University of Georgia Law

Digital Commons @ Georgia Law

Scholarly Works

Faculty Scholarship

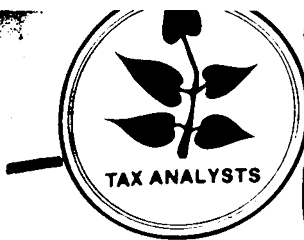
5-1-1997

Taxing Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation

Walter Hellerstein
UGA School of Law, wallyh@uga.edu

Repository Citation
Walter Hellerstein, *Taxing Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation* (1997),
Available at: http://digitalcommons.law.uga.edu/fac_artchop/866

This Article is brought to you for free and open access by the Faculty Scholarship at Digital Commons @ Georgia Law. It has been accepted for inclusion in Scholarly Works by an authorized administrator of Digital Commons @ Georgia Law. For more information, please contact tstriepe@uga.edu.



TAXING ELECTRONIC COMMERCE: PRELIMINARY THOUGHTS ON MODEL UNIFORM LEGISLATION

by Walter Hellerstein

Walter Hellerstein is professor of law, University of Georgia, and is a partner with Sutherland, Asbill & Brennan, Atlanta. He is chair of State Tax Notes' *Advisory Board*.

This report was presented at the symposium on multijurisdictional taxation of electronic commerce at Harvard University on April 5, 1997.

The author would like to thank Thomas M. Cook of NETCOM On-Line Communication Services Inc., Fred E. Ferguson of Arthur Andersen LLP, and Richard D. Pomp of the University of Connecticut Law School for their helpful suggestions in connection with this report.

Table of Contents

I. Areas of Consensus 819
A. General Principles 819
B. Specific Principles 820
II. The Content of Uniform State Legislation .. 822
A. Nexus 822
B. Transmission Versus Content 824
C. Income Tax issues 825
III. Constitutional Considerations 828

Despite the complexity of the problems spawned by state taxation of electronic commerce, and the daunting challenges that they pose for state taxpayers and state lawmakers alike, there is a considerable degree of consensus among all interested (and disinterested) parties on the normative principles that ought to guide any informed legislative solution to these problems. The recent flurry of "white papers" addressed to state taxation of electronic commerce reflects this consensus,[1] as do other efforts to examine these issues.[2]

This report describes the normative principles shared by most serious analyses of the problems raised by state taxation of electronic commerce. It then attempts to translate these principles into legal rules that could provide a model for uniform legislation in this area. Finally, it addresses constitutional questions that will likely be encountered in any effort to implement such legislation.

I. Areas of Consensus

A. General Principles

1. Economic neutrality. Virtually all concerned parties agree that state taxes on electronic commerce should be economically neutral. The principle of tax neutrality suggests that those who provide goods or services in electronic commerce should be taxed no differently from those who provide goods or services in conventional commerce. "[T]his means that businesses that provide services on [the information] highway and their customers should not be subjected to different excise, property, or income taxes than those that are imposed on businesses providing competing services and products off [the information] highway

---

[1] These include Information Technology Association of America, "Straight Talk: Internet, Tax & Electronic Commerce: A White Paper on Taxation of Electronic Commerce and the Internet" (undated) (mimeo) [hereinafter cited as ITAA White Paper]; Interactive Services Association, "Logging On to Cyberspace Tax Policy: An Interactive Services Association

(Footnote 1 continued in next column.)

Task Force White Paper" (December 1996), reprinted in *State Tax Notes*, Jan. 20, 1997, p. 209 [hereinafter cited as ISA White Paper]; Information Highway State and Local Tax Study Group, "Supporting the Information Highway: A Framework for State and Local Taxation of Telecommunications and Information Services" (undated), reprinted in *State Tax Notes*, July 3, 1995, p. 57 [hereinafter cited as SALT Study Group White Paper]; Karl A. Frieden and Michael E. Porter, "The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce," *State Tax Notes*, Nov. 11, 1996, p. 1363 [hereinafter cited as Arthur Andersen White Paper]; Multistate Tax Commission, Statement of Direction on Electronic Commerce Issues (Jan. 17, 1997) [hereinafter cited as MTC Statement]; *cf.* Department of the Treasury, Office of Tax Policy, "Selected Tax Policy Implications of Global Electronic Commerce" (November 1996) [hereinafter cited as Treasury Discussion Paper] (for the full text of the Treasury discussion paper, see *Doc 96-30614 (50 pages)*); Interagency Task Force, "A Framework for Global Electronic Commerce," Draft # 9 (Dec. 11, 1996) [hereinafter cited as White House White Paper] (for the full text of the White House White Paper, see *Doc 97-1677 (18 pages)*).

[2] *See, e.g.*, Walter Hellerstein, "Telecommunications and Electronic Commerce: Overview and Appraisal," *State Tax Notes*, Feb. 17, 1997, p. 519.

and their customers."[3] Similarly, "[i]ntangible products sold and delivered over the Internet should be treated the same way for tax purposes as products purchased off-line in the tangible world."[4]

2. **Uniformity.** Virtually all concerned parties agree that state taxes on electronic commerce should be uniform. "[I]f states do impose taxes on Internet and on-line services, they should adopt uniform definitions among the states."[5] "Whatever standards are applied should be done uniformly from state to state and from taxpayer to taxpayer."[6] "Should State officials choose to adapt established State tax systems to electronic commerce, the [Multistate Tax] Commission encourages State officials to do so in as uniform . . . a manner as possible."[7]

3. **Administrability.** Virtually all concerned parties agree that state taxes on electronic commerce should be administrable. "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."[8] Accordingly, if electronic commerce is going to be taxed, such taxes should be "clear and consistent" so that "taxpayers can comply with the rules and take them into account for purposes of business decisions."[9] State tax organizations, no less than business groups, fully embrace the "goal[] of . . . administrative ease and efficiency"[10] in taxation of electronic commerce.

B. Specific Principles

Beyond the consensus on the general principles delineated above, which represent little more than the familiar list of the desiderata of tax policy that one can find in any public finance text, there is general agreement about a number of more specific principles that bear directly on the taxation of electronic commerce. Some of these are corollaries of the broader principles set forth above as applied to electronic commerce. Others relate to particular issues that must be addressed if there is to be a rational solution to the problems raised by state taxation of electronic commerce.

1. **Rethinking of nexus rules.** There is widespread recognition that traditional nexus criteria are ill-suited to the creation of sensible and administrable rules for determining the taxability of taxpayers or transactions in electronic commerce. Traditional tax jurisdiction or "nexus" principles, after all, are rooted in concepts of territoriality and the physical presence of the taxpayer in the state.[11] Indeed, although the U.S. Supreme Court has abandoned physical presence as the touchstone of Due Process Clause nexus,[12] it has retained the physical-presence standard, however grudgingly,[13] as a litmus test of Commerce Clause nexus,[14] at least in the context of sales and use taxes.[15] And, in any event, whether we are talking about traditional concepts of jurisdiction to tax based on physical presence or more "modern" concepts of jurisdiction to tax based on "economic" presence, the fact remains that we are still, in the end, counting contacts — be they tangible or intangible.

But such an approach makes little sense in cyberspace. The signal characteristic of cyberspace is the irrelevance of geographic borders. As the codirectors of the Cyberspace Law Institute have declared, "[g]lobal computer-based communications cut across territorial borders, creating a new realm of human activity and undermining the feasibility — and legitimacy — of laws based on geographic boundaries."[16] This thought has not been lost on those seeking a solution to the problems raised by state taxation of electronic commerce. They recognize that "traditional concepts of nexus may not be entirely appropriate for electronic commerce and Internet related services,"[17] and that we need to "rethink nexus standards as they apply to the Internet and Internet-based transactions."[18]

2. **Content versus transmission.** Most observers agree that a sound state taxing scheme applied to electronic commerce, particularly with respect to sales and use

---

[3] SALT Study Group White Paper, *supra* note 1, *State Tax Notes*, July 3, 1995, p. 61.

[4] ITAA White Paper, *supra* note 1, at 10.

[5] ISA White Paper, *supra* note 1, *State Tax Notes*, Jan. 20, 1997, p. 221 (emphasis in original omitted).

[6] ITAA White Paper, *supra* note 1, at 10.

[7] Multistate Tax Commission Statement, *supra* note 1, at 2.

[8] SALT Study Group White Paper, *supra* note 1, *State Tax Notes*, July 3, 1995, p. 61.

[9] Arthur Andersen White Paper, *supra* note 1, *State Tax Notes*, Nov. 11, 1996, p. 1393.

[10] MTC Statement, *supra* note 1, at 2.

[11] *Cf. Pennoyer v. Neff*, 95 U.S. 714 (1877).

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

[13] *See* Walter Hellerstein, "Supreme Court Says No State Use Tax Imposed on Mail-Order Sellers . . . for Now," 77 *J. Tax'n* 120 (1992).

[14] *Quill*, 504 U.S. at 309-19.

[15] *But see Geoffrey Inc. v. South Carolina State Tax Comm'n*, 437 S.E.2d 13, *93 STN 133-12* (S.C.), *cert. denied* 510 U.S. 992 (1993) (state has jurisdiction to tax out-of-state taxpayer with no physical presence in the state on income earned from licensing trademarks to in-state licensee).

[16] David R. Johnson and David Post, "Law and Borders — The Rise of Law in Cyberspace," 48 *Stan. L. Rev.* 1367 (1996).

[17] ITAA White Paper, *supra* note 1, at 10.

[18] ISA White Paper, *supra* note 1, *State Tax Notes*, Jan. 20, 1997, p. 221. The U.S. Treasury has made the same point in the context of U.S. income taxation of international transactions:

> The concept of a U.S. trade or business was developed in the context of conventional types of commerce, which generally are conducted through identifiable physical locations. Electronic commerce, on the other hand, may be conducted without regard to national boundaries and may dissolve the link between an income producing activity and a specific location. From a certain perspective, electronic commerce doesn't seem to occur in any physical location but instead takes place in the nebulous world of "cyberspace." Persons engaged in electronic commerce could be located anywhere in the world and their customers will be ignorant of, or indifferent to, their location.
> Treasury White Paper, *supra* note 1, at 26.

taxes, should clearly distinguish between transmission-based services and content-based services. The vast majority of states tax the sale of transmission-based services,[19] which may be roughly defined as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received."[20] Most states do not tax content-based services (e.g., the provision of information or data processing[21]), unless the services are embodied in the sale of tangible personal property (e.g., magnetic tape). When content-based services are delivered through transmission-based services, however, and the charge for the two services is bundled, there can be uncertainty and controversy over the taxability of the transaction.

In light of the existing pattern of state taxation of services, and the gradual expansion of the sales tax base to include specified content-based services,[22] distinguishing between transmission-based services and content-based services can be critical to achieving some of the broad tax policy objectives identified above. To assure competitive equality between economically similar transactions, for example, it may be necessary to distinguish between transmission-based services and content-based services, so that particular transactions are taxed or exempted in their own right, not because they are delivered along with some other taxable or exempt service.[23] Moreover, states are unlikely to achieve uniformity in taxation of electronic commerce unless they draw "explicit distinctions between transmission-based services and content-based services" to "avoid endless wrangling over definitional issues."[24] For these reasons, "[s]tates need to recognize and acknowledge the difference between the transport of a signal (telecommunications), enhanced services, and content."[25] It is worth keeping in mind, however, that the line between transmission-based services and content-based services may not always be self-evident.[26]

3. Avoidance of double taxation. Another widely shared goal among those concerned with taxation of electronic commerce is the desirability of avoiding double taxation. The white papers addressed to taxation of electronic commerce generally support the view that "[s]tate and local governments should take action to prevent double taxation,"[27] and that "transactions, income, or property related to the information highway should not be subject to multiple taxation."[28]

The precise scope of this policy objective, however, may be uncertain. For example, if an online service provider purchases and pays tax on telecommunications services and in turn collects tax on the charges for the services it sells to its customers at a price that includes the value of the purchased telecommunications services, there will be double taxation in an economic sense. Moreover, such double taxation is contrary to the normative view of a retail sales tax as a single-stage levy on consumer expenditures, i.e., one that applies only to final sales for use and consumption.[29] Yet many state taxing regimes would treat the online service as the taxable consumer of the telecommunications service while imposing a tax on the full charge for the online service provider's services to its customer.

Distinguishing between transmission-based services and content-based services can be critical to achieving broad tax policy objectives.

Despite the theoretical premise that the retail sales tax is a single-stage levy on consumer expenditures, and despite the existence of statutory provisions (such as the sale-for-resale exemption) that exclude intermediate purchases in the economic process from the retail sales tax, producers' purchases (as distinguished

---

[19] Thirty-nine of the 45 states with sales taxes impose a tax on telecommunications services. Federation of Tax Administrators, *Sales Taxation of Services: An Update* 20 (1994). Twenty of these states tax interstate telecommunications services. *Id.*

[20] The definition is taken from section 3(51) of the Telecommunications Act of 1996, P.L. 104-104, 110 Stat. 56 (Feb. 8, 1996), to be codified at 47 U.S.C. section 153(48).

[21] A recent survey lists 14 states as imposing a tax on "information mainframe services" and 11 states as imposing a tax on "data processing services." Federation of Tax Administrators, *supra* note 19, at 2.

[22] Federation of Tax Administrators, *supra* note 19.

[23] SALT Study Group White Paper, *supra* note 1, *State Tax Notes*, July 3, 1995, p. 63.

[24] Arthur Andersen White Paper, *supra* note 1, *State Tax Notes*, Nov. 11, 1996, p. 1392.

[25] ITAA White Paper, *supra* note 1, at 10. The ITAA White Paper defines enhanced services as follows:

> These services, such as e-mail and Internet access, are distinct from telecommunications services. They are value added services, the primary purpose of which is to act on the form, content, code or protocol of information. They are distinct products which are made available to consumers through the use of telecommunications services. They are not, in and of themselves, communications services.

Id. at 3.

[26] There is room for debate, for example, at least in the eyes of state legislators, whether certain enhanced services (*see supra* note 25) — such as Internet access, e-mail, electronic bulletin boards, facsimile services, packet switching, and ATM transactions — constitute "transmission" or something else. Arthur Andersen White Paper, *supra* note 1, at p. 1369. On the one hand, they bear some resemblance to traditional telecommunications services in that they connect two or more parties through electronic signals. On the other hand, they involve some additional services in the form of linkage or value added such as temporary storage of messages on a computer server or change in the protocol of the transmitted information. *Id.*

[27] ITAA White Paper, *supra* note 1, at 10.

[28] SALT Study Group White Paper, *supra* note 1, at p. 62. *Cf.* Treasury White Paper, *supra* note 1, at 22-23 (describing U.S. tax policy against international double taxation); White House White Paper, *supra* note 1, at 6 (same).

[29] John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration* 16 (2d ed. 1994).

from consumers' purchases) in fact make up a healthy portion of most states' sales tax bases. Indeed, a nationwide study concluded that producers' share of the sales tax base averaged 40 percent for 45 states and the District of Columbia.[30] For example, transportation equipment, office furniture, advertising catalogs, and supplies purchased by manufacturers and other businesses are usually taxable under state sales taxes. Yet the cost of these items is likely to be reflected in the final cost of the products the business sells. Consequently, these items are effectively subjected to a second tax, assuming the products sold by the business are taxable.

In short, while avoidance of double taxation of electronic commerce is a worthy and widely shared objective, implementation of that objective, at least in the context of sales and use taxation, may be complicated by the well-entrenched tradition of taxing many business inputs under state retail sales taxes. Clearly this problem can be solved by a "radical restructuring of the sales tax itself" so that "all inputs and sales for resale [w]ould be exempt from sales taxation," as one observer has suggested.[31] And there certainly is nothing to prevent adoption of that solution for taxation of electronic commerce, even if it is not extended to other transactions subject to sales and use tax. Nevertheless, the pervasiveness of the "double taxation" problem should serve as a reminder that some of the issues raised by state taxation of electronic commerce extend far beyond that particular context.[32]

II. The Content of Uniform State Legislation

If uniform state legislation addressed to state taxation of electronic commerce is to be adopted, whether from the bottom up[33] or from the top down[34] — and I take no position here on the advisability of one pursuing one course or the other[35] — such legislation should seek to implement the foregoing principles around which considerable consensus has emerged. In this section, I offer some thoughts, on a tentative and preliminary basis, as to what such legislation might look like.[36]

A. Nexus

Any statutory solution to the problems raised by state taxation of electronic commerce is going to have to tackle the issue of nexus if it is going to be of much practical benefit to industry and the states. The nexus issue — determining the circumstances under which potential taxpayers are subject to tax and the circumstances under which potential tax collectors have an enforceable obligation to collect a tax — is second to none in the consternation it has created in discussions of state taxation of electronic commerce and in its unsuitability to resolution under existing legal criteria. Moreover, without a solution to the nexus issue, sensible solutions to other critical issues (e.g., apportioning income and situsing sales) will be difficult, if not impossible. It makes little sense, for example, to assign the sales, use, or income tax base to a state in which the taxpayer is not taxable, or to assign the sales or use tax base to a state in which the vendor cannot be required to collect the tax.[37]

As suggested above, traditional approaches to the nexus question appear to be doomed to failure in the context of taxation of electronic commerce. To ask about the "location" of electronic commerce — whether that location is defined in terms of physical contacts (e.g., the presence of computer servers or leased telecommunications lines) or nonphysical contacts (e.g., the deemed presence of intangibles or electromagnetic impulses) — is to ask a question that is not worth answering. The reason is twofold.

First, the location of those tangible or intangible contacts often will bear little relationship to the location of the essential economic activity that electronic commerce constitutes — the production and consumption of information. Second, even if the location of those tangible and intangible contacts were thought to be relevant to the location of electronic commerce, the location of those contacts can be changed so easily (without affecting the underlying transaction in electronic commerce) that efforts to prevent tax avoidance by creative tax planning are likely to be futile. If the

[30] Raymond J. Ring Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax" 42 *Nat'l Tax J.* 167, 175 (1989).

[31] Matthew N. Murray, "Telecommunication Services and Electronic Commerce: Will Technology Break the Back of the Sales Tax?" *State Tax Notes*, Jan. 27, 1997, p. 273.

[32] The same point can be made with respect to nexus issues.

[33] As, for example, through the collaborative efforts of the states and the business community to forge uniform legislation that state legislatures would then adopt. The Uniform Commercial Code, which has been adopted by all 50 states, provides one example of such legislation. Another is the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA, however, has not been adopted by all states with income taxes. *See infra* note 56.

[34] *I.e.*, through preemptive federal legislation.

[35] I do, however, consider the constitutional issues that must be considered in pursuing these alternatives. *See infra* notes 62-71 and accompanying text.

[36] In offering these thoughts, I wish to make it clear that I am not suggesting that states should (or should not) tax electronic commerce. Rather I am suggesting that *if* states decide to tax such commerce, they should do so according to the principles set forth above and, perhaps, along the lines set forth below.

[37] To be sure, when this problem does arise, a "throwback" rule can provide an antidote. *See infra* note 38. But it is hardly desirable from the standpoint of policy or practice to design a system where the throwback rule plays a significant role. Insofar as it is possible, one ought to design the attribution rules appropriately in the first place without having to resort to a throwback rule that effectively changes the normal attribution rule in order to assure that the tax base is available for taxation by some jurisdiction. *See* Walter Hellerstein, "Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court's Reading of the 'Throwback' Rule," 45 *U. Chi. L. Rev.* 768 (1978).

server's presence is relevant, Oregon (a state with no sales tax) will soon become the server capital of the world; if the presence of the electronic impulse is relevant, those impulses will be routed through non-taxable paths, assuming one can even trace the paths through which they are routed.

What we need instead is a fresh approach that essentially "reverse engineers" the nexus issue. In other words, the first question ought to be what kind of taxing regime will allow participants in electronic commerce to pay and collect taxes in an administratively feasible fashion to those states with a legitimate claim to the tax revenues. Once we answer that question, we can build our nexus rules (and, also our tax sourcing or situsing rules) around such a regime.

To ask about the 'location' of electronic commerce — whether that location is defined in terms of physical contacts or nonphysical contacts — is to ask a question that is not worth answering.

With regard to sales and use taxes imposed on transactions in electronic commerce, we need a regime in which vendors can be certain about their tax collection obligations and can comply with them at reasonable administrative costs. One possible means of achieving these objectives would be the establishment of nexus over the out-of-state vendor in the state of the purchaser, defined by reference to the purchaser's billing address or other locational information furnished to the vendor by the purchaser (e.g., the area code and local exchange from which the purchaser accessed the seller's Web site). The vendor who obtained such information in good faith would be able to rely on it in remitting the tax to the purchaser's state.

The statute implementing such a regime might read something like this:

> Every vendor who makes a retail sale of electronically transmitted taxable services to a purchaser in this state shall collect from the purchaser the sales or use tax imposed by this act on the sale or use of such services and shall remit the tax to this state. A purchaser is "in this state" if his billing address is in this state. Every vendor must make reasonable and good faith efforts to determine the purchaser's billing address.

To deal with cases in which the vendor is unable to determine the purchaser's billing address, the statute might include a sales tax version of the familiar income tax "throwback" rule[38] along the following lines:

> If, after making reasonable and good faith efforts to determine the purchaser's billing address, the vendor is unable to determine such address, the vendor shall collect from the purchaser any sales or use tax that may be imposed by this state on the sale or use of such services, if the vendor's principal place of business is in this state.[39]

The statute might also include a credit provision like that set forth below to avoid any possibility (or contention) that it is creating a risk of multiple taxation:

> The tax imposed by this act on the sale or use of electronically transmitted services shall be reduced by the amount of any sales or use tax paid to any other state or political subdivision thereof on the sale or use of such services.

Finally, it is important to recognize one assumption that underlies the proposed statutory provisions set forth above: Regardless of the payment mechanism — be it check, credit card, debit card, prepaid cash card (e.g., "Visacash"), or even electronic cash — it is assumed that the vendor would add the appropriate tax, if any, to the amount of the purchaser's bill and remit that amount to the appropriate jurisdiction.[40]

The proposed nexus rule (which implicitly amounts to a situsing rule as well) has some obvious virtues. First, it is simple. The vendor need know only the purchaser's billing address in order to determine the scope of its tax obligations. Second, the rule protects

---

[38] Under the "throwback" rule embodied in the Uniform Division of Income for Tax Purposes Act, 7A *U.L.A.* 331 (1985) [hereinafter cited as UDITPA], sales of tangible personal property, which are normally assigned to the destination state in the sales factor of the tax apportionment formula, are "thrown back" to the state of origin when the taxpayer is not taxable in the destination state. UDITPA section 16.

[39] *Cf.* Jerome R. Hellerstein, "The *Quill* Case: What the States Can Do to Undo the Effects of the Decision," *State Tax Notes*, Feb. 8, 1993, p. 273:

> To plug up the mail-order house and other out-of-state loopholes in use tax collection, I suggest that the states modify their statutes by adding a sales tax throwback provision with respect to sales of property that is delivered to the purchaser in another state, in the event that the state is not empowered under the Supreme Court's decisions to require the vendor to collect that state's use tax and no sales or use tax is in fact paid to the destination state. Under the proposed throwback rule, the sales tax would be imposed by the state only if the purchased property is shipped from an office, store, warehouse, factory, or other place of storage within the state.

In the context of sales and use taxation of electronic commerce, a rule more consistent with the traditional throwback concept might throw the sale back to the state from which the vendor electronically transmitted such services. However, such a rule is easily manipulable because of the ease with which the origin of electronic transmissions can be arranged. Moreover, once we deviate from place of consumption (or a proxy therefor, such as billing address) in a sales tax regime, practical rather than theoretical considerations should play a greater role in the evaluation of our second-best solution.

[40] Although a purchaser could refuse to pay the tax, that is no different from a purchaser refusing to pay a tax today on a bill for a shipment of tangible personal property from a vendor with nexus in the state. It does not seem to raise any problems peculiar to electronic commerce.

the vendor so long as it makes reasonable efforts[41] to ascertain the purchaser's billing address. Third, the rule protects the sales tax base (at least viewed from a national perspective) in the event that the vendor cannot determine the purchaser's billing address, on the assumption that the statute incorporated the throwback rule.

The proposed nexus rule, however, has weaknesses that are no less apparent than its strengths. First, it may be quite difficult for the vendor to obtain the purchaser's billing address (or other locational data), in which case the default regime using the throwback concept would be the rule rather than the exception.[42] Under those circumstances, our sales and use tax, which ought to be a levy on consumption,[43] and thus a tax imposed at the state of destination where consumption is ordinarily deemed to occur, ends up more closely resembling an origin-based tax than a destination-based tax.[44] Second, the rule may be vulnerable to manipulation. For example, purchasers might establish "billing addresses" in states without sales taxes.[45] Third, one may object to the concept of a throwback rule, especially in the sales tax context, as changing tax attribution rules "in middle of the stream" for reasons that cannot be justified by the underlying purposes of a retail sales tax.[46]

Whatever its shortcomings, the proposed regime for imposing and collecting sales and use taxes may serve as a useful focus for further discussion of legislative solutions to nexus and situsing issues raised by sales and use taxation of electronic commerce.

B. Transmission Versus Content

As noted above, most observers believe that the states will need to separate "transmission" from "content" in their sales and use tax statutes in order to achieve the goal of tax neutrality and to avoid excessive double taxation.[47] To accomplish this objective, states that tax telecommunications services might provide:

---

[41] The requisite efforts presumably would be spelled out in detail elsewhere in the statute. They might encompass a requirement that, where the billing address was not provided with the purchase, the vendor must make a reasonable inquiry to determine the purchaser's billing address. For example, the vendor might be required to condition the purchase of electronic services by credit card or e-cash on the purchaser's furnishing its billing address (or some other proxy for its location, e.g., its area code and local exchange).

[42] To be sure, vendors will often have (or be able to require purchasers to furnish) billing information (e.g., in the typical direct broadcast satellite or commercial online service transaction). But this will not be true for many Internet sales "due to security concerns about credit card information and the fact that often the seller has no idea who the purchaser is." R. Scot Grierson, "State Taxation of the Information Superhighway: A Proposal for Taxation of Information Services," 16 *Loyola Entertainment L.J.* 603, 639 (1996). In some transactions, financial intermediaries such as Cybercash provide encrypted codes for Internet sales in order to avoid the risk of unwanted disclosure of a purchaser's credit card information. *Id.* Because the Internet seller never sees the credit card number and may not know the identity of the purchaser, it may contend that it cannot obtain such information through "reasonable efforts." Grierson suggests, however, that

> [t]o obtain billing address information in an Internet transaction (and for information services using other types of telecommunications), the state could impose a duty on the seller to acquire the billing address information through the third-party intermediary. Third-party intermediaries are in a perfect position to obtain billing address information without compromising security because the credit card number is never divulged.

Id.

While observing that sellers are likely to balk at this type of requirement as being administratively cumbersome because it requires them to coordinate tax collection with the billing intermediary, Grierson notes that this type of arrangement is not uncommon. Specifically, he states:

> The typical 900 number service, for example, uses the telephone company as a third-party billing intermediary, just as Internet sellers will use Cybercash. The telephone company bills the 900 service customer by including the charge in the phone bill. Under such a requirement, the seller would contract with the intermediary for collection of the charge, the intermediary would determine the state according to billing address, and the appropriate sales tax would be collected, passed on to the seller, and remitted by the seller to the state.

Id.

[43] At least in terms of the theory of a retail sales tax. *See supra* note 29 and accompanying text. *But see supra* note 30 and accompanying text.

[44] *But see supra* note 39 (suggesting that a second-best default regime should be evaluated more on practical than on theoretical grounds).

[45] While this may be a possibility in some cases, certainly for most individual purchasers the transaction costs of establishing a tax-haven billing address will outweigh the tax savings of doing so. For larger purchasers, the establishment of a tax-haven billing address may be more of a problem, but it is no different in principle from the problems states face when, for example, corporations take delivery of corporate aircraft in states without sales taxes. The "solution" to the problem in the context of sales of tangible personal property suggests an analogous solution to the problem in the context of electronic commerce, namely, the use tax. When the corporation uses the aircraft delivered in a state with a retail sales tax, it pays a use tax to the state identical to the sales tax it would have paid if the aircraft had originally been purchased in the state. *See* 2 Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* para. 18.04[2] (2nd ed. 1993) (discussing corporate aircraft cases). The same result should obtain with respect to the use of services purchased in electronic commerce. If a corporation with an Oregon "billing address" purchases electronically transmitted services that it uses in states that tax such services, the corporation will owe a use tax to the state in which those services are used. Such liability would presumably be established on audit the same way that liability is established in traditional sales and use tax audits: by reviewing the taxpayer's records to ascertain if any purchases have been made on which sales or use tax was due but not paid.

[46] *Cf.* Walter Hellerstein, *supra* note 37, at 778-79.

[47] Some would regard all double taxation as "excessive." I use the term "excessive" only to differentiate the double taxation that is endemic to the retail sales tax as we know it today, *see supra* notes 30-32 and accompanying text, from the double taxation that may be peculiarly associated with state taxation of electronic commerce and related telecommunications services. I am not suggesting that the line between these two categories is bright.

> The tax hereby imposed on the sale or use of telecommunications services shall not apply to the amount, if any, for services other than telecommunications services, if the charges for such other services are separately stated on the bill for the telecommunications services.

Similarly, states taxing information or other content-related services might provide:

> The tax hereby imposed on the sale or use of electronically transmitted services shall not apply to the amount, if any, for telecommunications services used in the transmission of other services, if the charges for such telecommunications services are separately stated on the bill for the electronically transmitted services.

These provisions are designed to protect the integrity of the states' sales and use taxes on telecommunications services and their sales and use taxes, if any, on electronically transmitted services. By identifying and taxing each service separately, so long as the charges for the respective services are separately stated, the provision will tend to avoid the economic neutrality problems that can arise when charges for services that include both transmission and content are bundled and are taxed (or not taxed) based on an undifferentiated characterization of the service as transmission, on the one hand, or content, on the other.

Without a solution to the nexus issue, sensible solutions to other critical issues will be difficult, if not impossible.

The ease with which the principle may be stated, and even translated into statutory language, cannot mask the underlying difficulties of defining "transmission" and "content," a task I will not undertake here. As noted above,[48] there is room for debate whether certain types of enhanced services,[49] such as Internet access, constitute "transmission" or something else.[50] In the end, however, this problem is definitional. The more fundamental problem at which the foregoing statutory language is directed assumes that the states have settled upon what services they wish to define and tax as "transmission" and what services they wish to define and tax as "content." Once the states have resolved the definitional issue, they should then structure their taxes in a manner that does not inadvertently treat transmission as content or vice versa.

One might object to the proposed method of unbundling transmission-based charges from content-based charges as formalistic and subject to manipulation, because they ultimately rest on how the service provider prepares the bill. For example, in a state that taxed transmission-based services but not content-based services, there would be an incentive to inflate the separately stated portion of the bill attributable to the latter while minimizing the separately stated portion of the bill attributable to the former.

There is room for debate whether certain types of enhanced services, such as Internet access, constitute 'transmission' or something else.

The same problem, of course, exists today in many garden-variety transactions in traditional commerce. When I take my car in for service in Georgia, I receive a bill that separately states the charges for parts, on the one hand, and for labor, on the other, taxing me on the former but not the latter. Presumably, if my automobile dealer's invoices showed unreasonably low parts charges and unreasonably high labor charges, it would have to explain that discrepancy to the state tax auditor. Indeed, there is little incentive for the dealer to take that risk, especially because it is in a position to collect the tax from me now, and may not be in a position to collect it from me later, should it ultimately be determined that the dealer overstated its labor charges and understated its parts charges.[51]

One partial solution to this problem, assuming it is a problem, would be the addition of the following language to the provisions set forth above:

> The separately stated charges for telecommunications services and for electronically transmitted services shall be treated as consideration for the respective services only if they reflect the fair market value of such services. The Commissioner of Revenue may require the vendor to furnish evidence of the fair market value of such separately stated services.

C. Income Tax Issues

Although most of the attention directed to state taxation of electronic commerce has focused on sales and use taxation, there are important issues raised by state income taxation of electronic commerce as well. The two most significant state income tax issues in the electronic commerce arena are nexus and apportionment. With regard to nexus, the essential point made earlier in the context of sales and use taxation is equally relevant to income taxation: We need a nexus rule that will allow participants in electronic commerce to ascertain with certainty the jurisdictions where they have tax liability and to comply with their tax obligations in an administratively feasible manner.

One cannot sensibly evaluate the suitability of a nexus rule for taxpayers deriving income from electronic commerce, however, without thinking about the sourcing principles that will apply to such income. For example, it makes little sense to have a bright-line nexus rule of substantial physical presence for jurisdic-

[48] *See supra* note 26.

[49] *See supra* note 25.

[50] *See* Grierson, *supra* note 42, at 635 (suggesting criteria distinguishing between "transmission" and "content").

[51] My personal experience with automobile dealers is that *both* parts *and* labor charges are overstated.

tion to tax income from electronic commerce if income from such commerce is going to be assigned to states in which the taxpayer has no physical presence. To be sure, a throwback rule[52] can assure that income will be "re-sourced" from a state in which the taxpayer is not subject to tax to a state in which it is taxable. But from the perspective of ideal legislative design, which is the perspective of this report, it makes more sense to create nexus rules that generally are in harmony with the sourcing rules than to have nexus and sourcing rules that lean in opposite directions and thus to rely heavily on a second-best default principle (such as the throwback rule) for sourcing substantial amounts of income.

One cannot sensibly evaluate the suitability of a nexus rule for taxpayers deriving income from electronic commerce without thinking about the sourcing principles that will apply to such income.

With these design features in mind, one can posit two alternative nexus/sourcing regimes. One could construct a taxing regime that adopts a bright-line, physical-presence rule for nexus over income taxpayers engaged in transactions in electronic commerce coupled with sourcing rules that attribute income only to jurisdictions in which the taxpayer has such physical presence. Indeed, because the physical location of tangible property used in the conduct of electronic commerce often bears little relationship to the underlying economic activity that such commerce constitutes,[53] and such location can easily be shifted to states that do not tax income (e.g., computer servers), it may well be that a residence-based sourcing principle would be the most satisfactory in this context. The Treasury White Paper embraces this view in the context of income taxation of electronic commerce in the global context.[54]

Alternatively, one might construct an income tax regime for electronic commerce that is more analogous to the sales and use tax regime suggested above. In such a regime, nexus over those engaged in transactions in electronic commerce would exist in the states of their customers' billing addresses, when these addresses could be ascertained at reasonable administrative costs. Income would likewise be assigned to those states. If the billing address could not be ascertained at reasonable administrative costs (so that nexus based on billing address would not exist), a throwback rule "re-sourcing" the income to a state where the taxpayer was taxable (e.g., its principal place of business) would apply.

The choice between these two regimes obviously implicates fundamental policy choices about where income should be taxed. The first regime favors the states in which electronic commerce is "produced" (assuming it is produced either where the seller's physical facilities are located or at its principal place of business) over those states in which it is "consumed" (assuming it is consumed at the billing address of the purchaser). The roughness of these assumptions, however, may undermine any principled arguments favoring the attribution of income to "production" states rather than to "market" states and vice versa. Moreover, in the context of electronic commerce, it may well be that a bias in sourcing income to "production" states rather than "market" states would have a less pronounced distributive effect than it would, say, in the context of an income tax on heavy industry, where the dichotomy between "production" states and "market" states is more perceptible. Under those circumstances, perhaps one ought to opt for the simpler regime (and the first regime is plainly simpler than the second).

In any event, I do not seek to resolve these issues here. Rather, in keeping with my charge, I offer the following to suggest what statutory language implementing these two alternative tax regimes might look like. These provisions are drafted on the assumption that the state has already adopted the Uniform Division of Income for Tax Purposes Act (UDITPA)[55] or a statute closely resembling UDITPA.[56] In other words, it assumes there are provisions in place that apportion income among the states by the familiar three-factor formula of property, payroll, and sales.[57]

---

[52] *See supra* notes 37-38 and accompanying text.

[53] *See supra* notes 11-18 and accompanying text.

[54] The Treasury White Paper states:

> The growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item with a specific geographical location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce.
>
> In situations where traditional source concepts have already been rendered too difficult to apply effectively, the residence of the taxpayer has been the most likely means to identify the jurisdiction where the economic activities that created the income took place, and thus

(Footnote 54 continued in next column.)

> the jurisdiction that should have the primary right to tax such income. . . . . United States tax policy has already recognized that as traditional source principles lose their significance, residence-based taxation can step in and take their place. This trend will be accelerated by developments in electronic commerce where principles of residence-based taxation will also play a major role.

Treasury White Paper, *supra* note 1, at 24.

[55] 7A *U.L.A.* 331 (1985).

[56] Of the 46 states (including the District of Columbia) with corporate income taxes, 23 have adopted UDITPA, [1] Multistate Corporate Income Tax Guide (CCH) para. 145 (1996), and most states have similar statutory schemes. *Id.*

[57] *See generally* Walter Hellerstein, "State Taxation of Corporate Income From Intangibles: *Allied-Signal* and Beyond," 48 *Tax L. Rev.* 751-55 (1993).

1. Income tax regime with physical-presence nexus rule.

Nexus. The income tax imposed by this state shall not apply to income derived by any person from sales of electronically transmitted services if such person has no tangible property or employees in the state.[58]

. . .

Sales Factor. (a) Sales of electronically transmitted services are in this state if the purchaser's billing address is in this state and if the taxpayer is taxable in this state. Purchasers shall be deemed to have their billing addresses in this state only if the taxpayer can determine such billing addresses at reasonable administrative costs.

(b) If the taxpayer is not taxable in the state of the purchaser's billing address, or if the purchaser's billing address cannot be determined at reasonable administrative costs, sales of electronically transmitted services are in this state if the taxpayer's principal place of business is in this state.

. . .

Definition of 'Property in This State.' Property is "in this state" if it is in the numerator of the taxpayer's property factor for this state.

Definition of 'Employee in This State.' An employee is "in this state" if the employee's compensation is in the numerator of the taxpayer's payroll factor for this state.

The foregoing provisions implement the first regime described above, namely, one in which there is a bright-line physical-presence rule of nexus and a sourcing principle that assigns income only to states in which there is nexus. The property and payroll factors (which are assumed to be identical to UDITPA's[59]) would assign the taxpayer's income to the state of the physical location of its property and payroll. As for the sales factor, the regime would continue the market-state-oriented sales destination rule that UDITPA adopts for sales of personal property, in cases where the taxpayer can determine the purchaser's billing address at reasonable administrative costs and where the taxpayer has the requisite physical presence in the state. In other cases, the sales (and, hence, a portion of the taxpayer's income) would be assigned to the taxpayer's principal place of business. In addition, the statute would need to define "income from sales of electronically transmitted services," a task I leave for the future.

2. Income tax regime with billing-address nexus rule.

Nexus. The income tax imposed by this state shall apply to income derived by any person from sales of electronically transmitted services only (1) if more than $______ of such sales are made to purchasers whose billing addresses are in this state or (2) if the person has property or payroll in the state.[60] Purchasers shall be deemed to have their billing addresses in this state only if the vendor can determine such billing addresses at reasonable administrative costs.

. . .

Sales Factor. (a) Sales of electronically transmitted services are in this state if the purchaser's billing address is in this state and if the taxpayer is taxable in this state.

(b) If the taxpayer is not taxable in the state of the purchaser's billing address, or if the purchaser's billing address cannot be determined at reasonable administrative costs, sales of electronically transmitted services are in this state if the taxpayer's principal place of business is in this state.

The foregoing provisions implement the second regime described above, namely, one in which nexus exists over an out-of-state vendor of electronic services when the purchaser's billing address is in the state and when the vendor can determine that address at reasonable administrative costs. To avoid creation of income tax liability for a *de minimis* amount of sales, a dollar threshold is suggested (without specifying the precise amount) under which billing-address nexus would not exist. In addition, nexus would continue to exist based on traditional notions of physical presence.

As in the first suggested alternative, the corresponding sourcing principles assign income only to states in which there is nexus. The property and payroll factors (which are again assumed to be identical to UDITPA's[61]) would assign the taxpayer's income to the state of the physical location of its property and payroll, where the taxpayer presumably will be subject to income tax jurisdiction. As for the sales factor, the regime would continue the market-state-oriented sales destination rule that UDITPA adopts for sales of personal property, in cases in which the taxpayer is subject to tax in the state of purchaser's billing address (i.e., when it exceeds the dollar threshold of sales to purchasers whose billing address is reasonably ascertainable or when it has physical presence in the state and can reasonably ascertain the purchasers' in-state

---

[58] In preemptive mode, the statute might provide:

No state, or political subdivision thereof, shall have power to impose a net income tax on income derived by any person from sales of electronically transmitted services if such person has no tangible property or employees in the state.

[59] *See* UDITPA sections 10-14.

[60] In preemptive mode, the statute might provide:

No state, or political subdivision thereof, shall have power to impose a net income tax on income derived by any person from sales of electronically transmitted services unless (1) more than $______ of such sales are made to purchasers whose billing addresses are in this state or (2) the such person has property or employees in the state.

[61] *See* UDITPA sections 10-14.

billing addresses). In other circumstances, the sales (and thus a portion of the taxpayer's income) are thrown back to the state of the taxpayer's principal place of business. As in the first alternative, the statute would need to define "income from sales of electronically transmitted services."

III. Constitutional Considerations

Any effort to design legislation establishing uniform rules for state taxation of electronic commerce must consider the constitutional concerns that such legislation might raise. The states, of course, are restricted by the Commerce and Due Process clauses in exercising their taxing power over interstate commerce and out-of-state taxpayers. While some of the statutory provisions set forth above might pass muster under existing constitutional restraints, others plainly would not. For example, the sales and use tax provision creating a tax collection responsibility for an out-of-state vendor of electronically transmitted services based solely on the existence of a purchaser with an in-state billing address would clearly be unconstitutional under *Quill Corp. v. North Dakota*.[62] More fundamentally, if one of the principal purposes of the creation of a uniform taxing statute is to establish clarity and certainty in an area currently beset by confusion and doubt, the last thing we need is a statutory regime that would trigger significant constitutional controversy. For that reason, the wiser course in attempting to implement any significant restructuring of the present pattern of state taxation of electronic commerce is to seek congressional approval.

The remaining question is whether congressional action in this domain — whether through consent to legislation that the states develop on their own initiative or by affirmative federal legislation that is thrust upon unwilling states — can resolve the Commerce and Due Process Clause difficulties that such legislation might otherwise raise.

The answer to half of this question is easy. It is apparent Congress possesses ample power to remove any Commerce Clause impediment to legislation of the type described above. Thus Congress may consent to state legislation affecting interstate commerce that would be unconstitutional under the so-called "dormant" Commerce Clause in the absence of such consent, and it may preempt state legislation that would be constitutional under the dormant Commerce Clause in the absence of such preemption. 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,"[63] subject only to the limitations that the Constitution imposes on Congress's own power. Because the legislation under consideration indisputably has a substantial effect on interstate commerce, there can be no serious question of any Commerce Clause bar to such legislation, if Congress either consents to it or affirmatively enacts it.[64]

> ***Congress may consent to state legislation affecting interstate commerce that would be unconstitutional under the so-called 'dormant' Commerce Clause in the absence of such consent.***

The answer to the other half of the question is more difficult. That question is whether congressional consent to (or enactment of) legislation of the type described above would eliminate any due process objections to such legislation or its application. The question must be answered in two parts. First, would the foregoing draft legislation authorize violations of the Due Process Clause and, if so, does Congress have the power to eliminate the due process bar?

The answer to the first part of the question depends on whether a state would have the "definite link" or "minimum connection" that the Due Process Clause requires "between a state and the person, property, or transaction it seeks to tax."[65] As the Court construed this requirement in *Quill*, the "link" or "connection" need no longer be physical: "The requirements of due process are met irrespective of a corporation's lack of physical presence in a State."[66] What is required is that the out-of-state taxpayer "purposefully direct" its activities toward residents of the taxing state.[67] Whether a billing-address nexus standard would satisfy this criterion is open to question and might require resolution on a case-by-case basis.

The answer to the second part of the question is likewise subject to debate. The Court *in dicta* has declared that "while Congress has plenary power to regulate commerce among the States and thus may authorize state actions that burden interstate commerce, it does not similarly have the power to authorize violations of the Due Process Clause."[68] Nevertheless, a strong case can be made that Congress has power to consent to violations of the Due Process Clause so long as they are not restraints by which Congress itself is bound.[69] Under this theory, Congress can authorize what would otherwise be federalism-based violations

---

[62] 504 U.S. 298, *92 TNT 110-2* (1992).

[63] *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408, 434 (1946) (sustaining tax that allegedly discriminated against interstate commerce because had consented to such legislation).

[64] *Cf. Quill*, 504 U.S. at 318 ("Congress is . . . free to decide whether, when, and to what extent the States may burden mail-order concerns with a duty to collect use taxes").

[65] *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954).

[66] *Quill*, 504 U.S. at 308.

[67] *Id.*

[68] *Id.* at 305. *See also id.* at 318; *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 350 n.14 (1982) (O'Connor, J., dissenting).

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

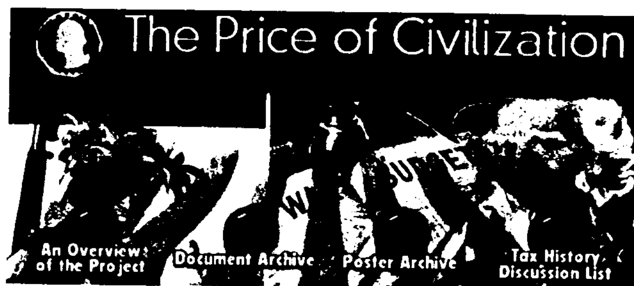
of the Due Process Clause but not due process violations of individual rights. It has also been suggested that Congress may have power under section 5 of the Fourteenth Amendment to expand state taxing powers beyond what they would be in the absence of implementing federal legislation.[70]

Under this theory, Congress can authorize what would otherwise be federalism-based violations of the Due Process Clause but not due process violations of individual rights.

In the end, it seems unlikely that the U.S. Supreme Court would hold that the framers of the Constitution and the Fourteenth Amendment left the nation powerless, short of a constitutional amendment, to legislate an administratively workable solution to the problem of state taxation of electronic commerce, despite the joint exercise by Congress and the states of their respective powers under the Constitution.[71]

[70] Jerome R. Hellerstein, "Significant Sales and Use Tax Developments During the Past Half Century," 39 *Vand. L. Rev.* 961, 986-92 (1986).

[71] *See id.* (making a similar point in the context of mail-order sales).



Discover the History of American Taxation

Tax Analysts is pleased to announce a new resource for everyone with an interest in the development of the U.S. tax system.

The Tax History Project, staffed by scholars and tax experts, has created a new website called ***THE PRICE OF CIVILIZATION***. Focusing on federal tax policy during the Great Depression and World War II, the project helps explain why the individual income tax developed as it did.

The website features an extensive archive of historical documents, including details of alternative means of raising revenue that were considered and rejected. There's also a fascinating collection of wartime propaganda posters. The website can be found at **http://www2.tax.org/taxhistory**.

THE PRICE OF CIVILIZATION reproduces about 3,000 pages of text, including key policy studies on federal taxation. Documents from the Department of the Treasury, the National Archives, and the Library of Congress are included. More historical documents will continue to be added, to offer scholars, students, and policymakers access to a variety of primary materials.

The Tax History Project offers a new perspective on how tax policy is forged in the heat of world events and domestic pressures. It's available to everyone with an interest in American taxation.

Tax Analysts

319-96