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THE INTERNET TAX FREEDOM ACT: NECESSARY PROTECTION OR DEFERRAL OF THE PROBLEM?

I. INTRODUCTION

One of the last legislative efforts of the 105th Congress was the passage of the Internet Tax Freedom Act,¹ which was signed into law by President Clinton on October 21, 1998. This legislation was the culmination of two years of bipartisan effort, led by the co-sponsors of the Act, Rep. Christopher Cox (R-CA) and Sen. Ron Wyden (D-OR). The Act reflects a national policy decision to keep the Internet unfettered by state and local taxation during the critical early formation period.² This policy will be achieved by the imposition of a three year moratorium on state and local taxes of the Internet, the Act's major provision.³

The ultimate objective of this "time-out" on Internet taxation is to develop an efficient and fair long-term tax policy; that is, a system which will accommodate the state and local needs for revenue without placing an undue burden on the development of the Internet as a major channel of international commerce.⁴ This Note will begin with a brief discussion of the rapid development of the Internet as a commercial medium and the unique policy questions presented. The discussion will then move to the major provisions of the Internet Tax Freedom Act itself. Finally, there will be an analysis of the state and local interest objections to and predicted effects of the legislation.

¹ Internet Tax Freedom Act, Pub. L. No. 105-277, §§ 1100 et seq., 112 Stat. 2681, 2681-719 (1998).

² *Senator Wyden's Outline of 'Cybertax Problems' at Finance Hearing on Internet Taxation*, STATE TAX NOTES, July 21, 1998, available in WL 98 STN 139-41.

³ Internet Tax Freedom Act § 1101(a).

⁴ See, e.g., *Congressional News Releases: Cox Release on Internet Tax Freedom Act*, TAX NOTES TODAY, Oct. 16, 1998, available in WL 98 TNT 200-27 (announcing presidential approval of Internet Tax Freedom Act).

II. THE DEVELOPMENT OF THE INTERNET AS A CHANNEL OF COMMERCE

Since its functional inception as a means of sharing limited computer resources and information for portions of the scientific community, the Internet has experienced a boom in commercial activity, especially during the last four years.⁵ In 1998, the number of host computers servicing the Internet had grown from the incipient four computers to almost thirty million located in 240 countries and territories.⁶ An estimated 66 million Internet users were located in the United States alone in 1998.⁷ Currently, 1.5 million new web pages are being created every day.⁸ The commercial statistics related to this growth are staggering. Estimates have placed aggregate electronic commerce at \$200 million for 1996,⁹ \$8 billion for 1997,¹⁰ and electronic commerce is expected to grow to greater than \$300 billion by the year 2002.¹¹ In 1997, online traders executed approximately \$120 billion in securities transactions.¹² The Dell Computer Corporation has reported the sale of as much as \$6 million of computer equipment in a single day from its web page, and there is no indication that these numbers will slow.¹³ The figures clearly indicate that the Internet has established itself as a viable commercial storefront with unlimited growth potential.

One commentary answers the question of "Who's Using the Internet?" quite simply: "Everyone."¹⁴ Consumers are using the Internet both to order tangible items of personal property which are then delivered by mail, and for electronic items which are ordered and delivered over the modem connection. Many traditional businesses (housed in "brick-and-mortar" storefronts) use the Internet as a means of providing information, which

⁵ Michael A. Geist, *The Reality of Bytes: Regulating Economic Activity in the Age of the Internet*, 73 WASH. L. REV. 521, 522 (1998).

⁶ *Id.*

⁷ *Id.*

⁸ Thomas W. Bonnett, *Is the New Global Economy Leaving State and Local Tax Structures Behind?*, STATE TAX NOTES, July 13, 1998, available in WL 98 STN 133-10.

⁹ *Id.*

¹⁰ *Ashcroft Release on Internet Tax Bill's Passage in Senate*, TAX NOTES TODAY, Oct. 13, 1998, available in WL 98 TNT 197-73.

¹¹ *Id.*

¹² Geist, *supra* note 5, at 522.

¹³ *Id.*

¹⁴ David Cowling & Andrew M. Ferris, *Internet Taxation Reviewed*, STATE TAX NOTES, July 23, 1997, available in WL 97 STN 141-53.

consumers use to educate themselves regarding their prospective purchases. Modern electronic businesses are using the system to conduct "electronic commerce"¹⁵ by using the computer interface as their primary storefront. In order to access these electronic markets, consumers must procure online access through an Internet Service Provider (ISP).

Once online, consumers may access online catalogs, which display a limitless range of goods for sale. These goods can be ordered online and delivered by the same conventional means as would be used by a mail-order catalog. Other goods, such as computer software, may be transferred electronically, eliminating the need for any form of ground delivery. Consumers may also access online research database information, or obtain professional services such as securities brokerage, legal, and medical consultation. The Internet also serves as a blossoming medium of communication; with such features as electronic mail (e-mail) and video-conferencing, many predict (or fear) that the Internet could even replace more conventional modes of communication such as the telephone.¹⁶ Due to the Internet's ability to provide the functions of advertising, marketing, order placement, and delivery of electronic goods all at one time, it is possible that it could become the principal means for consumers to obtain such items as television programs, movies, music, software, and news.¹⁷

This potential for large increases in Internet sales revenues, and thus tax revenues, has not gone unnoticed by state and local tax policymakers. In the United States alone, there are nearly 30,000 state and local taxing jurisdictions,¹⁸ each with a viable claim to a slice of the Internet pie. The intangible nature of an Internet transaction makes it an effort in futility to try to determine the geographic endpoints of any transmission, and it is this feature which prompted federal concerns of multiple state and local taxation killing the Internet before it has a chance to firmly establish itself.¹⁹ Speaking of the legislation he co-sponsored, Rep. Christopher Cox stated: "Congress has acted, as it should have long ago . . . to clearly identify the boundaries of state taxation of interstate commerce."²⁰ The purpose of the Act is, stated simply, to ensure the formation of a neutral tax treatment of the Internet and

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Congressional News Releases: Cox Release on Internet Tax Freedom Act, supra* note 4.

¹⁹ *Id.*

²⁰ *Id.*

electronic commerce, thereby allowing market forces to determine the long-term success or failure of this medium as a commercial outlet.²¹

As will be discussed below, many opponents of the legislation contend that the effect will be the opposite, and will actually ensure the supremacy of the electronic channel of commerce over more traditional means due to an unfair tax exemption. This could lead to a siphoning of community business sales, and an “undermin[ing] of public-sector revenues.”²² The counter-argument presented by supporters of the uniform federal legislation concedes the loss of sales tax revenues in the short-term, but in favor of an increase in other revenue sources in the long-term, such as income taxes, due to overall benefits for the economy and individual businesses resulting from the success of the Internet. An examination of the major provisions of the Internet Tax Freedom Act provides a better understanding of the arguments supporting both of these positions.

The unique characteristics that make the Internet so exciting as a new form of commerce are accompanied by unique problems in the area of taxation. However, this does not imply that the scheme which is to be employed in the long-term should not adhere to the fundamentals of good tax policy. The basic policy objectives that any legislation of Internet taxation should aspire to achieve are neutrality, administrability, uniformity among the state and local jurisdictions, and the avoidance of double taxation.²³ Many argue that the current state and local tax systems are outdated and are simply unable to meet the needs of today’s complex service-based economy, and believe that any plans to tailor a system to tax Internet transactions should merely be part of a larger plan for restructuring state taxation of all telecommunications and electronic commerce.²⁴

There is a general consensus among all concerned parties that state and local taxation of Internet commerce must be both economically neutral and uniform.²⁵ The principle of tax neutrality indicates a belief that goods or services provided by means of electronic commerce should not be taxed any differently than goods or services procured through more conventional

²¹ David S. Prebut, *The Forging of Cyberspace Tax Policy*, STATE TAX NOTES, July 27, 1998, available in WL 98 STN 143-19.

²² Bonnett, *supra* note 8, ¶ 26 (outlining development of Internet tax policy).

²³ See Cowling & Ferris, *supra* note 14 (reviewing state tax action on Internet).

²⁴ *Id.*

²⁵ Walter Hellerstein, *State Taxation of Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation*, STATE TAX NOTES, Apr. 29, 1997, available in WL 97 STN 82-36.

forms of commerce. When tax neutrality is achieved, the tax system will not have the undesired outcome of affecting decisions which are usually determined by market forces, such as whether to do business over the Internet or from a conventional physical location; that is, whether to buy goods and services via the Internet or down on "Main Street."

The lack of uniformity among the numerous state and local taxing jurisdictions in the country has helped create the current quandary that tax officials from these jurisdictions now face. In the context of sales and use taxes and remote sellers, the onus of having to comply with hundreds or even thousands of diverse tax systems and the potentially enormous burden on interstate commerce led to the tax "loophole" that mail-order catalog businesses currently employ to avoid assuming collection responsibility of these taxes.²⁶ Once uniformity among the state tax laws is achieved, the tax will be easier to administer.

Administrability is the key to a successful tax assessment and collection mechanism. "No matter how perfectly a taxing system may comport with other requirements of tax policy, if a tax is difficult to understand, if compliance burdens are excessive, and if the costs of administering the tax are unreasonable, the tax will fail to serve its basic function as an effective raiser of revenue."²⁷ Both the industries and the representatives of state and local tax jurisdictions agree that whatever tax mechanism is settled upon must be administratively efficient. A tax system that can be understood by businesses will encourage compliance and boost actual revenue collection by the taxing authority. However simple this proposition may appear, it has not been achieved by most state tax schemes, and the complex and abstruse nature of the Internet has clearly exposed the shortcomings of these tax mechanisms.

From the perspective of the corporate taxpayer, administrability will create the certainty that businesses greatly desire. For these interested business groups,²⁸ certainty will reduce the costs of compliance with the tax

²⁶ See *infra* text accompanying notes 167-175.

²⁷ Hellerstein, *supra* note 25 (quoting Tax Study Group, *Supporting the Information Highway: A Framework for State and Local Taxation of Telecommunications and Information Services*); cf. STATE TAX NOTES, July 12, 1995, available in WL 95 STN 133-22.

²⁸ One commentator has identified four interest groups within the business community that are either actively engaged, or have the potential to be engaged, in electronic commerce, and thus will be directly affected by the system state and local tax jurisdictions employ to tax this commerce channel: (a) telecommunications groups including cable companies, and cellular/wireless companies, (b) online and

and will allow for effective business planning.²⁹ Additionally, certainty can help create a perception of fairness stemming from similar comparative tax treatment of other equivalent services.³⁰ Businesses engaged in electronic commerce are also concerned with the issue of "unfair double taxation."³¹ This issue arises most commonly in the context of the taxation of Internet access fees. Many Internet service providers are already taxed on the telephone service that they utilize to connect their customers to the Internet. These businesses are opposed to the double tax that results when an assessment is added to their Internet access services, services which include the resale of access to these telephone lines which have already been taxed once. The elimination of this form of "pyramiding"³² of taxes is, as most tax experts agree,³³ sound tax policy in theory. However, this is an objective that is rarely achieved by state tax regimes.³⁴ One potential solution to this problem of double taxation is to exempt certain business inputs from the obligation to pay state retail sales taxes, thereby reducing the tax imposed to a single layer at the point of resale to the final consumer.³⁵ This proposal, however, would likely face staunch opposition from the states who are partial to the "well-entrenched tradition"³⁶ of taxing business inputs.

The Internet Tax Freedom Act was spawned by a realization that the current patchwork of state and local tax laws does not adhere to these basic fundamental tax policy principles. While the movement of the United States economy into one based on service providers has been outgrowing the state systems for some time now, the boom of electronic commerce may be the

Internet service providers, (c) content providers such as advertisers and financial service providers that allow for consummation of commercial transactions over the Internet connection, and (d) infrastructure companies such as the hardware and software companies that enable electronic commerce to exist in the first place. Kendall L. Houghton, *COST's Kendall Houghton Reviews Sales/Use Tax Collection Plans for Electronic Commerce*, STATE TAX NOTES, Sept. 30, 1997, available in WL 97 STN 189-13.

²⁹ *Id.*

³⁰ *Id.*

³¹ Michael Mazerov & Iris J. Lav, *A Federal Moratorium on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households*, STATE TAX NOTES, May 26, 1998, available in WL 98 STN 100-29.

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ Charles E. McLure, Jr., *Achieving a Level Playing Field for Electronic Commerce*, STATE TAX NOTES, June 1, 1998, available in WL 98 STN 104-21.

³⁶ Hellerstein, *supra* note 25.

straw that will "break the camel's back."³⁷ The Internet Tax Freedom Act does not purport to create a long-term mechanism that would incorporate and build upon these principles of sound tax policy, but rather, has a purpose of restraining the states and protecting electronic interstate commerce until someone can devise a scheme that will allow for a neutral, uniform, and administrable taxation of the Internet. To assess whether this legislation is a realistic attempt to achieve the stated goals, or whether it will actually exacerbate the problem, the provisions of the Act must be analyzed closely.

A. MAJOR PROVISIONS OF THE LEGISLATION

The Internet Tax Freedom Act progressed through many versions and amendments en route to being signed into law by President Clinton in October of 1998. While the vast majority of both Houses of Congress supported the policy underlying the legislation, there was much disagreement on how this policy was to be implemented.³⁸ The House passed its version of the Internet Tax Freedom Act³⁹ on June 23, 1998 without dissent.⁴⁰ The Senate's version of the legislation⁴¹ was approved by a vote of 96-2 on October 8, 1998.⁴² The heated debate and negotiation in the Senate before the Act's approval would prove very significant since the Senate's version of the bill would be adopted by the House in order to get the legislation passed before the end of the session. The final incarnation of the Act, identical to the Senate's version, includes a three-year moratorium⁴³ on many forms of possible Internet taxation, the prohibition of "discriminatory"⁴⁴ application of legal taxes, the creation of a Commission for the study of long-term tax policy,⁴⁵ and a Congressional mandate for executive negotiation of international compliance.⁴⁶

³⁷ Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World*, STATE TAX NOTES, Apr. 13, 1998, available in WL 98 STN 70-21.

³⁸ See, e.g., S. REP. NO. 105-184 (1998) (highlighting opposing viewpoints in the Senate discussion of S. 442).

³⁹ H.R. 4105, 105th Cong. (1998).

⁴⁰ *The Internet Tax Freedom Act Homepage* (visited Oct. 18, 1998) <<http://cox.house.gov/nettax>>.

⁴¹ S. 442, 105th Cong. (1998) (enacted).

⁴² *The Internet Tax Freedom Act Homepage*, *supra* note 40.

⁴³ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101, 112 Stat. 2681, 2681-719 (1998).

⁴⁴ Internet Tax Freedom Act § 1101(a)(2).

⁴⁵ Internet Tax Freedom Act § 1102.

⁴⁶ Internet Tax Freedom Act § 1203.

The major provision of the Act is the three-year moratorium placed on the imposition of certain forms of taxation of the Internet. This moratorium prohibits the imposition of the enumerated taxes for the period beginning on October 1, 1998 through October 21, 2001 (three years after the date of enactment).⁴⁷ The expressly prohibited taxes include "taxes on Internet access"⁴⁸ and "multiple or discriminatory taxes on electronic commerce."⁴⁹

The moratorium placed on taxation of "Internet access"⁵⁰ covers primarily the monthly fees paid to service providers such as America Online. Thus, states may not compel these types of Internet service providers to charge and collect for remittance to the state a tax on top of their monthly service charge. This provision also prohibits the implementation of "bit taxes," or taxes based upon a usage measurement, such as the amount of data exchanged.⁵¹ However, in one of the more contested issues surrounding the legislation, the Act provides a grandfather clause for taxes "generally imposed and actually enforced prior to October 1, 1998."⁵² This grandfather clause will allow the District of Columbia and the eleven states that already impose such a tax on Internet access to continue this practice.⁵³ The House version of the bill also contained a reenactment provision which would have required a state legislature to expressly ratify its intent to continue the tax under the federal legislation's grandfather clause.⁵⁴ Many state and local tax advocates declared that this ratification action on the part of any state politician would amount to political suicide, and predicted that the reenactment requirement would effectively eliminate any use of the Act's grandfather clause.⁵⁵ Others argued that the inclusion of a grandfather clause in any form was inconsistent with the basic policy underlying a moratorium.⁵⁶ The inclusion of the grandfather clause, without the House's

⁴⁷ Internet Tax Freedom Act § 1101(a).

⁴⁸ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(a)(1), 112 Stat. 2681, 2681-719 (1998).

⁴⁹ Internet Tax Freedom Act § 1101(a)(2).

⁵⁰ Internet Tax Freedom Act § 1101(a)(1).

⁵¹ Internet Tax Freedom Act § 1104(1).

⁵² Internet Tax Freedom Act § 1101(a)(1).

⁵³ Mazerov & Lav, *supra* note 31.

⁵⁴ H.R. 4105, 105th Cong. (1998).

⁵⁵ See Doug Sheppard, *Electronic Commerce Dominated Multistate Tax Issues in '98*, STATE TAX TODAY, Dec. 30, 1998, available in WL 98 STN 250-17 (quoting Gene Gavin, Connecticut Revenue Services Commissioner, who referred to the grandfather clause as a "dead man's clause").

⁵⁶ See Doug Sheppard, *Internet Legislation Becomes Law with Omnibus Appropriations Act*, TAX NOTES TODAY, Oct. 22, 1998, available in WL 98 TNT 204-6 (quoting Carol Cayo of Information Technology of America).

reenactment requirement, was a necessary compromise en route to the Act's passage in the Senate.⁵⁷

Upon closer inspection it is easy to see why this grandfather clause was such an important issue for many legislators. In addition to the District of Columbia, the states which had previously imposed some form of tax on Internet access included Colorado, Connecticut, Iowa, New Mexico, North Dakota, Ohio, South Carolina, South Dakota, Tennessee, Texas, and Wisconsin.⁵⁸ The effect on revenues that a prohibition of taxation of Internet access services could have for these states is alarming. The Congressional Budget Office had estimated that the annual loss of revenue for these twelve jurisdictions would be approximately \$50 million.⁵⁹ Others estimate that this figure is extremely conservative. One commentator has projected that by the year 2000, annual losses for these twelve states could actually approach \$500 million.⁶⁰ This figure takes into account the projected growth of Internet access services, whereas the Congressional Budget Office study was based solely upon current state revenues.⁶¹ These figures become even more startling when one considers that the twelve jurisdictions in this group comprise twenty percent of the United States' national economy.⁶²

Another important aspect of the moratorium is that it is to be applied prospectively, and does not affect previously incurred tax liabilities. The legislation provides that "[n]othing in this title affects liability for taxes accrued and enforced before the date of enactment of this Act, nor does this title affect ongoing litigation relating to such taxes."⁶³ This provision was included to prevent Internet service providers currently embroiled in litigation relating to state tax liabilities from claiming an exemption under the Act.⁶⁴ Senator Graham (D-FL) stated, "We wanted to make sure that the bill did not interrupt current litigation . . . the agreement to make the

⁵⁷ *Id.*

⁵⁸ Mazerov & Lav, *supra* note 31, § 46.

⁵⁹ *Id.* § 55.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* This figure is based on personal income statistics of the individual states in the group.

⁶³ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(c), 112 Stat. 2681, 2681-719 (1998).

⁶⁴ See *Electronic Commerce: Senate Clears Internet Taxation Bill; Focus Turns to Resolving Differences*, DAILY TAX REPORT, Oct. 9, 1998, available in WL 196 DTRG-3 (noting Sen. Graham's concern over situations like the one in Connecticut, where the State is involved in litigation with America Online over allegations of "millions in unremitted sales taxes").

moratorium on taxes on Web site access 'prospective' rather than 'retroactive' brought the various parties and interests into concurrence."⁶⁵ This grandfather clause was a major concession made for the benefit of state and local advocates, but is obviously of little or no value to the majority of states that had not previously enacted and enforced legislation of this type.

In addition to taxes on Internet access, the three-year moratorium also prohibits the imposition of "multiple or discriminatory taxes on electronic commerce."⁶⁶ This provision of the Act has the most significant effect in the context of state and local sales and use taxes. Prior to the enactment of the Internet Tax Freedom Act, there had been much uncertainty in regard to the way a sales transaction in cyberspace was to be treated for purposes of state and local sales and use taxes.⁶⁷ The problem is: When must a business that is soliciting and consummating sales of goods via the Internet be required to collect sales taxes for remittance to the state and local tax collectors? What if the company has its headquarters based in California, employs computer servers in multiple states, and the customer for a particular transaction is located in Tennessee? Many businesses currently absolve themselves of any legal duty to collect and remit these sales taxes to the numerous jurisdictions in which they conduct business based on the same legal precedents which relieve the mail-order industry of this burden. This protection for out-of-state sellers is based on the 1992 Supreme Court decision of *Quill Corp. v.*

⁶⁵ *Id.*

⁶⁶ Internet Tax Freedom Act § 1101(a)(2).

⁶⁷ Hereinafter the term "sales tax" will be used to refer to both the sales tax and the alternative use tax which many state taxing jurisdictions impose. A sales tax is the all-too-familiar four to nine percent that most people are accustomed to paying when they purchase retail items at a traditional physical-store business. It is comprised of a base level percentage that is levied by the state, supplemented by additional percentages imposed by the local governments. A use tax is essentially a substitute for a sales tax that cannot be collected because the goods have been purchased out-of-state. A use tax is levied on the purchase price of goods that are purchased out-of-state but are brought back into the state for use or consumption. The difference between these two taxes is subtle, as the use tax was designed to achieve the same result as the sales tax. A use tax would appear to resolve the discrepancy in competitive positions that remote sellers enjoy over in-state sellers, but this has not happened because the use tax is a self-assessed tax. Many taxpayers are not aware that they owe this tax when they purchase goods from an out-of-state seller for use in their home state, and unlike a sales tax which is "enforced" by the merchant at the point of sale, the use tax goes largely uncollected. The same legal principles that preclude a state from forcing an out-of-state seller from collecting and remitting a sales tax also preclude a legal duty to enforce a use tax. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (adopting a "substantial nexus" test for collection of taxes from mail-order houses).

North Dakota.⁶⁸ In *Quill Corp.*, the Court held that the Commerce Clause⁶⁹ exempted mail-order houses from a duty to collect sales taxes absent a "substantial nexus"⁷⁰ with the taxing jurisdiction. The holding of the Court extended further to indicate that a physical presence was necessary within the jurisdiction to satisfy the "substantial nexus" standard.⁷¹ Based on a cursory review of this analysis, Internet-based businesses have a strong argument to forego the collection of state and local sales taxes in jurisdictions where they do not have a physical presence.

Taking this position under *Quill Corp.* is not without risks for a company engaged in Internet commerce. Prior to the Internet Tax Freedom Act, the extent of protection offered by the analogy to mail-order businesses was uncertain. The holding in *Quill Corp.* does not explicitly lay out what will be sufficient to constitute "physical presence."⁷² Since Internet transactions, and the technology that is employed to facilitate them, are markedly different from the mail-order business, the *Quill Corp.* defense is not impenetrable when invoked by electronic commerce participants. One commentator stated: "The [*Quill Corp.*] Court, however, did not explain how substantial a vendor's presence must be in the taxing state to satisfy the "substantial nexus" requirement. Consequently, *Quill Corp.* provides limited guidance for Internet activity, and its application to cyberspace is just beginning."⁷³

Various aspects of electronic commerce raise uncertainties in determining when a business could be found to have physical presence within a jurisdiction, and thus a legal obligation to collect sales taxes on transactions with customers located within that jurisdiction. Based on these uncertainties, a cautious business might want to collect the tax in spite of the *Quill Corp.* holding in order to prevent a subsequent determination that the

⁶⁸ 504 U.S. 298 (1992).

⁶⁹ U.S. CONST. art. I, § 8, cl. 3.

⁷⁰ 504 U.S. at 313.

⁷¹ *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

⁷² *Id.* at 317.

⁷³ Prebut, *supra* note 21.

taxes were owed⁷⁴ and would have to come from the funds of the business and not the customer.

The uncertainty is caused by the ambiguity of the term “physical presence”⁷⁵ and the fragmented nature of the technology that drives the Internet. For example, could a computer server located within a state constitute physical presence, and thus an obligation to collect sales taxes? At least one state, Texas, has attempted to thrust nexus on out-of-state sellers by employing this theory. The State has taken the position that any Internet service provider locating a computer server and related equipment within the state has a sufficient nexus for tax purposes.⁷⁶ Additionally, the State has held that a business that maintains a website through an Internet service provider who uses a server located in Texas also has nexus for tax purposes.⁷⁷ The rationale is that the company is “using the ISP [Internet service provider] and the Web site as its representative to establish a market in Texas.”⁷⁸ One commentator notes that this definition of physical presence “tread[s] the perilous ground between ‘slightest presence’ and ‘substantial nexus.’”⁷⁹ This nexus analysis becomes even more complicated when one considers that “a Web site can be ‘moved’ from one server to another server in a different state with a few keystrokes.”⁸⁰ This would allow a Web site to establish nexus for tax purposes in multiple states in a single day!

One of the first major controversies resulting from the uncertainty of the “substantial nexus”⁸¹ principle as applied to Internet-related business arose

⁷⁴ These uncertainties of when a legal obligation could be imposed to collect sales taxes have also fostered a discourse between business and state tax representatives with the goal of achieving stability and predictability of the law that would benefit both parties. Some critics of the Internet Tax Freedom Act have made the argument that the legislation will actually create a disincentive for businesses to participate earnestly in these progressive discussions since they will expressly be given the same protection afforded to mail-order businesses. See Mazerov & Lav, *supra* note 31 (regarding state and local opposition arguments).

⁷⁵ See *Quill Corp.*, 504 U.S. at 317 (defining “physical presence”).

⁷⁶ See Wade Anderson, *Care and Feeding of the Internet*, STATE TAX NOTES, May 13, 1997, available in WL 97 STN 92-35 (stating, as director of tax policy for the Comptroller of Public Accounts, “Texas is a leader in taxing services surrounding the Internet”). Virginia has apparently taken a similar position regarding the creation of a nexus through owned or leased property that is located within the state and that is essential to the taxpayer’s core business activity. See Priv. Ltr. Rul. PD 97-306 (July 18, 1997)(Va. Dept. Tax) available in WL 97 STN 214-23.

⁷⁷ Anderson, *supra* note 76.

⁷⁸ Cowling & Ferris, *supra* note 14.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Quill Corp. v. North Dakota*, 504 U.S. 298, 299 (1992).

between Connecticut and America Online, Inc.⁸² The state alleges that America Online owes in excess of \$2 million in uncollected sales taxes on the subscription fees paid by Connecticut members.⁸³ America Online has taken the position that under the *Quill Corp.* standard of “substantial nexus,”⁸⁴ it cannot be constitutionally required to collect these taxes. The State alleges that the company is required to collect the sales taxes on these service fees due to the physical presence of the company’s modems throughout the state. To complicate matters, it appears that America Online is arguing that it does not even own the modems, but rather, is leasing them from a third party.⁸⁵ Indeed, it appears that the company has taken this same position in all states that have enacted sales taxes on Internet service fees.⁸⁶ As discussed earlier, under the “Liabilities and Pending Cases” provision of the Act, ongoing litigation will not be affected.⁸⁷ However, the legislation will protect America Online from future litigation based on this theory of physical presence and nexus via modems or other “points of presence.”⁸⁸

While these types of “strained interpretations of nexus” were one of the major motivations behind the Internet Tax Freedom Act,⁸⁹ some tax administrators argue that prohibiting the states from employing them is unjustified.⁹⁰ It was pointed out that:

[v]aluable Internet-related equipment is enjoying the benefits of state and local government services (e.g., police and fire protection) just as surely as [other

⁸² *America Online, Inc. v. Gavin, Comm’r of Revenue Services* (Super. Ct. Tax Session Judicial Dist. of Hartford/New Britain 1997) (CV97-0571869S).

⁸³ *Id.* The \$2 million assessment also consists of allegedly unpaid use taxes due on the value of the company’s modems that are located throughout the state.

⁸⁴ 504 U.S. at 311-313.

⁸⁵ See *Mazero & Lav, supra* note 31 (noting that America Online’s ownership of the modem is in dispute).

⁸⁶ See *id.* (pointing out that the company’s standard “Terms of Service Agreement” states: “[Billed] rates do not include any sales, use, value-added, personal property, or other governmental tax or levy imposed on goods or services billed to Member’s account. The customer is responsible for any such taxes”).

⁸⁷ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(c), 112 Stat. 2681, 2681-719 (1998).

⁸⁸ This term refers to minimal physical presence within a jurisdiction in the form of servers, modems, or related communications equipment.

⁸⁹ See *The Internet Tax Freedom Act Homepage* (visited Oct. 18, 1998) <<http://cox.house.gov/nettax>>.

⁹⁰ See *Mazero & Lav, supra* note 31 (arguing that Internet equipment is served by government services).

forms of accepted physical presence]. There is no reason why federal legislation should limit a state's taxing jurisdiction over a business that has consciously established a physical presence within its borders.⁹¹

While this argument is logical, it apparently fails to consider how many taxing jurisdictions would be granted taxing authority over out-of-state sellers under this "slightest presence" definition. The avoidance of this heavy administrative burden upon Internet commerce is a fundamental policy objective of the legislation.

The inclusion of the provision prohibiting "multiple or discriminatory taxes"⁹² coupled with an understanding of its purpose from congressional debate confirms the extension of the "substantial nexus" protection to Internet businesses.⁹³ The prohibition on "discriminatory taxes"⁹⁴ is meant to ensure that Internet transactions are afforded the same Commerce Clause protections as other remote sellers, effectively exempting them from sales and use tax collection.⁹⁵ Co-sponsor of the bill Rep. Christopher Cox (R-Col.) summarized the effect of the legislation as a protective measure ensuring equal treatment of Internet transactions with other remote-sale transactions, such as mail-order catalog transactions, by precluding the "application of discriminatory tax collection requirements imposed on out-of-state businesses through strained interpretations of 'nexus'."⁹⁶

This aspect of the legislation was assailed by state and local jurisdiction advocates as another strike against the protection of local "main street" businesses. Many Democratic legislators argued that "Congress should not compound the injury catalogue sales inflict on state tax bases by also exempting the Internet taxation."⁹⁷ Others argued that the loss of such

⁹¹ *Id.*

⁹² Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(a)(2), 112 Stat. 2681, 2681-719 (1998).

⁹³ Section 1104(2)(B) of the Internet Tax Freedom Act defines "discriminatory tax" to include taxes based on nexus standards that are less than "substantial." Internet Tax Freedom Act § 1104(2)(B).

⁹⁴ Internet Tax Freedom Act § 1101(a)(2).

⁹⁵ Except in jurisdictions where the business does have a physical presence, such as its offices, etc. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (stating that those who conduct activity within a state are receiving the benefits of services from that state).

⁹⁶ *The Internet Tax Freedom Act Homepage* (visited Oct. 18, 1998) <<http://cox.house.gov/nettax>>.

⁹⁷ *Electronic Commerce: Internet Tax Bill Moves Closer to Passage as Senate Tables Remote Sales Amendment*, DAILY TAX REPORT, Oct. 5, 1998, available in WL 192 DTR G-2.

substantial tax revenues that could otherwise be collected if not for this sales tax “loophole” essentially amounted to an “unfunded mandate.”⁹⁸ The contrary position argued that any amendment to the legislation allowing such a tax on Internet transactions “would merely create a new tax.”⁹⁹ Senator Ron Wyden (D-Or.), co-sponsor of the act, argued:

I think that it would be a mistake to let each state have its own sales tax on the Internet. What the debate is all about is that some states believe that because they can't collect on mail-order today, they want to go out and collect taxes with respect to the Internet because they see the Internet as the cash cow.¹⁰⁰

The attempt by advocates of state governments to preclude Internet transactions from obtaining the same protection as mail-order transactions failed,¹⁰¹ but state and local tax interests did win a victory with the inclusion of all remote-sales transactions being reviewed within the scope of the special Commission's report to Congress.¹⁰²

The Act also provides for the creation of the “Advisory Commission on Electronic Commerce”¹⁰³ (the Commission). The Commission will have the duty of conducting 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.”¹⁰⁴ The Commission's primary purpose will be to examine “model State legislation” that “would ensure that Internet access services, online services, and communications and transactions using the Internet, Internet access service, or online services would be treated in a tax and technologically neutral manner relative to other forms of remote

⁹⁸ See Doug Sheppard, *Senate Votes Against Collection of Sales Taxes on Remote Commerce*, STATE TAX TODAY, Oct. 6, 1998, available in WL 98 STN 193-26 (quoting Senator Bumpers of Arkansas).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² Internet Tax Freedom Act, Pub. L. No. 105-277, § 1102(g)(2)(E), 112 Stat. 2681, 2681-719 (1998).

¹⁰³ Internet Tax Freedom Act § 1102(a).

¹⁰⁴ Internet Tax Freedom Act § 1102(g)(1).

sales. . . ."¹⁰⁵ The Commission will then have a period of eighteen months to issue a report to Congress which includes "legislative recommendations"¹⁰⁶ of the most fair and efficient means to tax the Internet, if at all. The Commission is to be terminated eighteen months following the enactment of the legislation.¹⁰⁷

Advocates of state and local interests won a hard-fought battle over the expansion of the investigative scope of the Commission, which includes a study of the effects of taxation of all interstate remote-sales transactions and not just Internet transactions.¹⁰⁸ The scope of the Commission's study will thus include a reconsideration of the "substantial nexus" standard of *Quill Corp.*¹⁰⁹ as applied to the mail-order business and could potentially lead to a change in policy. Many felt that the inclusion of this issue in the study was the most significant victory for state and local taxation interests¹¹⁰ and that this was one issue which mail-order businesses would have been quite content to leave undisturbed.¹¹¹ This aspect of the legislation creates a fair compromise between state and local tax authorities and all forms of remote sellers. The states will be prohibited from taxing sales by Internet merchants for the period of the moratorium in the same manner that they have been precluded from imposing the tax on mail-order businesses. However, there is now the possibility, based on the findings and proposals of the Commission, that at the end of the three-year period, both mail-order businesses and Internet merchants could be brought within the sales tax regime. Considering the expanded scope of the Commission's investigation, the composition of the Commission membership took on greater significance.

The Commission will be comprised of nineteen members who will serve for the duration of its existence.¹¹² Of these nineteen members, three will be representatives of the Federal Government,¹¹³ eight will be representatives

¹⁰⁵ Internet Tax Freedom Act § 1102(g)(2)(D)(ii).

¹⁰⁶ Internet Tax Freedom Act § 1103.

¹⁰⁷ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1102(e), 112 Stat. 2681, 2681-719 (1998).

¹⁰⁸ Internet Tax Freedom Act § 1102(g)(2)(E).

¹⁰⁹ 504 U.S. at 312.

¹¹⁰ See, e.g., Sheppard, *supra* note 56 (discussing Internet legislation in the Omnibus Appropriations Act).

¹¹¹ *Id.* ("Direct Marketing Association [DMA] waged a major battle in the Senate to defeat [the expanded scope of the study].").

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

¹¹³ Internet Tax Freedom Act § 1102(b)(1)(A).

from state and local governments,¹¹⁴ and eight will be representatives of the electronic commerce industry, including small businesses, telecommunications carriers, local retail businesses, and consumer groups.¹¹⁵ Of the eight representatives of state and local governments, one must represent a jurisdiction that does not impose a sales tax and one must represent a jurisdiction that does not impose an income tax.¹¹⁶ Early versions of the legislation sparked concerns by state and local advocates that a lack of membership diversity could lead to a one-sided investigation.¹¹⁷ The diverse composition of the Commission is the result of much negotiation, and is designed to provide a balanced investigation and discussion of the policy issues involved with Internet and other remote sales transactions. No findings or recommendations may be included in the report to Congress without a two-thirds approval by the members of the Commission.¹¹⁸

The legislation also includes a provision indicating a Congressional policy that the Internet tax protection should extend outside of the borders of the United States. This international "hands off" policy is included in the "Declaration" of section 1203.¹¹⁹ This provision "directs the President"¹²⁰ to seek consensus with other nations to keep the Internet free of "foreign tariffs, trade barriers, and other restrictions."¹²¹ The Act states that it is the "sense of Congress that the President should seek bilateral, regional, and multilateral agreements" with foreign jurisdictions through certain organizations, such as the World Trade Organization.¹²² Through these agreements with foreign nations, the Act intends to protect Internet activity

¹¹⁴ Internet Tax Freedom Act § 1102(b)(1)(B).

¹¹⁵ Internet Tax Freedom Act § 1102(b)(1)(C).

¹¹⁶ Internet Tax Freedom Act § 1102(b)(1)(B).

¹¹⁷ See, e.g., Doug Sheppard, *Colorado Home-Rule Cities Question U.S. Internet Legislation*, STATE TAX NOTES, Sept. 3, 1998, available in WL 98 STN 171-1 (quoting Geoff Wilson, general counsel for the Colorado Municipal League, on the Senate Finance version: "It's very possible the commissions in the bills will be a complete farce because of the lack of Main Street representatives and the way local government representatives are appointed.").

¹¹⁸ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1103, 112 Stat. 2681, 2681-719 (1998).

¹¹⁹ Internet Tax Freedom Act § 1203.

¹²⁰ *Senator Wyden's Outline of 'Cybertax Problems' at Finance Hearing on Internet Taxation*, STATE TAX NOTES, July 21, 1998, available in WL 98 STN 139-41.

¹²¹ Internet Tax Freedom Act § 1203.

¹²² Internet Tax Freedom Act § 1203(a). This portion of the Act also indicates the potential to work with other international organizations such as the Organization for Economic Cooperation and Development, the TransAtlantic Economic Partnership, the Asia Pacific Economic Cooperation forum, the Free Trade Area of America, the North American Free Trade Agreement, and "other appropriate venues."

from the same types of discriminatory taxes which are prohibited domestically¹²³ and to further “accelerate the growth of electronic commerce”¹²⁴ The United States has been successful in negotiating other forms of tax treaties, and currently has income tax treaties with forty-eight foreign countries.¹²⁵ However, the problems that will be encountered in reaching agreements with foreign authorities due to the nebulous structure of the Internet can already be predicted based on the difficulties in applying these established income tax treaties to Internet commerce.

The operation of business over the Internet has already created much uncertainty in the area of established income tax law. In accordance with the aforementioned international tax treaties, the United States government taxes only that income of foreign individuals or corporations which is allocable to a “permanent establishment” or “fixed base” located within its borders.¹²⁶ Applying these rules to the nebulous world of cyberspace creates obvious problems. A foreign company can conduct business operations in the United States without anything more than the use of phone lines. A foreign business need not maintain a “permanent establishment” or any other “fixed base” within the borders of the United States to reap the benefits of sales to customers located there.¹²⁷ Indeed, it appears that electronic commerce could cause these international tax laws to become obsolete as foreign businesses use the Internet to avoid income taxation in other countries like the United States.¹²⁸ These problems, which are encountered in the application of the international income tax treaties, merely serve to indicate the level of difficulty that will be met in attempting to devise and implement other international tax agreements.¹²⁹

¹²³ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1203(b)(1)(A)-(C), 112 Stat. 2681, 2681-719 (1998).

¹²⁴ Internet Tax Freedom Act § 1203(b)(2).

¹²⁵ Walter Hellerstein, *Telecommunications and Electronic Commerce: Overview and Appraisal*, STATE TAX NOTES, Feb. 25, 1997, ¶ 17, available in WL 97 STN 37-43.

¹²⁶ Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce*, Nov. 1996, available in WL 97 STN 54-48, reprinted in STATE TAX NOTES, Mar. 20, 1997.

¹²⁷ Hellerstein, *supra* note 125.

¹²⁸ See *id.* (stating that foreign electronic commerce may escape taxation because of a lack of “permanent establishment” in the United States).

¹²⁹ For example, in addition to the taxation of income from electronic commerce, there must be agreements that govern sales and use taxes and the limitless other forms of taxes which may be levied by revenue-eager jurisdictions throughout the world.

The level of anticipated success with these foreign agreements is dubious, as stated by Sen. Wyden, one of the sponsors of the legislation:

[o]ne can never underestimate the desire of some politicians, in the United States and abroad, to invent new ways to tax, and our approach has run up against some powerful opposition. Although the bill specifically and surgically targets the moratorium on only those taxes which are not technologically neutral, some politicians just can't keep their hands off the Internet.¹³⁰

Therefore, legislators may receive the same objections to the moratorium from international jurisdictions as those presented by domestic state and local jurisdictions.

B. THE STATE AND LOCAL POSITION

The effect of the Internet Tax Freedom Act on state sovereignty cannot be underscored enough. All but eleven states are unable to utilize the grandfather provision of the Act and are therefore preempted from imposing virtually any taxes on potentially huge revenue-producing activities for the next three years.¹³¹ The potential effects of the moratorium and resulting policy decisions are not limited to this time period but will change the structure of state and local tax regimes well into the future. State and local interest advocates have objected to the legislation on the constitutional grounds of state sovereignty and autonomy. They have argued that the Act will cause an erosion of tax revenues. In contrast, opponents have argued that the legislation creates the possibility of a permanent moratorium on Internet taxes, and if not, that the Act merely defers discussion of the issue because it will arise again at the end of the moratorium.

The first argument of opposition to the legislation centers around the constitutionality of the federal congressional action. The power by which Congress justifies the legislation is found in those enumerated by the

¹³⁰ Senator Wyden's Outline of 'Cybertax Problems' at Finance Hearing on Internet Taxation, STATE TAX NOTES, July 21, 1998, available in WL 98 STN 139-41.

¹³¹ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(a), 112 Stat. 2681, 2681-719 (1998).

Constitution, including the power “to regulate commerce among the several states,”¹³² commonly known as the commerce power. The commerce power gives Congress the right to regulate interstate commerce whenever it deems necessary and especially when there is “a complete lack of uniformity and certainty regarding state and local taxation of [an interstate commercial activity].”¹³³ Clearly, the Congress appreciated the competing interests at stake, as one commentator stated:

[t]he stakes in this battle seem high: the need to facilitate the growth of Internet technology and to support the international competitiveness of American technology industries on the one hand, and the need to preserve state and local tax revenues in the face of dramatic changes in the means of conducting business that render many current tax schemes ineffective or unworkable on the other.¹³⁴

The magnitude of the competing national and local interests appears to indicate a clear-cut situation where federal government intervention is warranted. Yet, opponents have assailed the legislation as “an affront to federalism.”¹³⁵ This argument is based on the fact that the development of state and local tax policy has historically, under the American federalist system, been left largely to the states themselves:

[t]he exercise of tax policy is among the important areas where the states have substantial sovereignty. Subject only to very general limits having to do primarily with due process and with interstate and foreign commerce, the states have essentially

¹³² U.S. CONST. art. I, § 8, cl. 3.

¹³³ Kendall L. Houghton, *The Internet Tax Freedom Act and the Control of Electronic Commerce Tax Policy*, 2 No. 7 ELECTRONIC BANKING L. & COM. REP. 6, available in WL 2 No. 7 GLEBLCR 6 (1998).

¹³⁴ *Id.*

¹³⁵ Sheppard, *supra* note 117 (quoting Geoff Wilson, general counsel for the Colorado Municipal League).

unlimited power to levy whatever taxes they wish and administer them as they see fit.¹³⁶

The exercise of federal power to preclude states from establishing their own tax policies that they implement and administer could, some argue, effectively make the states "wards" of the federal government.¹³⁷ This argument reasons that the elimination of sovereignty in this area would cause the states to become reliant upon "revenue sharing funds" which would basically be grants from the federal government.¹³⁸ This is the very type of unintentional consequence that some fear could be brought about by Congress' attempt to legislate in a field of law, namely state and local tax, with which it has "relative unfamiliarity."¹³⁹

The drafters of the Act recognized the possibility, however remote, of a constitutional challenge. This is evidenced by the inclusion of a severability provision in the legislation.¹⁴⁰ Due to the broad interpretation of the federal government's power under Commerce Clause jurisprudence, a state's objection to the legislation on constitutional grounds would likely prove ineffective.¹⁴¹

¹³⁶ McLure, Jr., *supra* note 35. The author makes an interesting point regarding the collateral benefit of "tax competition" which results from this high level of state and local sovereignty. Since the states may set their own level of taxing and spending, taxpayers can choose their locations and avoid those jurisdictions that levy taxes on producers that are disproportionate to the benefits received from public services.

¹³⁷ McLure, Jr., *supra* note 37.

¹³⁸ *Id.*

¹³⁹ *Hellerstein Urges Caution in Consideration of Internet Tax Freedom Act*, STATE TAX NOTES, July 24, 1997, available in WL 97 STN 142-6 (reprinting portions of the testimony of Walter Hellerstein on H.R. 1054 before the Subcommittee on Commercial and Administrative Law).

¹⁴⁰ Section 1206 of the Internet Tax Freedom Act reads:

If any provision of this title, or any amendment made by this title, or the application of that provision to any person or circumstance, is held by a court of competent jurisdiction to violate any provision of the Constitution of the United States, then the other provisions of that title, and the application of that provision to other persons and circumstances, shall not be affected.

Internet Tax Freedom Act, Pub. L. No. 105-277, § 1206, 112 Stat. 2681, 2681-719 (1998).

¹⁴¹ See Hellerstein, *supra* note 25 (noting Professor Hellerstein's comments regarding the constitutionality of a possible federal uniform legislative plan that would be "thrust upon unwilling states":

Because it has plenary power over the channels of interstate commerce, "Congress may keep the way open, confine it broadly or closely, or close it entirely," subject only to the limitations that the Constitution imposes on Congress's own power. Because the legislation under consideration

The most ardent opposition to the legislation is rooted in the potential effect that it could have on state and local tax revenues. This concern stems from two premises. First, some believe that the legislation will create a tax advantage for Internet goods and services, rather than putting them on the same terms as traditional methods of commerce, and will thereby lower sales tax revenues. Second, some predict that the legislation could also eliminate the collection of other currently enforceable taxes, such as certain use taxes.

The first prediction is, at least during the short-term period of the three-year moratorium, almost certain to occur to some extent. Local businesses that have physical presence within a state will still be required to impose sales taxes, which will put them at a competitive disadvantage. Any effect beyond this point will depend upon the results of the Commission's study and on the development of a long-term tax policy for the Internet and for other remote sellers. During this period of competitive disadvantage, there is likely to be a "siphon" of sales away from community "main street" businesses and, thus, a decrease in sales tax revenues for state and local governments.¹⁴² This could create a major problem for many state and local governments that rely upon the sales tax for a substantial portion of their revenues, which in turn fund important programs such as education.¹⁴³ The possibility that this congressionally-created competitive advantage for Internet commerce could lead to "the death of the sales tax as the primary revenue source for the states" is a compelling argument against any preferential treatment.¹⁴⁴ On the other hand, it could simply indicate that the time has come for an overhaul of state and local tax structures.

indisputably has a substantial effect on interstate commerce, there can be no serious question of any Commerce Clause bar to such legislation)

(quoting *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 434 (1946)).

¹⁴² Bonnett, *supra* note 8.

¹⁴³ See Statement of Sen. Bob Graham:

[T]here is really a larger issue at stake here Many of our States, including my own, are heavily dependent upon the sales tax as the means for financing their basic responsibilities, and the most basic responsibility of State government is education. In my State, some 35 to 40 percent of its tax collections, which are predominantly sales tax, are used to finance education.

Congressional Record: Motion to Proceed on Internet Tax Freedom Bill Halted, STATE TAX TODAY, Oct. 8, 1998, available in WL 98 STN 195-31.

¹⁴⁴ Bonnett, *supra* note 8.

The uncollectability of remaining legal taxes is the second premise invoked to support the conclusion that this legislation will cause a drop in state and local tax revenues. This argument is more speculative. The argument under this point is bifurcated: First, companies involved in electronic-type commerce will find ways to avoid paying taxes that should still be enforceable notwithstanding the Internet Tax Freedom Act. Second, businesses that were not intended to receive any protection from taxation under the Act will maneuver to position themselves within the protective ambit of the legislation.

State and local advocates fear that this legislation could give Internet businesses a sustainable argument for the avoidance of many taxes that were not intended to be excluded by the Act. This concern is based on the apparent vague wording of the statute and could prompt "lawyers for Internet businesses [to] scrutinize the law looking for every possible justification it would hold to cease paying a tax or to challenge state and local taxes for which such businesses are currently liable."¹⁴⁵ The prospect of increased litigation in order to stretch the limits of the legislation is not implausible when anticipated tax savings appear to make this a cost-effective strategy. Indeed, this scenario has been played out as a result of similar past legislation.¹⁴⁶ Employing this strategy, Internet businesses could immediately cease to comply with any state or local tax assessment that might be invalidated under the Act.¹⁴⁷ The burden would then shift to the taxing authorities to detect the noncompliance and to present a successful argument to a court as to why this tax is preserved under the Act.¹⁴⁸ This could, in turn, defeat the goal of uniformity among states, resulting in different courts making different determinations as to those taxes that are preserved under the Act and those that are not.¹⁴⁹

There is also concern that other businesses that were not originally intended to be included within the protection of the legislation will position

¹⁴⁵ Mazerov & Lav, *supra* note 31.

¹⁴⁶ See, e.g., *id.* (discussing the Railroad Revitalization and Regulatory Reform Act of 1976, which similarly prohibited certain forms of state and local taxation of railroads. Once the legislation was enacted, the industry apparently reneged on certain promises not to challenge the validity of other taxes under the Act and succeeded in obtaining judicial invalidation of some of these taxes which, according to the legislation's history, were intended to remain intact).

¹⁴⁷ Mazerov & Lav, *supra* note 31.

¹⁴⁸ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(b), 112 Stat. 2681, 2681-719 (1998) (providing preservation of state and local taxing authority).

¹⁴⁹ Mazerov & Lav, *supra* note 31.

themselves so as to fall within its scope. This concern is centered primarily on the increasing merger between Internet access and telephone services. Telephone services are becoming increasingly more available over the Internet. Some predict that greater than one-third of all telephone calls could be routed through the Internet by the year 2002.¹⁵⁰ This could arguably fall within the prohibition of "taxes on Internet access,"¹⁵¹ and lead to large revenue losses for state and local governments. This exemption of telephone services from taxation could result, even in spite of the legislation's intention to leave telecommunications taxes alone.¹⁵²

Supporters of the federal legislation counter that the long-term effects of the Act will actually be beneficial for state and local tax revenues. First, online businesses will be subject to all the same taxes that conventional businesses are, since the former will have a physical presence somewhere.¹⁵³ Proponents of the legislation speculate that the resulting increases in Internet commerce will increase revenues from the income taxation of those electronic businesses.¹⁵⁴ Also, nothing would prevent the "Main Street" businesses from going online and boosting their own sales and taxable income.¹⁵⁵ The possibility also exists that the protection offered to electronic commerce could actually allow the local business to be more competitive. As one legislator noted: "Having the ability to reach millions of new customers through a few computer clicks gives a small town shopkeeper the chance to compete against the giant superstore chain at the edge of town and across the globe."¹⁵⁶ At least a few states have found this rationale persuasive. In 1998, before the passage of the federal Internet Tax Freedom Act, both

¹⁵⁰ *Id.*

¹⁵¹ Internet Tax Freedom Act § 1101(a)(1).

¹⁵² Section 1102(g)(3) of the Internet Tax Freedom Act does purport to exclude telecommunications taxes from the moratorium, but as "Internet access" and telephone services become increasingly less distinguishable, the attempt to exempt the former while continuing to tax the latter may become unworkable. See Mazerov & Lav, *supra* note 31.

¹⁵³ Physical presence is necessary, under the Supreme Court's analysis in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), to subject a business to a jurisdiction's sales tax requirements. Internet businesses are obviously subject to the same income taxes, property taxes, and business license requirements as conventional businesses.

¹⁵⁴ Senator Wyden's Outline of 'Cybertax Problems' at Finance Hearing on Internet Taxation, *supra* note 2.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

California¹⁵⁷ and Colorado¹⁵⁸ passed state legislation similar to the federal act. Other states, including New York and New Jersey, have also limited taxation of certain Internet services and transactions through executive orders by state tax officials.¹⁵⁹ Clearly then, not all state and local governments perceive the limitations of Internet taxation as inimical to their revenue interests.

State and local interests also fear the possibility that the moratorium on Internet taxation could become permanent. This fear is based upon two arguments. First, critics suggest that the legislation has actually removed industry incentives to negotiate a long-term arrangement with state tax authorities. Second, the opposition proposes that after three years of tax immunity, the Internet industry will be very reluctant to forego its favorable tax treatment.

The Act is likely to remove, or at least defer, much of the motivation and incentive that Internet businesses have to negotiate a current solution with states regarding the collection of sales taxes. Prior to this legislation, Internet businesses were using the *Quill Corp.*¹⁶⁰ standard to absolve themselves of any obligation to collect state sales taxes. However, since many aspects of Internet operations are distinguishable from those of mail-order houses,¹⁶¹ this defense has not been established as impenetrable. In order to avoid the potentially huge liabilities resulting from a subsequent determination of historical sales taxes due, many businesses were showing a willingness to come to the bargaining table.¹⁶² The potential appeared to exist for an agreement whereby Internet merchants would agree to collect state sales taxes if the states agreed to simplify their tax schemes and make them more uniform across state lines.¹⁶³ This legislation, however, appears to make the prospect of an agreement, at least for the next three years, unlikely. The Internet Tax Freedom Act ostensibly fortifies the *Quill Corp.* protection for

¹⁵⁷ 1998 Cal. Legis. Serv. 351 (West).

¹⁵⁸ 1998 Colo. Legis. Serv. 210 (West).

¹⁵⁹ Kathleen K. Wright, 'States of Mind' [sic]: Logging onto the New Tax World: California Passes Its Internet Tax Freedom Act, STATE TAX NOTES, Sept. 16, 1998, available in WL 98 STN 179-3.

¹⁶⁰ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

¹⁶¹ Mail-order business was the subject upon which the *Quill Corp.* decision was rendered. See *supra* text accompanying notes 68, 73.

¹⁶² Mazerov & Lav, *supra* note 31.

¹⁶³ *Id.*

Internet businesses to equal that level provided to mail-order businesses.¹⁶⁴ In reality, it is difficult to imagine that Internet companies will find such a resolution a pressing concern during the next three years when they are guaranteed tax immunity.

A possibility exists that after three years of tax freedom, taking this benefit away from the unwilling industry will be difficult. The argument notes that during this three-year period, businesses are likely to become entrenched after designing costly systems for billing and online purchasing that are not equipped to include sales taxes.¹⁶⁵ This long period of immunity from taxation will likely lead to an ardent effort on the part of the Internet industry to make the moratorium permanent.¹⁶⁶

C. DISCRIMINATORY BENEFITS FOR THE AFFLUENT?

Another interesting argument presented by the opposition alleges that to a large extent, the benefits of suspending Internet taxation accrue to the wealthy. This position is based on statistics noting the correlation between Internet use and average annual income.¹⁶⁷ These studies indicate that the discrepancy between percentages of higher-income and lower-income households that utilize the Internet is increasing.¹⁶⁸ One study has indicated that the percentage of households that have online service for the \$10,000 to \$14,999 annual income bracket is 4.9 percent, as compared to 32.4 percent of all households in the \$50,000 to \$74,999 annual income bracket.¹⁶⁹ Another report showed that the average annual income of those making

¹⁶⁴ See *supra* text accompanying notes 68, 73 (discussing the "substantial nexus" test and its relation to Internet sales).

¹⁶⁵ Mazerov and Lav, *supra* note 31.

¹⁶⁶ Support for this proposition is found in the example of the now infamous "Public Law 86-272." Public Law 86-272 is legislation that was passed by Congress in 1959 with the purpose of placing a temporary moratorium on the imposition of state corporate income taxes on out-of-state corporations. This legislation is still "on the books," and many argue that it created a situation where many corporate taxpayers spent more resources trying to take advantage of the law as opposed to negotiating a long-term settlement with states. See Mazerov & Lav, *supra* note 31.

¹⁶⁷ See Doug Sheppard, 'Digital Divide' Has Expanded, NITA Study Finds, STATE TAX NOTES, Sept. 9, 1998, available in WL 98 STN 174-30.

¹⁶⁸ *Id.* (citing study which indicated that "the difference in PC-ownership levels between households earning \$10,000-\$14,000 and those earning \$50,000-\$74,999 was 47.7 percentage points in 1997, up from 38.2 percentage points in 1994") (quoting James W. McConnaughey & Wendy Lader, *Falling Through the Net II: New Data on the Digital Divide By National Telecommunications and Information Administration* <<http://www.ntia.doc.gov/intiahome/net2/falling.html>>).

¹⁶⁹ Sheppard, *supra* note 167.

Internet purchases to be \$76,000 for men and \$60,000 for women.¹⁷⁰ As one researcher has summarized: "The ticket to benefiting from the Act is logging on the Internet."¹⁷¹

The prohibition of taxes on Internet access and related goods and services transactions could, in effect, create a regressive tax structure. Technically, the sales tax is already a regressive tax. A regressive tax structure, in theory, causes the effect of tax on income to rise as the income of the taxpayer *decreases*. In contrast, a progressive tax structure causes the tax rate applied to *increase* as taxable income increases. The United States federal income tax is such a progressive tax. Many critics agree that a regressive structure is *per se* bad tax policy.¹⁷²

The argument here is that a harmful regressive structure will be created (or compounded) when lower-income taxpayers are forced to bear the brunt of state sales taxes due to the high percentage of income allocated to necessary items of consumption.¹⁷³ Since these lower-income groups will not possess the wherewithal to access the Internet and to avoid such sales taxes by purchasing online, more of their income will be spent on these taxes while more affluent individuals avoid the tax by buying over the Internet.¹⁷⁴ The adverse effect on low-income households will be compounded when the decrease in crucial sales tax revenues causes sales tax rates to increase to compensate for these losses. To take the argument to its logical extreme, the loss of revenues would then have an adverse effect on the amount and quality of public services, upon which low-income individuals are traditionally most reliant.¹⁷⁵

While this argument is susceptible to attack as an unlikely and extreme extrapolation of potential effects, it is not completely implausible. While in the long-term Internet access will become cheaper and, therefore, more available to lower-income individuals, the conclusion that low-income consumers will be adversely affected is based on the reality that many state tax structures will continue to be anchored by sales tax revenues, at least in the short-term. If the Internet provides a sales tax shelter for the affluent, the

¹⁷⁰ Mazerov & Lav, *supra* note 31.

¹⁷¹ Sheppard, *supra* note 167 (quoting Michael Mazerov of the Center on Budget and Policy Priorities (CBPP)).

¹⁷² See, e.g., McLure, Jr., *supra* note 35.

¹⁷³ See *id.*

¹⁷⁴ See Mazerov & Lav, *supra* note 31.

¹⁷⁵ See *id.*

poor will be left with the burden unless a plan is devised either to level the playing field between "main street" and remote (Internet as well as mail-order) sellers of goods, or to shift state tax systems away from the reliance upon sales taxes. The development of a long-term plan for taxation of electronic commerce is a necessity. At this point in time, it is difficult to predict whether the Internet Tax Freedom Act will foster an environment where such a plan can successfully be devised, or whether it will remove all incentives for businesses to even negotiate in good faith, potentially to the detriment of lower-income individuals.

III. CONCLUSION

The passage of the Internet Tax Freedom Act merely marks the beginning of a period of intense policy study and development for this area of law. The potential for expansion of the Internet as a medium of commerce appears to be unlimited,¹⁷⁶ and this fact raises the stakes involved with early policy decisions. As Internet accessibility and sales revenues continue to rise, the potential for lost state tax revenues grows as well.

This legislation is intended to merely create a period during which new taxes on the Internet will be halted and to allow for an objective analysis to determine the long-term strategy for future taxation. The three-year moratorium period in coordination with the creation of the Commission to study policy implications appears to be a reasonable means to achieve the goals sought by the legislation. The only problem, as state and local representatives point out, is the potential for many unintended adverse effects.

This legislation does intrude into an area that has traditionally been left to the states in their sovereign capacities. However, the issue of Internet taxation is clearly one with national implications, and certainly an area of interstate commerce that requires uniformity of treatment amongst the states. In attempting to preempt a potential circumscription of Internet growth, the federal government may have asserted its authority in an area that it is ill-equipped to handle.

¹⁷⁶ Indeed, current stock prices for Internet-based companies such as Yahoo!, eBay, and America Online indicate that many investors also believe that the potential profitability of the Internet is unlimited.

The Act does present a potential for decreased state tax revenues, at least during the three-year moratorium period. Sales tax dollars will be lost as consumers flee to the safe haven of buying goods via their modems, and as potential fees from access services are precluded. If the time-out period does actually foster the development of a more permanent scheme that businesses and states can abide by, then this short period of lost tax dollars will have been worth it. However, the legislation may have removed one of the primary incentives that the businesses had to negotiate a deal.

In the final analysis, the Internet Tax Freedom Act merely exacerbates the current situation by attempting to defer consideration of the problem to a later date. Without this protection, Internet corporations and state governments would both have a sense of urgency in coming together to hammer out a deal. Both sides undoubtedly desire certainty in this area. States would like to be able to predict the source of their future revenues, which fund crucial state programs. Businesses would be well-served by knowing what role taxes are going to play in their operations before they spend money to design compliance mechanisms for their computer systems. This legislation gives only one of the two interested parties any certainty and for only a short period of time.

During the operation of the moratorium, Internet businesses will enjoy a competitive advantage over their traditional physical location competitors. This will be to the detriment of "Main Street" businesses as well as to lower-income individuals who will be unable to take advantage of the lower prices that Internet merchants can offer. At the end of this period, the Internet industry is unlikely to relinquish the advantages that it has grown accustomed to without a fight. It appears that Congress' attempt to smooth the process of Internet inclusion into the state and local tax regime will merely create a new set of problems that will simply surface at a later date.

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