manage and enforcement would stifle the development of e-commerce and raise costs for consumers.<sup>10</sup>

This Note examines issues surrounding the taxation of e-commerce. Following Part II's brief overview of the concepts behind e-commerce, Part III addresses congressional response to e-commerce, Part IV analyzes the constitutional considerations and implications of taxing e-commerce, and finally, Parts V and VI discuss the approaches to e-commerce taxation that are under consideration.

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3. Josh Schonwald, *Cybertax Talk Re-Emerging*, CRAIN'S CHICAGO BUS. SB4 (Aug. 9, 1999) (available in 1999 WL 8742809).

4. Jason L. Riley, *Keep the Tax Man Off Line*, WALL ST. J., June 29, 1999, at A14.

5. Representative Christopher Cox, United States House of Representatives <<http://cox.house.gov/nettax/Web-commerce.html>> (accessed Jan. 13, 2001); Doug Sheppard, *Booksellers Launch Initiative Against Sales Tax 'Inequities'*, State Tax Today (Aug. 31, 1999) (available in LEXIS, 1999 STT 168-42); see also Schonwald, *supra* note 3, at SB4 (noting some traditional retailers are feeling the impact from tax-free e-commerce). However, in 2000, traditional retailers adapted to the changing economy by increasing their presence on the Web and developing online outlets for their products. See Bob Tedeschi, *Retail Battle Returns to the Bricks*, N.Y. Times on the Web, <<http://www.nytimes.com/2000/11/20/technology/20ECOMMERCE.html>> (Nov. 20, 2000).

6. Riley, *supra* note 4, at A14. In 1998, the estimated lost revenue for states from e-commerce was \$170 million—roughly “one-tenth of one percent of total state and local government sales and use tax collections.” Robert J. Cline & Thomas S. Neubig, Ernst & Young, *The Sky Is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998* <[http://www.ey.com/global/gcr.nsf/US/Library\\_-\\_Economics\\_Consulting](http://www.ey.com/global/gcr.nsf/US/Library_-_Economics_Consulting)> (June 18, 1999).

7. See *Framework*, *supra* note 1, at 6.

8. Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101, 112 Stat. 2681-719, 2681-719 (1998).

9. Sheppard, *supra* note 5.

10. Schonwald, *supra* note 3, at SB4.

## II. OVERVIEW OF ELECTRONIC COMMERCE

### A. Definitions and Examples of Electronic Commerce

The Internet has changed the structure and focus of the national and international economy. While the traditional modes of conducting business remain, the explosion of commercial transactions conducted over the Internet has forced market participants—governments, businesses, and consumers—to adapt to the changing economy.<sup>11</sup> To understand this transformation, and the complexities involved in this change, it is necessary to explain and define certain concepts. The following explanations are also illustrative of the complexity of online transactions and the problems policy makers face in attempting to regulate and tax such transactions.

E-commerce is defined as:

[A]ll forms of commercial transactions involving organizations and individuals that are based upon the processing and transmission of digitized data, including text, sound, and visual images. It also refers to the effects that the electronic exchange of commercial information may have on the institutions and processes that support and govern commercial activities. These include organizational management, commercial negotiations and contracts, legal and regulatory frameworks, financial settlement agreements, and taxation, among many others.<sup>12</sup>

The Internet is a dynamic system comprising an “open-ended aggregation of computer and communications networks”<sup>13</sup> used to facilitate e-commerce transactions.<sup>14</sup> Commonly described as a “network of networks,”<sup>15</sup> the Internet is a “world-wide communications network accessible through commercial Internet

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11. United States Department of Commerce, *The Emerging Digital Economy II* <<http://www.ecommerce.gov>> at 4-5 (June 1999) [hereinafter *Digital Economy II*] (noting that current estimates of online retail sales for 2002 are projected to be between \$40 and \$80 billion).

12. United States Government Electronic Policy Web Site, *Defying Definition*, <<http://www.ecommerce.gov/6.htm>> (accessed Jan. 21, 2001). The Internet Tax Freedom Act more narrowly defines e-commerce as “any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access.” Internet Tax Freedom Act, § 1104(3), 112 Stat. at 2681-725.

13. Information Technology Association of America (ITAA) Paper, *Straight Talk: Internet, Tax, & Electronic Commerce: A White Paper on Taxation of Electronic Commerce & the Internet*, reprinted in Thomas H. Steele & James P. Kratochvil, Tax Mgmt. (BNA) Multistate Tax Portfolios Worksheet 24, at 1350:8401 (2000) [hereinafter *Straight Talk*].

14. *Id.*

15. Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 429 (1997) (citing *United States v. Baker*, 890 F. Supp. 1375 (E.D. Mich. 1995)) [hereinafter *Electronic Commerce*].

access providers."<sup>16</sup> The Internet is one of the main components of the so-called "information superhighway," which also consists of telecommunications systems such as cable and satellite communications.<sup>17</sup> Individuals and businesses access the Internet through an Internet Service Provider (ISP).<sup>18</sup> The ISP has a main server that accesses the Internet and allows it to handle large volumes of traffic.<sup>19</sup>

Some of the more common examples of e-commerce include purchasing a book, a computer, airline tickets, computer software, or buying and selling stocks over the Internet,<sup>20</sup> as well as accessing banking services, information brokers, and medical services online.<sup>21</sup> Companies also conduct business over the Internet, including purchasing inventory, customer order and payment processing, and employee services.<sup>22</sup> The e-commerce equation is complicated because a consumer's transaction often involves "multiple e-commerce transactions."<sup>23</sup> For example, when an individual purchases a computer from a company transacting business on the Internet, multiple online transactions may occur between the consumer and the company to ensure the company can service the order and then deliver the computer.<sup>24</sup> In addition, there may be third parties involved in securing the consumer's credit and processing the payment.<sup>25</sup> The fact that many parties are involved in an online transaction adds to the complexity of tracking e-commerce transactions.<sup>26</sup>

Parties involved in purchasing the computer play multiple roles.<sup>27</sup> The online computer retailer is not only a seller to the consumer, but also a consumer of both the third-party payment services provider and delivery services.<sup>28</sup> The third-party payment service company is a seller to the online retailer as well as to the original consumer's credit card company.<sup>29</sup> The compounding of e-commerce transactions and the complexities that accompany it have had a

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16. *Id.*

17. *Id.*

18. *Straight Talk*, *supra* note 13, at 1350:8402.

19. *Id.*

20. *Digital Economy II*, *supra* note 11, at 4-5.

21. *Electronic Commerce*, *supra* note 15, at 430-31.

22. Thomas L. Mesenbourg, *Measuring Electronic Business—Definitions, Underlying Concepts, and Measurement Plans* <<http://www.ecommerce.gov/ecomnews/e-def.html>> (accessed Jan. 13, 2001).

23. *Id.*

24. *Id.* (obtaining detailed business statistics for such transactions would be unprecedented).

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.* If the seller is not the manufacturer of the computer, then another transaction is added to the purchase. *Id.*

29. *Id.*

significant effect on the American economy, and have forced the government to address the taxation of e-commerce.<sup>30</sup>

### B. *The Impact of Electronic Commerce in the United States*

In North America, eighty-seven million people were using the Internet at the start of 1999, up from fifty-eight million in 1997 and thirty-five million in 1996.<sup>31</sup> It is believed the number of Internet users is increasing exponentially.<sup>32</sup> The growth rate for e-commerce is equally staggering, with \$7.8 billion in online retail sales in 1998, up from \$2.6 billion in 1997 and \$1.1 billion in 1996.<sup>33</sup> However, there are inherent difficulties in accurately measuring e-commerce transactions.<sup>34</sup>

Most business-to-consumer transactions include numerous business-to-business transactions and result in the "transactions multiplier effect"—in which one business-to-consumer transaction spawns multiple business-to-business transactions.<sup>35</sup> Business-to-business e-commerce is the largest sector of e-commerce, with 1998 sales figures reaching \$43 billion.<sup>36</sup> The equation is further complicated by the fact that not all online transactions are completed

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30. See *id.*

31. Cox, *supra* note 5. These figures were taken from Representative Christopher Cox's homepage, which also offers jump sites for current updates on Internet statistics, including NUA, *Internet Surveys* <[http://www.nua.ie/surveys/how\\_many\\_online/index.html](http://www.nua.ie/surveys/how_many_online/index.html)> (last updated Nov. 2000) (providing continuous updates for statistics of online users) and Network Wizards, *Internet Domain Survey* <<http://www.isc.org/ds/WWW-200007/index.html>> (last updated July 2000) (surveying the Domain Name System in an attempt to discover every host on the Internet).

32. Cox, *supra* note 5.

33. *Id.* (citing statistics from Forrester Research <<http://www.forrester.com>>); see also *Digital Economy II*, *supra* note 11, at 5 (noting forecasts for online retail sales of \$40 to \$80 billion by 2002 and business-to-business e-commerce estimates of over \$1 trillion by 2003).

34. See *supra* text accompanying notes 23–30.

35. Mesenbourg, *supra* note 22.

36. Cox, *supra* note 5; see also *Digital Economy II*, *supra* note 11, at 5–6 (noting a recent survey by Cisco Systems estimated 1998 business-to-business and business-to-consumer e-commerce reached \$102 billion and citing Anitesh Barua, et al., *The Internet Economy Indicators* <<http://www.internetindicators.com>> (June 10, 1999)). The Commerce Department has a quarterly index to monitor e-commerce retail sales and will begin to track business-to-business e-commerce statistics in early 2001. Yochi J. Dreazen, *U.S. Unveils New Quarterly Index to Track E-commerce*, WALL ST. J., Mar. 3, 2000, at A2. However, the index does not monitor services, such as financial and brokerage services, or travel and ticket services provided via the Internet, so the index likely reflects conservative estimates of e-commerce. *Id.* The first results from the index, from the 1999 fourth quarter, estimated online sales of \$5.3 billion, "accounting for 0.6% of the \$821.2 billion in overall retail sales." *Id.* However, tracking online sales is still plagued by the infancy of the industry. *Id.* Estimates of retail e-commerce sales in the third quarter of 2000 were \$6.373 billion, 0.78 % of total sales. United States Department of Commerce, *Retail E-commerce Sales in Third Quarter 2000 Increased 15.3 Percent From Second Quarter 2000*, Census Bureau Reports <<http://www.census.gov/mrts/www/current.html>> (Nov. 27, 2000).

online, with orders coming in online and payments being made offline.<sup>37</sup> Regardless of the difficulties in measuring the impact of e-commerce, the reasonable conclusion is e-commerce will continue to constitute a large portion of the American economy, through both retail and commercial transactions.<sup>38</sup>

One of the challenges e-commerce presents is how the state and federal governments will react to this fundamental change in our economy. Other challenges include regulatory, jurisdictional, privacy, and taxation issues.<sup>39</sup> Congress responded to the growth of e-commerce and the implications it may have on tax policy with the Internet Tax Freedom Act.<sup>40</sup>

### III. THE INTERNET TAX FREEDOM ACT

One of the congressional responses to the explosion of e-commerce and the tax implications of e-commerce is the Internet Tax Freedom Act.<sup>41</sup> This preemptive legislation put a three-year moratorium on the states' ability to tax e-commerce.<sup>42</sup> The Act also established the Advisory Commission on Electronic Commerce (the Commission) to "conduct a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate or international sales activities."<sup>43</sup> The goal of the Act is to establish a comprehensive strategy for dealing with the taxation issues surrounding e-commerce.<sup>44</sup>

#### A. *The Origin of the Internet Tax Freedom Act*

In March of 1997, Representative Christopher Cox and Senator Ron Wyden introduced companion bills in the United States House of Representatives and Senate.<sup>45</sup> Both pieces of legislation sought to impose a national moratorium

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37. *Digital Economy II*, *supra* note 11, at 6.

38. See Bob Tedesh, *Riding the Traffic Surges on the World Wide Web*, N.Y. Times on the Web, <<http://www.nytimes.com/library/tech/99/10/cyber/commerce/18commerce.html>> (Oct. 18, 1999).

39. See generally John F. Delaney et al., *The Law of the Internet: A Summary of U.S. Internet Caselaw and Legal Developments*, 545 PRAC. L. INST. 61 (1999) (discussing legal and public policy issues presented by the Internet).

40. Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101, 112 Stat. 2681-719, 2681-719 (1998).

41. See *id.*

42. *Id.*

43. *Id.* § 1102(g)(1), 112 Stat. at 2681-723.

44. David Brunori, 'The Politics of State Taxation: Starting to Slide Down the Slippery Slope: What's Next for the Internet Tax Freedom Act?', *State Tax Today* 34-25 (Feb. 22, 1999) (available in LEXIS, 1999 STT 34-25).

45. Cox, *supra* note 5.



on Internet taxes.<sup>46</sup> Over the course of the next year, committee work on both bills garnered widespread support in the House and Senate.<sup>47</sup> Public support grew with endorsements of the legislation by the National Governors' Association, National League of Cities, National Conference of State Legislatures, and the U.S. Conference of Mayors.<sup>48</sup>

Another impetus for enactment of a moratorium on Internet taxes was the Clinton Administration's endorsement of the legislation and a major policy paper addressing e-commerce.<sup>49</sup> The Clinton Administration set forth guiding principles for the Administration's approach to e-commerce in *A Framework for Global Electronic Commerce (Framework)*.<sup>50</sup> Among the stated principles were leadership by the private sector, no undue restrictions by the government on e-commerce, minimal involvement by the government in e-commerce, and e-commerce development with a global focus.<sup>51</sup> Furthermore, the *Framework* established a policy of tax neutrality for e-commerce.<sup>52</sup>

[T]he United States believes that no new taxes should be imposed on Internet commerce. The taxation of commerce conducted over the Internet should be consistent with the established principles of international taxation, should avoid inconsistent national tax jurisdictions and double taxation, and should be simple to administer and easy to understand.

Any taxation of Internet sales should follow these principles:

- It should neither distort nor hinder commerce. No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions.
- The system should be simple and transparent. It should be capable of capturing the overwhelming majority of appropriate revenues, be easy to implement, and minimize burdensome record keeping and costs for all parties.
- The system should be able to accommodate tax systems used by the United States and our international partners today.

Wherever feasible, we should look to existing taxation concepts and principles to achieve these goals.<sup>53</sup>

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46. *Id.*

47. *Id.*

48. *Id.*

49. See *Framework*, *supra* note 1, at 6 ("No new taxes should be applied to electronic commerce . . .").

50. See *id.* at 5.

51. *Id.*

52. *Id.*

53. *Id.*

The *Framework* also expressed the concern that state and local governments would move to tax e-commerce and Internet access, thus stifling the development of e-commerce.<sup>54</sup> The *Framework* endorsed cooperation among state and local governments "to develop a uniform, simple approach to the taxation of electronic commerce, based on existing principles of taxation where feasible."<sup>55</sup>

The White House released the *Framework* in July 1997 and, through both a free market philosophy and tax neutrality, helped set the direction of the federal government's approach toward e-commerce.<sup>56</sup> The Internet Tax Freedom Act was one of the first steps, implementing the three-year moratorium on certain Internet taxes and establishing the Advisory Commission on Electronic Commerce.<sup>57</sup>

#### B. *The Moratorium Imposed by the Internet Tax Freedom Act*

The Act placed a moratorium on three types of taxes.<sup>58</sup> The first restriction was on taxing Internet access unless a jurisdiction imposed and enforced the tax prior to October 1, 1998.<sup>59</sup> This restriction "forbids the states from taxing the monthly fee that America Online and other Internet access providers charge to their customers for connecting to the Internet."<sup>60</sup>

Second, the Act restricts the implementation of a multiple tax.<sup>61</sup> The Act defined multiple tax as "any tax that is imposed by one State or political subdivision thereof on the same or essentially the same electronic commerce that is also subject to another tax imposed by another State or political subdivision thereof without a credit for taxes paid in other jurisdictions."<sup>62</sup> The objective of

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54. *Id.*

55. *Id.*; see *supra* Part VI.

56. Ernest T. Patrickis & Stephanie Heller, *The Government's Role in Electronic Commerce: A Review of the Clinton Administration's Framework on Global Electronic Commerce*, 18 ANN. REV. BANKING L. 325, 326 (1999).

57. See Internet Tax Freedom Act, Pub. L. No. 105-277, § 1102(g)(1), 112 Stat. 2681-719, 2681-723 (1998).

58. *Id.* § 1101(a)(1)-(2), 112 Stat. at 2681-719.

59. *Id.*; see also Walter Hellerstein, *Internet Tax Freedom Act Limits States' Power to Tax Internet Access and Electronic Commerce*, 90 J. TAX'N 5, 6 n.3 (1999) [hereinafter *Internet Tax*] (noting that at the time the Act was signed, eight states were exempt: Connecticut, Iowa, Nebraska, North Dakota, South Carolina, South Dakota, Tennessee, Texas, and Wisconsin). Iowa has repealed the tax on services of Internet Service Providers. IOWA CODE § 422.45(56) (2001); see also *Iowa Revenue Department to Amend Sales Tax Rules* (July 26, 1999) (available in LEXIS, 1999 STT 142-6).

60. *Internet Tax*, *supra* note 59, at 6.

61. Internet Tax Freedom Act, § 1101(a)(2), 112 Stat. at 2681-719.

62. *Id.* § 1104(6), 112 Stat. at 2681-719.



restricting multiple taxes was to prevent multiple states from taxing the same e-commerce transactions.<sup>63</sup>

The third category of restricted tax is any discriminatory taxes.<sup>64</sup> A discriminatory tax is, essentially, a tax that singles out a particular group, activity, or property, and taxes based on that classification, while not assessing other groups, activities, or properties with a similar tax.<sup>65</sup> The Act prevented treating e-commerce transactions "less favorably than conventional commerce."<sup>66</sup> Furthermore, the Act limited the states' ability to create a nexus<sup>67</sup> over out-of-state servers<sup>68</sup> and ISPs.<sup>69</sup> Included under the rubric of discriminatory taxes was a "tax (other than a grandfathered tax on Internet access) if the 'sole ability to access a site on a remote seller's out-of-[s]tate computer server is considered a factor in determining a remote seller's tax collection obligation.'"<sup>70</sup> This provision prohibited states from imposing taxes on Internet sales conducted by "remote" . . . sellers, if the state relies on the purchaser's 'sole ability' to access the seller's out-of-state computer server as a factor in determining whether the remote seller has nexus with the state and, consequently, an obligation to collect a tax on the transaction."<sup>71</sup>

The Act further restricts a state's nexus claim by:

[P]revent[ing] the states from claiming that they have nexus with a remote seller for purposes of requiring the remote seller to collect a use tax on its Internet sales into the state by characterizing an Internet access provider . . . as the remote seller's agent 'solely as a result of (I) the display of a remote seller's information or content on the out-of-State computer server' of the Internet access provider or '(II) the processing of orders through the out-of-State computer server' of the Internet access provider.<sup>72</sup>

With the exception of the "grandfather clause,"<sup>73</sup> the moratorium puts substantial limits on the individual states' ability to tax any type of e-commerce related

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63. *Internet Tax*, *supra* note 59, at 8.

64. Internet Tax Freedom Act, § 1101(a)(2), 112 Stat. at 2681-719.

65. *Internet Tax*, *supra* note 59, at 7.

66. *Id.*

67. See *infra* Part IV for a cursory discussion on nexus requirements for the states' ability to tax. For more in depth analysis of nexus requirements, see sources cited *infra* note 89.

68. *Internet Tax*, *supra* note 59, at 7.

69. Internet Tax Freedom Act, § 1104(2)(B)(i)-(ii), 112 Stat. at 2681-725; *Internet Tax*, *supra* note 59, at 7-8.

70. *Internet Tax*, *supra* note 59, at 7-8 (quoting Internet Tax Freedom Act, § 1104(2)(B)(i), 112 Stat. at 2681-725 (1998)).

71. *Id.* at 7 (footnote omitted).

72. *Id.* at 8 (quoting Internet Tax Freedom Act, § 1104(2)(B)(ii)(I)-(II), 112 Stat. at 2681-725 (1998)).

73. *Id.* at 7-8; see Internet Tax Freedom Act, § 1101(d)(1)-(2), 112 Stat. at 2681-719.

activity.<sup>74</sup> The three-year moratorium gave the Commission an opportunity to review proposals for addressing taxation of e-commerce.<sup>75</sup>

### C. *The Advisory Commission on Electronic Commerce*

While one component of the Act imposed a moratorium on the taxation of e-commerce, another component established the Advisory Commission on Electronic Commerce, which had the responsibility of studying federal, state, local, and international taxation of e-commerce.<sup>76</sup> The composition of the Commission included business and government officials, and reflected the balancing of interests and of political ideologies.<sup>77</sup> Nineteen members served on the Commission—three representatives of the Federal Government, eight representatives from state and local governments, and eight representatives from the e-commerce industry appointed by the majority and minority leadership of the House and Senate.<sup>78</sup> The Commission allowed state and local government officials to represent its interests in forging a tax policy for an increasingly digital economy.<sup>79</sup> The Commission had a term of eighteen months, at the end of which the Commission issued a report on the results of the study and made legislative recommendations to address the issues covered in the study.<sup>80</sup>

The Act gave the Commission broad jurisdiction over the taxation of e-commerce.<sup>81</sup> The Commission used this broad jurisdictional grant to study everything from transaction and property taxes to international tariffs, and even included the digital divide.<sup>82</sup> The substantive and procedural requirements the Commission had to meet tempered the Commission's broad jurisdictional grant.<sup>83</sup>

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74. See Internet Tax Freedom Act, § 1101(a)(1)-(2), 112 Stat. at 2681-719.

75. *Id.* § 1102(g)(1), 112 Stat. at 2681-722.

76. *Id.*; see also Advisory Commission on Electronic Commerce, *The Commission* <<http://www.ecommercecommission.org/about.htm>> (accessed Jan. 13, 2001) (detailing the composition, objectives, and goals of the Commission).

77. Internet Tax Freedom Act, § 1102(g)(1), 112 Stat. at 2681-722. "It is a balanced approach between our national interest in preventing parochial taxation of the Internet and Federal regulation of the Internet, and the concern of State and local governments who want to make sure that they retain their prerogatives." 144 CONG. REC. H5305 (daily ed. June 23, 1998) (statement of Rep. Cox).

78. Internet Tax Freedom Act, § 1102(b)(1), 112 Stat. at 2681-722.

79. *Id.* § 1102(b)(1)(B), 112 Stat. at 2681-722.

80. *Id.*

81. Jeffrey Friedman, *The Internet Tax Freedom Act: A Little Something for Everyone*, reprinted in Thomas H. Steele & James P. Kratochvil, Tax Mgmt. (BNA) Multistate Tax Portfolios Worksheet 27, at 1350:8701, 8703 (1999).

82. See Advisory Commission on Electronic Commerce, *Issues and Policy Option Paper* (Dec. 3, 1999) <<http://www.ecommercecommission.org/library.htm>> [hereinafter *Issues and Policy Options*]. This Note is concerned only with the taxation issues surrounding e-commerce.

83. *Internet Tax*, *supra* note 59, at 10.

First, the Commission's recommendations in the report were to be "technologically neutral and apply to all forms of remote commerce."<sup>84</sup> Second, the recommendations had to be "agreed to by at least two-thirds of the members of the Commission serving at the time the finding or recommendation is made."<sup>85</sup> The substantive and procedural requirements, coupled with the balanced representation of interests on the Commission, reflected the importance of the taxation issues surrounding e-commerce.<sup>86</sup> However, any recommendations regarding taxation made by the Commission also had to meet constitutional requirements for state sales and use taxes.<sup>87</sup>

#### IV. CONSTITUTIONAL IMPLICATIONS OF TAXING ELECTRONIC COMMERCE

The Commerce Clause<sup>88</sup> not only limits state taxing power, but also allows Congress to define national economic policy and priorities.<sup>89</sup> The famous quote that initiated the philosophy of intergovernmental immunity has some relevance solely to the policy implications of e-commerce taxation—that is, having fifty different taxing authorities exercising jurisdiction over e-commerce may stifle the growth of e-commerce.<sup>90</sup> In this context, the Internet Tax Freedom Act appears to partly embrace, and partly flout, that philosophy authored by Chief Justice Marshall:

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84. Internet Tax Freedom Act, § 1103, 112 Stat. at 2681-724; see also Friedman, *supra* note 81, at 1350:8703.

85. Internet Tax Freedom Act, § 1103, 112 Stat. at 2681-724; see also Friedman, *supra* note 81, at 1350:8703.

86. Internet Tax Freedom Act, § 1102, 112 Stat. at 2681-722.

87. See *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 758-60 (1967) (holding the State of Illinois could not impose use tax liability on an out-of-state mail-order firm); see also *Quill Corp. v. North Dakota*, 504 U.S. 298, 311-19 (1992) (holding mail order business did not need physical presence in state to require business to assess and collect use tax, but physical presence was needed to meet substantial nexus requirements of Commerce Clause).

88. U.S. CONST. art. I, § 8, cl. 3 ("To regulate Commerce with Foreign Nations, and among the several States . . .").

89. JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 8.11(e), at 316 (5th ed. 1995); see also *Electronic Commerce*, *supra* note 15, at 439 (noting the principle purpose of the Commerce Clause is "national economic unity"). For an overview of all the constitutional considerations involved in state taxation, see D. Michael Young, *Challenging State and Local Taxes on Constitutional Grounds*, 10 J. MULTISTATE TAX'N 12 (2000). For further discussion on the Commerce Clause and its application to taxation of e-commerce, see Walter Hellerstein, *Deconstructing the Debate over State Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 549 (2000) [hereinafter *Deconstructing the Debate*]; Charles E. McLure, Jr., *Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness*, 13 HARV. J.L. & TECH. 567 (2000); and David C. Powell, *Taxing the Web: The Potential Impacts of the Internet Tax Freedom Act and Federal Preemption of State Finances*, State Tax Today (Aug. 16, 1999) (available in LEXIS, 1999 STT 157-23).

90. See NOWAK & ROTUNDA, *supra* note 89, § 8.11, at 311 (discussing intergovernmental immunity and Chief Justice Marshall's "broad slogan" in *McCulloch v. Maryland*).

That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is plain repugnance in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied.<sup>91</sup>

The moratorium on taxation allows the United States to foster an e-commerce policy, free of government regulation, at a time when the industry is experiencing tremendous growth. Taxation of e-commerce at this pivotal time may impede this growth, offending the common market and economic unity created by the Constitution and defined by the three branches of government.

E-commerce may be the most appropriate vehicle to test new ideas and solutions for state and local taxation, provided the solutions meet constitutional requirements. Supreme Court jurisprudence can provide the framework for forging an e-commerce taxation policy.<sup>92</sup> However, fitting old notions to new technology may prove difficult.

The Court's decisions on the states' ability to burden interstate commerce with taxes are complex. The general considerations were set forth in *Complete Auto Transit, Inc. v. Brady*.<sup>93</sup> In *Complete Auto*, the Court noted it examines the practical effect of a tax statute, and it has "sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."<sup>94</sup> This summary context facilitates the understanding of the leading Supreme Court decisions dealing with the states' power to impose sales and use taxes on out-of-state vendors: *Quill Corp. v. North Dakota*,<sup>95</sup> in which North Dakota tried to assess a use tax on an out-of-state vendor;<sup>96</sup> and *National Bellas Hess, Inc. v. Department of Revenue*,<sup>97</sup> in which Illinois sought to impose tax liability on an out-of-state mail order firm.<sup>98</sup> Nonetheless, the *National Bellas* and *Quill* deci-

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91. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819); see also NOWAK & ROTUNDA, *supra* note 89, § 8.11(e), at 316.

92. See *Quill Corp. v. North Dakota*, 504 U.S. at 311-19 (holding mail-order business did not need physical presence in state to require business to assess and collect use tax, but physical presence was needed to meet substantial nexus requirements of Commerce Clause); see also *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. at 758-60 (holding the State of Illinois could not impose use tax liability on an out-of-state mail-order firm).

93. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

94. *Id.* at 279; see also NOWAK & ROTUNDA, *supra* note 89, § 8.11(a), at 311 (listing cases examining the components of the *Complete Auto* test).

95. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

96. *Id.*

97. *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753 (1967).

98. *Id.*

sions provide a framework for examining state taxation of interstate commerce, and may provide guidance for a permanent e-commerce tax policy.<sup>99</sup>

#### A. *The National Bellas Hess Decision*

*National Bellas Hess* addressed a use tax assessed on an out-of-state mail-order business that did not maintain physical facilities or sales representatives in Illinois.<sup>100</sup> The *National Bellas Hess* Court noted the Due Process and Commerce Clause concerns of imposing the tax and stated: "[T]he Court has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."<sup>101</sup> The *National Bellas Hess* Court also recognized the effects use taxes may have on national unity:

For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of local government.'<sup>102</sup>

The Court ruled the Illinois use tax created an unconstitutional burden on interstate commerce and failed to satisfy the requirements of the Due Process and Commerce Clauses.<sup>103</sup> For the *National Bellas Hess* Court, such taxes thwarted the goal of the Commerce Clause and led the Court to conclude: "The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control."<sup>104</sup>

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99. See *Quill Corp. v. North Dakota*, 504 U.S. at 310-11; *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. at 754.

100. *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. at 754.

101. *Id.* at 758.

102. *Id.* at 759-60 (footnotes omitted).

103. *Id.* at 760.

104. *Id.*; see also *Electronic Commerce*, *supra* note 15, at 437-40 (discussing the *Quill* decision).



## B. The Quill Decision

In *Quill*, the Court upheld the Commerce Clause holding of *National Bellas Hess*, but overruled the Due Process holding.<sup>105</sup> *Quill* dealt with an out-of-state office supply retailer that maintained no facilities or sales representatives in North Dakota.<sup>106</sup> The retailer solicited business through catalogs and advertisements in national periodicals, as well as telephone calls.<sup>107</sup> North Dakota sought to impose a use tax upon property for use within the state, and required the retailer "to collect the tax from the consumer and remit it to the State."<sup>108</sup> The Court, in overruling the *National Bellas Hess* Due Process Clause reasoning, adopted a more flexible test that reflected the evolution of the Court's Due Process Clause jurisprudence since the *National Bellas Hess* decision.<sup>109</sup> The well-known inquiry employed by the *Quill* Court was "whether a defendant's contacts with the forum made it reasonable, in the context of our federal system of Government, to require it to defend the suit in that State."<sup>110</sup> The *Quill* Court applied these principles to the Due Process analysis of the use tax North Dakota sought to implement.<sup>111</sup> "Comparable reasoning justifies the imposition of the collection duty on a mail-order house that is engaged in continuous and widespread solicitation of business within a State."<sup>112</sup> The Court concluded that Quill Corporation had met these minimal requirements by purposefully directing a sufficient amount of its marketing activities to North Dakota residents, and that the use tax was related to the benefits Quill Corporation received from access to the state.<sup>113</sup>

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105. *Quill Corp. v. North Dakota*, 504 U.S. 298, 301 (1992); see also *Nat'l Bellas Hess, Inc. v. Dept. of Revenue of Ill.*, 386 U.S. at 758 (refusing "to repudiate totally the sharp distinction which . . . other decisions have drawn between mail order sellers . . . within a State, and those who do no more than communicate with customers in the State by mail or common carrier"); *Electronic Commerce*, *supra* note 15, at 437-40 (examining the impact of *Quill* on previous United States Supreme Court state taxation jurisprudence).

106. *Quill Corp. v. North Dakota*, 504 U.S. at 302.

107. *Id.*

108. *Id.*

109. *Id.* at 307; see also *Electronic Commerce*, *supra* note 15, at 437-40 (noting the United States Supreme Court's movement toward a bright line physical presence rule).

110. *Quill Corp. v. North Dakota*, 504 U.S. at 307; see *Shaffer v. Heitner*, 433 U.S. 186, 206-12 (1977) (extending the *in personam* jurisdiction analysis of *International Shoe Co. v. Washington* to *in rem* jurisdiction) (citing *Int'l Shoe Co. v. Washington*, 326 U.S. 310 *passim* (1945)); see also *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985) (holding purposeful availment of the benefits of an economic market, even with no physical presence, renders foreign corporation subject to *in personam* jurisdiction).

111. *Quill Corp. v. North Dakota*, 504 U.S. at 308.

112. *Id.*

113. *Id.*



The *Quill* Court stated: "[T]he Commerce Clause and its nexus requirements are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy."<sup>114</sup> Using the original intent of the framers to elucidate the dormant Commerce Clause, the Court noted the Commerce Clause was a response to the Articles of Confederation that permitted states to levy taxes burdening interstate commerce.<sup>115</sup> Thus, under *Quill*, Article I, Section 8, Clause 3 of the Constitution "prohibits discrimination against interstate commerce, and bars state regulations that unduly burden interstate commerce."<sup>116</sup> The *Quill* Court differentiated the Commerce Clause requirements from those mandated by Due Process:

[T]he 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, contrary to the State's suggestion, a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause.<sup>117</sup>

The Court concluded "a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals."<sup>118</sup>

While not directly applicable, the principles and analysis of the *Quill* decision have a prescient quality relative to e-commerce. In the Court's overruling of the *National Bellas Hess* Due Process Clause analysis, the *Quill* Court quoted language from *Burger King Corp. v. Rudzewicz*:<sup>119</sup>

'Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted.'<sup>120</sup>

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114. *Id.* at 312.

115. *Id.* (citing THE FEDERALIST NOS. 7, 11 (Alexander Hamilton)); see *Electronic Commerce*, *supra* note 15, at 437-40.

116. *Quill Corp. v. North Dakota*, 504 U.S. at 312 (citations omitted).

117. *Id.* at 313 (footnote omitted).

118. *Id.* at 316.

119. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

120. *Quill Corp. v. North Dakota*, 504 U.S. at 308 (quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. at 476 (emphasis added)).

This language and its presence in *Quill* would appear to envelop e-commerce and satisfy any Due Process concerns. A tenuous argument could be made that the commercial activity of e-commerce is directed not toward the state, but rather toward, or on, the World Wide Web, thus not satisfying even the minimal Due Process requirements.<sup>121</sup> The intent of the Commerce Clause and the "structural concerns about the effects of state regulation on the national economy" appear to present the strongest argument.<sup>122</sup> In this context, fifty different taxing jurisdictions regulating such a pervasive component of the national economy can certainly be viewed as weakening national economic unity.

However, the *Quill* decision is an imperfect analogy for taxation of e-commerce. The e-commerce revolution has changed the national economy in a way that mail-order catalogues have not and are incapable of doing.<sup>123</sup> E-commerce offers not just products and convenience, but also services, communication, and information on a national and international level. The pervasiveness of and dependency on e-commerce make it an integral part of our national common market, as well as international trade.<sup>124</sup> States' efforts to tax e-commerce may endanger the cohesiveness of the common market and disrupt national economic unity. With the developments in e-commerce, the approach taken in *Quill* may not be the best fit for taxation of e-commerce.<sup>125</sup>

The *Quill* Court stated: "Undue burdens on interstate commerce may be avoided not only by a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes, but also, in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation."<sup>126</sup> Congress did precisely this with the Internet Tax Freedom Act<sup>127</sup> and imposed the moratorium on taxation of e-commerce.<sup>128</sup> The Court also noted, in terms of the Commerce Clause analysis, "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions."<sup>129</sup> The moratorium allows Congress and state policy makers the

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121. *Id.*

122. *Id.* at 312.

123. See Dave Chambers, *Internet Economy Indicators* <[http://www.internetindicators.com/jan\\_2001.pdf](http://www.internetindicators.com/jan_2001.pdf)> (accessed Feb. 6, 2001).

124. Advisory Commission on Electric Commerce, *Report to Congress* <<http://www.ecommercecommission.org>> at 9 (Apr. 2000) [hereinafter *Report to Congress*].

125. See *supra* Part II.

126. *Quill Corp. v. North Dakota*, 504 U.S. at 314-15.

127. See Internet Freedom Act, Pub. L. No. 105-277, § 1101, 112 Stat. 2681-719, 2681-719 (1998).

128. See *id.*

129. *Quill Corp. v. North Dakota*, 504 U.S. at 318.

opportunity to resolve these issues. However, the moratorium may be precedent for an e-commerce policy and, ultimately, be the legislative direction in which Congress goes.

The Supreme Court jurisprudence provides some direction for Congress and the states in terms of a sales and use tax, but the unique features and complexities of e-commerce can blur even the clearest of bright-line rules.<sup>130</sup> One scholar concluded:

The problems raised by state taxation of electronic commerce have spawned an enormous interest in—and controversy over—an area of the law that the Supreme Court has characterized as a “quagmire.” The most promising prospects for resolving these problems reside today in the legislative branches of government at both the federal and state levels. One can only hope that as Congress and the state legislatures turn their attention to these issues, their decisions are informed by sound principles of tax policy.<sup>131</sup>

#### V. PROPOSALS FOR TAXATION OF ELECTRONIC COMMERCE

The Advisory Commission on Electronic Commerce considered several policy options for the taxation of e-commerce.<sup>132</sup> The Commission examined whether to recommend expanding, reducing, or leaving unchanged the authority of state and local governments to tax e-commerce, and examined the extent of congressional involvement in legislating the states’ sales and use taxes.<sup>133</sup> The Commission published the *Issues and Policy Options Paper* in which it defines the scope of the issues studied and the options presented.<sup>134</sup>

One proposal in the Commission’s paper was to extend the moratorium for five years “while modifying the prohibition against sales and use taxes to prohibit all sales taxes on Internet business to consumer sales of tangible or intangible goods and property, intellectual property, digital goods, services, securities, information and entertainment.”<sup>135</sup> In considering this option, the Commission noted that no changes have occurred since the original moratorium issued; states currently have sufficient revenue; and an extension of the moratorium would

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130. See *Electronic Commerce*, *supra* note 15, at 437-41.

131. *Deconstructing the Debate*, *supra* note 89, at 565 (citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)).

132. *Issues and Policy Options*, *supra* note 82, at 12.

133. *Id.*

134. *Id.*; see also Advisory Commission on Electronic Commerce, *E-commerce Commission Document Library* <<http://www.ecommercecommission.org/library.htm>> (accessed Jan. 15, 2001) (providing links to numerous proposals on sales and use tax submitted to the Commission).

135. *Issues and Policy Options*, *supra* note 82, at 12.

continue to allow e-commerce to develop unadulterated by "a haphazard tax structure" and allow "the conclusion of national dialogue on how e-commerce should be taxed."<sup>136</sup> Similarly, the Commission paper proposed "pre-empting state and local governments' authority to tax sales of tangible personal property or services via the Internet, making such sales exempt from any Transaction Taxes."<sup>137</sup> Legislation calling for a permanent ban on the taxation of e-commerce, not just an extension of the current moratorium, was introduced in Congress.<sup>138</sup>

Another Commission proposal, at the other end of the spectrum, was to:

mak[e] no change in state and local governments' authority to impose Transaction Taxes on sales of tangible personal property facilitated by the Internet. Taxes would be imposed by state and local governments in the same manner and to the same extent as they impose Transaction Taxes on sales facilitated through any other means (including face-to-face retail sales and mail order sales).<sup>139</sup>

However, 'no change' is a misnomer because states do not have the constitutional authority to impose such taxes according to the Supreme Court's decision in *Quill*.<sup>140</sup>

Including this policy option, the Commission reasoned that the Internet is just another method for transacting business, and that there is no "overriding policy reason" for e-commerce to obtain tax-favored treatment.<sup>141</sup> Currently, the overriding policy reason is that Congress has mandated a moratorium on the taxation of e-commerce to study the issue.<sup>142</sup> The Commission paper stated: "A 'no change' recommendation allows state and local governments the autonomy to impose sales/use tax in a manner consistent with current nexus standards and allows all forms of commerce to proceed as they currently do."<sup>143</sup> However, there is legislative history that indicates the Internet Tax Freedom Act was directed toward codifying the Supreme Court's *Quill* decision:

The promotion of electronic commerce requires faithful adherence to the U.S. Supreme Court's clear statement in *Quill* that a "bright-line" physical

136. *Id.*

137. *Id.* at 13.

138. Doug Sheppard, *U.S. Senator Calls for Permanent Ban on Internet Taxation*, State Tax Today (Aug. 23, 1999) (available in LEXIS, 1999 STT 162-19).

139. *Issues and Policy Options*, *supra* note 82, at 12.

140. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 312-16 (1992); *supra* Part IV.B.

141. *Issues and Policy Options*, *supra* note 82, at 12.

142. Christopher Cox, *Detailed Legislative History of the Internet Tax Freedom Act* <<http://cox.house.gov/nettax/Web-history.html>> (accessed Jan. 13, 2001).

143. *Issues and Policy Options*, *supra* note 82, at 12.

presence—not some malleable theory of electronic or economic presence—is required for a State to claim substantial nexus. Even without the Act, the courts, in light of *Quill* are likely to view such arguments by State tax administrators with great skepticism. But the Act provides clarity and far greater certainty by specifically outlawing State or local efforts to pursue aggressive theories of nexus. This should result in decreased litigation which will benefit States, localities, taxpayers, and an often overworked court system.<sup>144</sup>

The Commission reasoned that instituting a permanent ban on e-commerce taxation is not tax neutral, as required by the Internet Tax Freedom Act.<sup>145</sup> The Commission paper anticipated that more sellers will move to e-commerce, and treating e-commerce “differently than other sales will increase administrative burdens for sellers.”<sup>146</sup>

The final proposal in the Commission’s paper regarding taxation of e-commerce was to “impos[e] a nationally collected, single rate, uniform sales/use tax on electronic commerce and remote sales in lieu of all sales/use taxes; all revenues to be shared with state and local governments.”<sup>147</sup> The reasoning behind this proposal was to ensure a uniform rate structure and administrative simplicity.<sup>148</sup> The Commission’s paper acknowledged that although this proposal “does not preserve the sovereignty of state and local governments, it does assure that tax is being paid/collected on all taxable sales. It would also provide a vehicle for offsetting any revenue dislocations currently being occasioned.”<sup>149</sup> The 106th Congress considered legislation providing for a national sales tax for e-commerce, but did not enact it.<sup>150</sup>

Ultimately, the Commission proposed—by a majority of the Commission supporting the proposal, not the two-thirds of the Commission required to substantiate a finding or recommendation—to extend “the current moratorium barring multiple and discriminatory taxation of e-commerce and prohibit taxation of sales of digitized goods and products and their non-digitized counterparts.”<sup>151</sup> Furthermore, the Commission encouraged policy makers to clarify the factors that may determine nexus with a state:

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144. *Report Concerning Provisions of H.R. 4105, The Internet Tax Freedom Act*, reprinted in 144 CONG. REC. E1289 (daily ed. July 14, 1998) (statement of Rep. Cox).

145. *Issues and Policy Options*, *supra* note 82, at 12.

146. *Id.*

147. *Id.* at 14.

148. *Id.*

149. *Id.* at 14–15.

150. Sales Tax Safety Net and Teacher Funding Act, S. 1433, 106th Cong. (1999) (calling for a 5% national sales tax collected by businesses conducting online sales).

151. *Report to Congress*, *supra* note 124, at 19–20.

Clarify that the following factors would not, in and of themselves, establish a seller's physical presence in a state for purposes of determining whether a seller has sufficient nexus with that state to impose collection obligations: (a) a seller's use of an Internet service provider ("ISP") that has physical presence in a state; (b) the placement of a seller's digital data on a server located in that particular state; (c) a seller's use of telecommunications services provided by a telecommunications provider that has physical presence in that state; (d) a seller's ownership of intangible property that is used or is present in that state; (e) the presence of a seller's customers in a state; (f) a seller's affiliation with another taxpayer that has physical presence in that state; (g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state; (h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller's Web site or catalogue to be returned to the other party's physical location within that state; and (i) the advertisement of a seller's business location, telephone number, and Web site address.<sup>152</sup>

This list sums up the most important issues policy makers must address in forging a tax policy for e-commerce—from both a constitutional and a practical viewpoint. The resolution of the uncertainty in an e-commerce taxation policy may well lie in a clarification of these issues. However, the diversity of interests and the complexity of the issues make finding a consensus a difficult task.<sup>153</sup>

The differences between the proposals in the *Issues and Policy Options Paper* and proposals debated by the Commission reflect the composition of the Commission.<sup>154</sup> The Commission's sales and use tax proposal submitted to

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152. *Id.*

153. See Cal-Tax Digest, *Dean Andal on Electronic Commerce* <<http://www.caltax.org/member/digest/may2000/may00-2.htm>> (accessed Dec. 28, 2000). Dean Andal, a member of the Advisory Commission on Electronic Commerce, stated:

First of all, the coalition that voted for the final report—it was approved on an 11-8 vote—came to the same conclusion that there shouldn't be taxes on the Internet and that's the report we are sending to Congress. But within that coalition, that majority coalition, there are two subsets. There are those who don't believe even if it could be done that it would be a good idea, and that's the camp I'm in. I don't want to force out-of-state sellers without physical presence to collect tax. The other subset said we're not against that and most of the business executives fell in this category: we're not against the idea that tax should be collected, we just don't think it is fair for you to do that before you simplify. So both of us lined up under the proposition, and we called the pro-taxers' bet. If the states and cities think they can simplify, more power to them, and that would lead them perhaps in the future to the ability to collect.

*Id.*

154. See *id.*; *Issues and Policy Options*, *supra* note 82, at 12.



Congress was a compromise between the business and governmental interests represented on the Commission.<sup>155</sup> However, it was a compromise that did not meet the procedural requirement of two-thirds approval; therefore, as only a majority proposal, it is not considered a finding or a recommendation.<sup>156</sup> The fact the Commission was unable to meet the procedural requirement of two-thirds support for a sales and use tax recommendation illuminates the contentiousness and complexity of the issues surrounding e-commerce.<sup>157</sup> The Commission proposals did not bind Congress, but Congress has taken the issues studied and raised by the Commission into consideration in legislatively addressing taxation of e-commerce.<sup>158</sup> Although the Commission was unable to reach a consensus, the Commission's efforts were not in vain.<sup>159</sup> The Commission's work is serving as an impetus for individual states to act on fashioning a tax policy to encompass e-commerce.<sup>160</sup>

## VI. UNIFORM SALES AND USE TAX ADMINISTRATION ACT

Perhaps the most interesting development, and the one with the best prospect for enactment in the debate over taxation of e-commerce, is the emergence of support from forty states for a uniform law on simplifying the collection of sales and use taxes.<sup>161</sup> The Commission's majority proposal sought to:

Encourage state and local governments to work with and through NCCUSL in drafting a uniform sales and use tax act within three years after the expiration of the current Internet Tax Freedom Act moratorium that would simplify state and local sales and use taxation policies so as to create and maintain parity of collection costs . . . between remote sellers and comparable jurisdiction vendors that do not offer remote sales, including the following: (a) uniform tax base definitions; (b) uniform vendor discount; (c) uniform and simple sourcing rules; (d) one sales and use tax rate per state and uniform limitations on state rate changes; (e) uniform

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155. See *Report to Congress*, *supra* note 124, at 19-20.

156. See *id.* (breaking down the Commission vote on sales and use tax—eleven yeas, one nay, and seven abstentions).

157. See *id.*

158. See Lizette Alvarez, N.Y. Times on the Web, *House Votes to Ban Internet Taxes for 5 More Years* <<http://www.nytimes.com/2000/05/11/technology/11tax.html>> (May 11, 2000) (noting House approval of extending the moratorium for five more years); see also Advisory Commission on Electronic Commerce: Press Room <<http://www.ecommerce.org/releases.htm>> (accessed Mar. 13, 2001) (listing action taken by the United States House of Representatives on Commission proposals, findings, and recommendations).

159. See generally David Hardesty, Ecommerceetax.com, *Streamlined Sales Tax Project Adopts Final Rules* <<http://www.ecommercetax.com/doc/122400.htm>> (Dec. 24, 2000) (noting several states approved of the Streamlined Sales Tax Project).

160. *Id.*

161. *Id.*

audit procedures; (f) uniform tax returns/forms; (g) uniform electronic filing and remittance methods; (h) uniform exemption administration rules; (i) a methodology for approving software that sellers may rely on to determine state sales tax rates; (j) a methodology for maintaining revenue neutrality in overall sales and use tax collections within each state to account for any increased revenues collected.<sup>162</sup>

The Streamlined Sales Tax Project has addressed these issues with the Uniform Sales and Use Tax Act.<sup>163</sup>

The Streamlined Sales Tax Project comprises representatives from forty states whose purpose is to "develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes."<sup>164</sup> The Project produced the Uniform Sales and Use Tax Administration Act, which seeks to coordinate sales tax collection among participating states.<sup>165</sup> "It is the purpose of this Agreement to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance."<sup>166</sup> The Uniform Sales and Use Tax Act seeks to provide a uniform state tax rate, uniform definitions for the sales tax base, uniform standards of collection, a central registration, and a reduction of the burdens of compliance with local sales and use taxes.<sup>167</sup> The Streamlined Sales Tax Project approved forwarding the model legislation to states for the 2001 legislative sessions.<sup>168</sup> Much like the Advisory Commission on Electronic Commerce and its recommendations, the Streamlined Sales Tax Project and the model legislation it produced have found strong support, as well as opposition, in state governments and in the business and consumer advocates communities.<sup>169</sup> Without further action from Congress, the Project could formulate a uniform sales and use

162. *Report to Congress*, *supra* note 124, at 19-20.

163. Streamlined Sales Tax Project, <<http://www.geocities.com/streamlined2000/>> (accessed Jan. 14, 2001).

164. *Id.*

165. See Streamlined Sales and Use Tax Agreement, Art. I, § 102 (amended Dec. 22, 2000) <<http://www.streamlinedsalestax.org>> (accessed Dec. 28, 2000).

166. *Id.*

167. See UNIF. SALES & USE TAX ADMIN. ACT (amended Dec. 22, 2000) <<http://www.streamlinedsalestax.org>> (accessed Dec. 28, 2000); see also Hardesty, *supra* note 159 (noting the Project has support in about forty states); Doug Sheppard, *Streamlined Effort Amends Draft, Nears Completion of First Phase*, *State Tax Today* (Dec. 1, 2000) [hereinafter *Streamlined Effort*] (available in LEXIS, 2000 STT 232-30) (reporting on phase one of the Streamlined Sales and Use Tax Agreement).

168. Doug Sheppard, *Streamlined Project to Forward Model Legislation to States*, *State Tax Today* (Dec. 27, 2000) (available in LEXIS, 2000 STT 249-22).

169. See *id.*; see also *Streamlined Effort*, *supra* note 167 (discussing generally support and opposition to streamlined tax proposals).

tax regime among participating states and dramatically alter the debate surrounding taxation of e-commerce, as well as state taxation in general.<sup>170</sup>

## VII. CONCLUSION

E-commerce presents issues that both challenge and fit traditional notions of the constitutional framework of interstate commerce. While Supreme Court jurisprudence provides some guidance on resolving these challenges in a constitutionally permissive manner, the federal government must work with state and local government authorities to find solutions palatable to all interested parties.

Congress has the enumerated power, and the duty, to ensure the preservation of the common market in furtherance of national economic unity.<sup>171</sup> Taxing e-commerce potentially subverts the theory of a common market in substance and form.<sup>172</sup> However, if the states find a solution that is simplified and uniform, it may further national economic unity. The changes brought by e-commerce to our economy and the common market call for a fundamental rethinking of state and local sales and use tax assessment. Congress provided a forum for such a task, and the states have responded to further the ideas of a common market and a unified, national economic policy. The federal structure of our government balances the complexity of this issue with the constitutional considerations of finding a solution. In reaching a solution to this complex issue, policymakers may find guidance in Justice Frankfurter's discerning summation of the relationship between the individual state and federal governments:

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170. A new idea in state legislatures provides that an out-of-state retailer must collect state sales and use tax if it is related to a retailer maintaining sales locations in the state, provided the retailer sells similar products under a similar name as the taxing state retailer, or facilities or employees of the related state retailer are used to advertise or promote sales by the out-of-state retailer to in-state purchasers. David Hardesty, EcommerceTax.com, *Clicks and Mortar 2* <<http://www.ecommercetax.com/doc/010701.htm>> (Jan. 7, 2001). The purpose of the legislation is to require online affiliates of retailers with a physical presence in the state to collect state sales tax. *Id.*

171. U.S. CONST. art. I, § 8, cl. 3. Chief Justice Marshall's familiar explanation of the Article I enumerated powers, from *McCulloch v. Maryland*, provides:

The clause is placed among the powers of [C]ongress, not among the limitations on those powers. Its terms purport to enlarge, not to diminish the powers vested in the government. It purports to be an additional power, not a restriction on those already granted. No reason has been, or can be assigned, for thus concealing an intention to narrow the discretion of the national legislature, under words which purport to enlarge it. The framers of the [C]onstitution wished its adoption, and well knew that it would be endangered by its strength, not by its weakness.

*McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 419-20 (1819).

172. See generally *Issues and Policy Options*, *supra* note 82 (discussing how Internet taxation would affect the market).

The interpenetrations of modern society have not wiped out state lines. It is not for us to make inroads upon our federal system either by indifference to its maintenance or excessive regard for the unifying forces of modern technology. Scholastic reasoning may prove that no activity is isolated within the boundaries of a single state, but that cannot justify absorption of legislative power by the United States over every activity.<sup>173</sup>

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173. *Polish Nat'l Alliance of the United States v. NLRB*, 322 U.S. 643 (1944).