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Current Issues in U.S. State and Federal Taxation of Electronic Commerce.

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Abstract

Currently, electronic commerce transactions in the U.S. largely escape taxation, even though their live transaction counterparts are almost always subject to some form of state or local sales tax or federal income tax. This has touched off a lively debate about how to extend tax liability to e-commerce in ways that are in parity with sales taxes, whether sales taxes should be restructured or replaced, and even whether e-commerce should be tax free, like many mail-order transactions. This paper will describe and evaluate the main issues in this debate, and point out how changes in this sector of the economy will also impact on U.S. taxation of international transactions.

I. Introduction

American jurisprudence regarding federal taxation of foreign transactions began to emerge in 1941. That year a Mexican radio station broadcasting from near the U.S. border persuaded U.S. federal courts that it should not have to pay U.S. income tax on its advertising revenues obtained from U.S. customers.[1] In accord with that precedent, the U.S. taxing authority (Internal Revenue Service or IRS) refrained from taxing mail order sales originating outside the U.S. and directed to U.S. customers.[2]

The authority of U.S. state and local governmental entities to tax mail order sales originating from outside the taxing authority's jurisdiction has also been limited. Presently, for instance, an American state may not levy a sales or use tax on a mail order transaction originating from outside the state and directed to a customer within that state, unless the tax is imposed on the in-state customer rather than on out-of-state seller.[3] The practical problems with identifying those customers and collecting the tax are so great as to discourage almost all effort to impose the tax.

This virtual U.S. tax exemption for foreign mail order transactions is easily extended by analogy to sales transacted over the internet; similarly, state and local taxing authorities find out-of-jurisdiction internet sales no more readily taxable than counterpart mail order sales. Indeed, one could view internet sales as simply a form of mail order sales initiated through electronic media and completed by the same couriers as used in mail order sales. If one questions why taxing authorities should show so much interest in internet sales when they have been basically content to leave mail order sales

untaxed, "the answer is that, potentially, the dollar volumes involved in electronic commerce transactions far surpass anything we have seen in the area of mail order sales."[4] In addition to potentially enormous volumes of traditional transactions in tangible goods, electronic sales of digitized products and services will soon explode and, in addition, could easily be so positioned as to originate outside the United States. Thus the taxing authorities are not concerned merely about losing a revenue opportunity, but have genuine worries about suffering significant revenue loss as traditional objects of taxation are shifting outside their reach. To avoid this, governments are seeking ways to include electronic commerce and mail order sales in their tax bases.

This paper first examines the potential impact of untaxed electronic commerce on the federal, state and local tax bases, and then summarizes the constitutional and legal impediments to extending U.S. federal and state taxation authority to electronic commerce. Proposals for restructuring state sale taxes to include electronic commerce and mail order sales are reviewed and evaluated, followed by an assessment of how imposing tax liability will affect electronic commerce. Finally the paper reports on the activities of the federal Advisory Commission on Electronic Commerce and offers a perspective on the future of electronic commerce taxation in the United States.

I. How e-commerce affects the federal, state and local tax bases.

In 1999, one expert estimated that in five years electronic commerce could account for one-third of all world trade.[5] If one considered only the sales of digitized products, whose point of origin can be easily moved outside the taxing jurisdiction, a few sample statistics illustrate the magnitude of the tax revenues at stake. In 1995, U.S. sales of prepackaged software totaled $19.9 billion, and sales of custom software and associated services totaled $26.2 billion, and both number have surely increased enormously since then. Moving those transactions outside the reach of taxing authorities would cause huge loss of potential revenue; in addition, much of that commerce that currently generates tax revenue could be electronically shifted to sites that escape taxation, causing huge losses of traditional tax revenue. These digitizable goods and services could include books, newspapers, magazines, videos, music, legal and accounting and other professional services, and gambling services. This scenario for digitized commerce could be rather easily replicated for traditional mail order commerce in tangible goods and services. On authority concluded, after reviewing the alternatives, that "the preferred solution is to find ways to keep Internet commerce in the state consumption tax and federal income tax bases, and to bring mail order commerce into both tax bases as the same time."[6]

II. Constitutional and legal challenges that may confront U.S. taxation of e-commerce

American federalism poses peculiar challenges to any attempt at sweeping electronic commerce into state and federal tax bases. Of course, the federal government's authority will suffice to impose uniform federal income taxation on foreign electronic commerce directed at U.S. customers, although use of that authority for that purpose will still require a change in the United States Supreme Court's view of the law.[7] At the level of state sales and use taxes, achieving any uniformity of approach among the states may require imposing some form of federal regulatory power, which raises constitutional questions about how far the federal authority may go in guiding this area of traditional state independence.

A. Commerce Clause

The most obvious source of federal power to regulate federal and state taxation is the so-called Commerce Clause of the U.S. Constitution: Congress shall have the power "to regulate commerce . . . among the several States."[8]This has been interpreted to give Congress the power to regulate even local tariffs if they affect interstate tariffs.[9] Congress may also permit states to tax in areas otherwise reserved for federal action, such as a state insurance premium tax imposed on foreign insurance companies.[10] The U.S. Supreme Court has suggested that Congress has the power to

impose uniform state tax rules on the states,[11] and even the *Quill Corp.* court acknowledged that "Congress is . . . free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.[12] Two more recent U.S. Supreme Court decisions have imposed more restrictive interpretations on the Commerce Power where there is no demonstration of a direct impact on interstate commerce.[13] Navigating among those decisions suggests that Congress could empower states to tax electronic commerce, but only by complying with certain federal prescribed conditions.

B. Eleventh Amendment (State Sovereign Immunity)

According to the Eleventh Amendment to the U.S. Constitution, a nonresident of a state may not sue that state in federal court, if the state has not consented so to be sued.[14] Underlying this specific prohibition is a broad recognition of state sovereign immunity blocking any legal action against a state governmental entity unless the entity has consented to be sued. The Eleventh Amendment, especially as interpreted by very recent Supreme Court cases, affirms that Congress does not have general power to override state sovereign immunity.[15] These decisions imply that Congress may not create a private judicial remedy to enforce substantive rules it may enact regarding state taxation of electronic commerce. Of course, states may consent-and have consented--to be sued in state courts over a variety of matters.

C. Due Process Clause Restrictions.

The issue of possible violations of the Due Process Clause of the U.S. Constitution[16] is at bottom a question of how far a state may go in imposing a tax on a person or an entity not physically present in the state. Current law requires only that the out-of-state taxpayer have purposefully directed its activities toward residents of the taxing state.[17] If Congress fashioned a broad statutory approach regulating (and requiring) state taxation of out-of-state electronic commerce, that federal legislation would have to comply with due process requirements. The *Quill Corp.* court stated in dictum that Congress does not have power to authorize state violations of the Due Process Clause,[18] but at least one legal scholar had previously stated a contrary view.[19]

D. Summary of American Constitutional Restraints on Federal Law Regulating Taxation of Electronic Commerce

The most recent expert analysis of these U.S. constitutional issues concluded that the document posed no serious restraints on federal legislation regulation taxation of electronic commerce:

Congress possesses ample power to forge a comprehensive solution to the problems raised by state taxation of electronic commerce. There is no doubt that Congress has the power under the Commerce Clause to legislate with respect to virtually any aspect of electronic commerce. It may restrict states' power to tax such commerce in ways that Congress finds burdensome, prescribe the precise conditions under which states may tax such commerce, and permit the states to tax such commerce in ways that the Commerce Clause currently forbids. Although Congress may not create federal or state jurisdiction over nonconsenting states to enforce whatever rights it may create under legislation addressed to electronic commerce, the states' courthouses are generally open for the vindication of such rights. Congress could insist that the states waive their sovereign immunity to suit in return for a relaxation of the Commerce Clause restraints on their power to tax remote sellers. There is an open question whether Congress may override any due process limitations on state taxing power, but, even if it may not, these restraints are not extensive and, in any event, would likely affect any broad-based legislation only in limited circumstances on an "as applied" basis.[20]

III. Proposals for restructuring state sales taxes to include or eliminate e-commerce

Both opponents and proponents of electronic commerce taxation began stirring at about the same

time. Just as the National Tax Association (NTA), a forum of members from business, government and academia who discuss and evaluate tax policy,[21] began designing a project to study taxation of electronic commerce, proposed legislation to impose a moratorium on such taxation appeared in Congress. That legislative process culminated in the Internet Tax Freedom Act (ITFA), enacted as part of the Omnibus Budget Reconciliation Act of 1998. The ITFA imposed a three-year moratorium-beginning October 1, 1998--on most forms of state and local local internet access charges and electronic commerce taxes.[22] During the moratorium period the Advisory Commission on Electronic Commerce (ACEC), created by the ITFA law, was charged to conduct a study and produce legislative recommendations. Of course, no enactment can precede the end of the moratorium on September 30, 2001. Simultaneously, other members of Congress introduced a bill they called the Internet Tax Elimination Act, whose title gives clear indication of its intended effect. [23] Testimony in Congress during this study period has suggested four principles about which some consensus is gathering:

* Electronic commerce should not be treated differently from other commerce.

* Remote sales should, to the extent possible, be taxed by the state of sales destination.

* Sales and use taxes should be simplified enough that destination-based taxation is feasible.

* By means of free software, discounts or de minimis rules, small vendors should be relieved from the administrative burdens of compliance as much as possible.[24]

The varying and contending views about taxation of electronic commerce can be sorted into a few major categories. Some argue that out-of-state retailers should not be subject to taxation by a state in which they have no physical presence, and that they often can not know the identity and location of their customers, so they would know which state's tax to assess and collect. A counter-argument is that taxation of electronic sales is only fair, inasmuch as conventional sales are taxed. Some assert that the internet is a national asset whose functions or fruits should not be subject to taxation from any state. Some oppose taxation of electronic commerce on the ground that taxation leads to control, and control will stifle the dynamic developments taking place in the internet. Some claim that any taxation of electronic commerce will inevitably lead to attempted taxation of the same transaction by more than one state, and thus be discriminatory as compared to taxation of conventional transactions. Finally, some believe that the U.S. Constitution prohibits states from reaching beyond their borders to impose tax liability on non-residents.

IV. A perspective on the future of e-commerce taxation in the U.S.

The debate over taxation of electronic commerce has raised the most fundamental issues of tax philosophy and tax policy. The traditional American state sales tax, which is the presumptive vehicle for imposing a tax on electronic commerce, is a tax with no rationale other than raising revenue for general purposes. Other taxes have more specific rationales, such as fuel tax revenues earmarked for highway construction and maintenance. If a general revenue tax cannot be applied and administered fairly, its existence is and should be in jeopardy; American state sales taxes are considered to be endangered for that very reason, and if these tenuous schemes are put forward as the tax schemes for electronic commerce, prospects for success are dubious. A huge and growing obstacle to imposing a type of sales tax on electronic commerce is the fact that such transactions are not now taxed, and almost everybody connected with this commerce as either vendor or purchaser will naturally resist the tax. This is especially true when the tax-admittedly only a general revenue source--is perceived as supporting no specific benefit related to the activity being taxed. With each passing day, and with growth in the numbers of customers in electronic transactions, natural resistance will only grow stronger and more implacable. Moreover, probably few politicians will risk their careers in an all-out struggle to introduce a tax that offends most of their constituents. Given these realities, the alternative gradually assumes appeal: simply drop efforts to impose sales taxes on electronic

commerce transactions, and drop the traditional sales taxes altogether, and find substitute sources of revenue, most likely increased income tax revenues.

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[1] Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297 (1941), *nonacq.* 1941-1 C.B. 18, *aff'd,* 127 F.2d 260 (5th Cir. 1942).

[2] Treas. Reg. § 1.864-4(b) Example (3).

[3] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[4] J. Clifton Fleming, "Electronic commerce and the State and Federal Tax Bases," 2000 *Brigham Young University L. Rev.* 1, 4.

[5] George Guttman, "Dealing with Electronic Commerce Will Require Global Cooperation," 85 *Tax Notes* 155 (1999).

[6] Fleming, *supra* note 4, at 7.

[7] That view is still defined by Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (holding, in essence, that out-of-state sellers who have no presence in the taxing state may not be compelled to collect use taxes from their customers in the taxing state).

[8] U.S. Const. art. I, § 8, cl. 3.

[9] Houston E & W Tex. Ry. V. United States, 234 U.S. 342 (1914).

[10] Prudential Insurance Co. v. Benjamin, 328 U.S. 408 (1946).

[11] Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978).

[12] 504 U.S. 298, at 318 (1992).

[13] United States v. Lopez, 514 U.S. 549 (1995) (no federal power under the Commerce Clause to prohibit possession of firearms in school zones, because possessing a gun in a local school zone does not affect interstate commerce); Printz v. United States, 521 U.S. 898 (1997) (no federal power to require state officials to conduct background checks on prospective handgun purchasers; the issue was not whether interstate commerce was affected, but whether local officials could be required to implement a federal regulatory scheme).

[14] "The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against of the United States by Citizens of another State, or Citizens or Subjects of any Foreign State." U.S. Const. amend. XI.

[15] Florida Prepaid Postsecondary Education Expense Board v. College Savings Bank, 119 S. Ct. 2199 (1999) (state sovereign immunity from patent infringement claims in federal court upheld); College Savings Bank v. Florida Prepaid Postsecondary Education Expense Board, 119 S. Ct. 2219 (1999) (requiring the state waiver of sovereign immunity to be intentional and explicit); Alden v. Maine, 119 S. Ct. 2240 (1999) (Congress may not subject nonconsenting states to private suits for damages in state courts); Kimel v. Florida Board of Regents, 120 S. Ct. 631 (2000) (Congress may not abrogate state sovereign immunity from federal court actions brought under the Age Discrimination in Employment Act).

[16] "nor shall any State deprive any person of life, liberty, or property, without due process of law; . . ." U.S. Const. amend. XIV, sec. 1.

[17] Quill Corp. v. North Dakota, 504 U.S. 298, 308 (1992).

[18]*Id.* at 305.

[19] William Cohen, "Congressional Power to Validate Unconstitutional State Laws: A Forgotten Solution to an Old Enigma," 35 *Stan. L. Rev.* 387 (1983); William Cohen, "Congressional Power to Interpret Due Process and Equal Protection," 27 *Stan. L. Rev.* 603 (1975).

[20] Kendall L. Houghton and Walter Hellerstein, "State Taxation of Electronic Commerce: Perspectives on Proposals for Change and Their Constitutionality," 2000 *Brigham Young University L. Rev.* 9.

[21] See the NTA website at http://ntanet.org/.

[22]Pub. L. No. 105-277, §§ 1101-04, 112 Stat. 2681-719 (1998).

[23] H.R. 3252 106th Cong. (1999).

[24] "State Sales and Use Taxation of Electronic Commerce: Simplification is Needed; A Statutory Exemption is Not: Testimony Before the Senate Budget Committee," 106yh Cong. (2000).