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TAXING THE RETICULUM TAXATION AND TARIFF ISSUES IN ELECTRONIC COMMERCE

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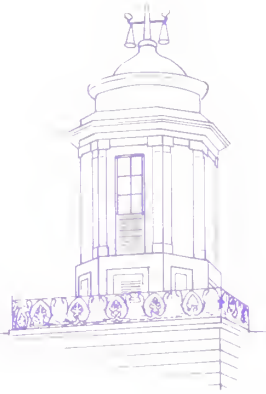

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by

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CHAPTER I

INTRODUCTION

The research and writing for this thesis began in mid-Summer 1999 amid continuous, often contentious, and nearly worldwide debate over electronic commerce and taxes. As the debate simmers, few, whether legal scholars, economists, politicians, business people, or consumers, are without an opinion on the subject. Not surprisingly, the lines have been drawn between, on one side, an amalgamation of often competing industries that either provide or exploit elements of electronic commerce and that naturally prefers a tax-free existence, and, on the other, state and local governments whose revenue sources are under all too real and exponentially increasing pressure. The Federal Government, principally through the Congress, is cast in the role of referee among all the disparate factions. That is not to say that there is no middle ground in the debate; there is.

As the writing of this thesis extends into the American Presidential election year, the issue of Internet taxation cannot help but become even more political than it has been over the past few years. Often voicing their positions in the strongest rhetoric, factions have developed, and not altogether cleanly along traditional party lines. Though somewhat raggedly, political parties, politicians, and lobbyists from every camp throughout the United States have aligned themselves on one of three basic sides of the issue of whether to tax electronic commerce and the transactions it facilitates. One

school of thought pleads that electronic commerce is an infant industry and as such should be allowed to find its own way, free from taxes completely and forever. The problem with that line of thinking is that quite often infants refuse to grow up[1].

At the other end of the spectrum are those who would tax not only the transactions, but the organs of electronic commerce as well. And in the middle, there are those who tend to favor taxation, but in recognizing the tangled, inconsistent morass of state taxation, call for uniformity imposed either by Congress, or by the states themselves.

Indeed, the unique characteristics of electronic commerce, when compared to every other form or method of conducting business, may in the end be the single strongest influence in forcing uniformity among taxing jurisdictions, not just here in the United States, but internationally as well. Yet despite the speed with which transactions can be completed in the realm of electronic commerce, the changes required to ensure that state and local taxing authorities collect the revenue necessary to meet the needs of the jurisdictions they serve may come, if at all, at an agonizingly slow pace, due as much to our own political, legislative, and legal climate as to any other single cause. It is that climate, and the interplay among taxing authorities, electronic commercial enterprises, the populace, and the government, that this thesis explores.

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[1] Author's note: The argument that electronic commerce is an infant industry and as such should be allowed to romp freely until it is at some unspecified time determined what kind of an adult it becomes is troublesome in the extreme. A similar line of thinking dominated 19th-Century America's relationship with her railroads, where massive land deals and sweetheart legislation allowed railroads to function with an economic sense of impunity and false security to the extent that the railroads had really few compelling reasons to strive for efficiency. The condition of American railroading today illustrates both the fallacy and the economic dangers with which that line of reasoning is fraught. Creating or maintaining a safe haven or a tax-free zone for electronic commerce creates far more problems than it solves in both the short and the long term. In the pages that follow, many of those problems will be explored.

At the outset, it should be noted that the problems requiring resolution are really not new ones at all, even though the terminology defining them and the technology framing them are sparklingly so. The problems or challenges, depending upon the point of view or agenda of the observer, are much the same as they have always been. And while computers are, in historical terms, relatively new, the taxing of commerce certainly is not.

Computers and peripheral devices have since the early 1950s become an increasingly important feature of science and commerce, to the extent that few areas of endeavor remain untouched by them. In the more immediate sense, say over the last twenty-five years or so, the influence of computers has grown steadily, due largely to the fact that enterprising people began to figure out ways to make money with them, not just by selling and servicing the machines that tallied the books, or provided guidance for satellites, or sent out the bills, but by allowing the machines to talk to one another. As that practice, made possible by successive and rapid technological developments, became all the more frequent, the stage was set for the concept, structure, and design of the Internet[2] and the World Wide Web,[3] both of which were conceived and developed

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[2] **Internet**: A cooperative message-forwarding system linking computer networks all over the world [for the] exchange [of] electronic mail, participat[ion] in electronic discussion forums (newsgroups), [for] send[ing] files from any computer to any other via FTP, retriev[ing] information via Gopher or HTTP, [or using] computers directly via Telnet or **rlogin**
Every user of every machine on the Internet has an address. For example, the address **covington@beetle.ai.uga.edu**
means:

covington	individual user (Covington)
beetle	machine [network or server] ("beetle")
ai	subnetwork (Artificial Intelligence Lab)
uga	site (University of Georgia)
edu	type of site (U.S. educational)

Here **beetle.ai.uga.edu** is a domain address that gets translated into a numeric IP address, in this

beginning in the mid-1970s. Since that time, all indicators point to a commercial, economic, social, and governmental revolution on the order of that experienced in the wake of other technological developments such as the printing press, railroads, the internal combustion engine, aviation, the telephone, telegraph, and television. One of the most intriguing aspects of the electronic commercial revolution is that electronic commerce marries, or in electronic commercial parlance, "links," each of the foregoing elements, forming among the various individual and collective associations a reticulum much like that network of synapses and nerves that overlies the human brain to form a system that integrates the autonomic, kinesthetic, and somatic functions in human beings, thus affording the left hand an opportunity to know what the right hand is doing.

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case 128.192.12.9, by the network itself.

U.S. commercial, government, and military sites have addresses that end in **com, gov,** and **mil** respectively. Other countries have distinctive suffixes, such as **ca** for Canada and **uk** for Great Britain.

The cost of running the Internet is paid largely by the sites that receive messages, and the sites that pass them along, not by the sites that send messages out. This has important legal and ethical implications. *Unsolicited advertising via e-mail or in newsgroups is almost always unwelcome*, as is any self-serving misuse of electronic communications, because the sender of the material is not paying the cost of distributing it. . .

The Internet grew out of the ARPANET (a U.S. Defense Department experimental network) as well as BITNET, Usenet, and other wide area networks. . .

Usage note: Many people confuse the Internet with the World Wide Web, which is only one of several forms of communication that take place on the Internet. Douglas Downing, Michael Covington, and Melody Mauldin Covington, *Dictionary of Computer and Internet Terms*, 6th ed. (New York: Barron's Educational Series, Inc., 1998), 239.

[3] **World Wide Web** (WWW): A loosely organized set of computer sites that publish information that anyone can read via the Internet, mainly using HTTP (Hypertext Transfer Protocol). Each screenful *(page)* of information includes menu choices and highlighted words through the user can call up further information, either from the same computer or by linking automatically to another computer anywhere in the world. Thus, the information is arranged in a web of tremendous size, and the links are created by the author of each page. Downing 516.

World Wide Web Consortium: A group of member organizations founded in 1994 that works to develop standards and otherwise enhance the World Wide Web. See web address **http://www.w3.org.** Downing 516.

As electronic commerce conducted via the Internet and the World Wide Web grows exponentially, not just from year to year but from month to month, it is changing the way the world transacts business, from the brick and mortar retailer to the most sophisticated traders in financial instruments or digital information services. At the close of 1999, the Internet, as well as those entities, whether businesses, individuals, or governments, that utilize, operate, or speculate in electronic commerce enterprises, has grown at such a rate, and changed or fostered change so rapidly, that research information and scholarly discourse greater than three or four years old is considered ancient history. In some instances, the useful life of an electronic publication is as little as a few weeks. That notwithstanding, and although writing on the subject is much like attempting to take a still photograph of a rapidly moving target, a considerable body of work still exists from which to frame the issues, determine the arguments, and present a conclusion. Information is available from a wide variety of sources, law review articles, government publications, business periodicals, texts, and on-line through the many so-called e-zines[4] and industry publications whose only presence is electronic. Electronic publications provide nearly minute-to-minute updates on issues concerning, among many other selections, electronic commerce and its interplay with government, business, the economy, and the society upon which it is having so profound an effect.

The Thesis Statement

This thesis will explore, first within an historical context, and second, in a contemporary model, the impact and effect of electronic commerce in both a general and

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[4] Electronic magazines.

limited way. In a more detailed fashion, the thesis will explore governmental and legal responses, from a taxation and tariff point of view, to the challenges posed by commercial transactions initiated and completed via the Internet and the World Wide Web. The broad question is therefore presented: How should governments, primarily American state and local governments, but also governments worldwide, respond to changes in technology that have a direct effect on the way business is conducted within their states and with their citizens? From that penumbral question an examination and exploration of the many options currently under discussion here and abroad will be conducted. Additionally, the thesis will explore a narrower question, one that applies almost exclusively to the state and local governments within the United States, at least as it pertains to the issue of taxation: What are the appropriate responses when technology virtually erases borders, rendering obsolete the need for physical presence within a taxing jurisdiction in order to conduct business within that jurisdiction?

Because the vast majority of electronic commerce, electronic commercial transactions, and electronic commercial Web pages[5], Web sites[6] and Web servers[7] are either within the United States or are generated by American concerns[8], much of this

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5 **Web page:** A file of information made available for viewing on the World Wide Web and seen by the user as a page of information on the [computer] screen. Downing 505.

6 **Web site:** A file or a group of related files available on the World Wide Web. Downing 506.

7 **Web server:** A computer that is attached to the Internet and contains Web pages . . . that can be viewed using a web browser [A program that enables the user to read Web pages, e.g. Netscape Navigator® or Microsoft Internet Explorer®]. Downing 506, 561.

8 Quoting the "*AcvtivMedia Research* sixth annual 'Real Numbers Behind Net Profits' . . . the report . . . says:

- 72 percent of Web sites are still based in the U.S.
- 92 percent of e-commerce is generated through U[.]S.-based Web sites. . .

thesis will focus upon American law at the federal and state levels and on the problems encountered by state and local governments whose sales and use tax revenues are directly threatened by what are currently non-taxed transactions. The thesis, however, will not confine itself completely to American law, as the European Union, Australia, and Asia, among others, grapple with the myriad issues presented by this interconnection of technologies that carries with it the promise of huge increases in efficiency and prosperity, but that is extremely difficult to define and control, as well as to tax.

By the time this thesis reaches final form, the Advisory Commission on Electronic Commerce ("ACEC"), created as part of Congress' passage of the Internet Tax Freedom Act[9] ("ITFA") that became law on October 21, 1998, has invited, received, and reviewed various taxing and tax system reform plans from politicians, academics, economists, governmental officials, and other interested parties. In addition, The ACEC has, according to its mandate, reported to Congress on those plans. The proposals, discussed in more detail below, cover a spectrum from thoughtful, well-considered calls for uniformity and a clear recognition of the potential of electronic commerce, its impact upon taxing authorities, and the ability and necessity of taxing authorities to generate revenue and the dependency upon that revenue, to ill-conceived, politically motivated, poorly considered, and even patently ridiculous calls for absolute restraints on taxing any

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- 9 in 10 revenue are product and service sales, not ads."
Beth Cox, *Report Projects 1999 E-Commerce Revenues at $95 Billion,* E-Commerce News, InternetNews.com 7 June 1999, http://www.internetnews.com/ec-news/print/ 0,1089_ 132421,00.html.

9 Title XI of the Omnibus Consolidated and Emergency Appropriations Act of 1998, P.L. 105-277, §§ 1101-04, October 21, 1998, 112 Stat. 2681-719, 47 USC § 151 ("ITFA"). (An Act apparently named as much to ensure its saleability as for any other reason.)

electronic commercial transaction, and instead, as one proposal suggests, supplying impoverished children with computers to afford them access to all the wonder and variety that is the Internet and the World Wide Web without regard to their ability to pay for such wonders as they will surely encounter there.

There are arguments, and quite sound ones, for taking a cautious approach as taxing authorities explore whether and how to extract revenues from this new method of conducting business. However, it should be noted at the outset that the kinds of taxes being debated, their methods of enforcement and collection, and the attendant equitable considerations bear little resemblance to taxation and taxing regimes of the past. Following is a brief look at the history of taxation from ancient times forward, from a time when taxation was a crudely wrought and ponderous beast that when unchecked and unrestrained led to the fall of great empires, and when uncollected often yielded the same result.

CHAPTER II

BACKGROUND

A Brief History of Taxation

Few have not heard the cliché proclaiming the certainty of only two things, death and taxes. Each, we are told, is inevitable and inescapable. Beginning with the writing[10] and the recording of history some five thousand years ago, records are replete with mention of taxes, and rarely in a good light. In fact, history is peppered with instances of ruinous, oppressive, and destructive taxation. As Charles Adams argues in *For Good or Evil*[11], taxation and the governmental authority to tax, as well as the response of the taxed, have all been unappreciated driving forces that have shaped world events to a much greater degree than appears at first blush.

> The dawn of history, and of tax history, is recorded on clay cones excavated at Lagash, in Sumer. The people of Lagash instituted heavy taxation during a terrible war, but when the war ended, the men refused to give up their

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10 "Most historians of ancient Mesopotamia mention the origin of writing . . . 'A script was invented early in Mesopotamia. The older inscriptions date back to 3000 BC.' [2] (footnoted: Lassor, Jorgen. People of Ancient Assyria, (New York: Barnes and Noble Inc.; 1963), pp. 78.) By the third millennium BC, the Sumerians already had a highly developed civilization. . . the script they developed was later taken over by the Akkadians--a Semitic people living north of Sumer. The script adopted by the Akkadians was a highly developed form of picture writing called 'cuneiform' (from the Latin cunneus or 'wedge'). Arden Eby, *The Origin and Development of Writing in Mesopotamia: An Economic Interpretation*, The History Guide: Letters on Ancient and Medieval European History, http://www.teleport.com/~arden/writing.htm 1999.

11 Charles Adams, *For Good and Evil,* 2nd ed. (Lanham, MD: Madison Books, 1999) 3.

> taxing powers. From one end of the land to the other, these clay cones say 'there were the tax collectors.' Everything was taxed. Even the dead could not be buried unless a tax was paid. The story ends when a good king, named Urukagina, 'established the freedom' of the people, and . . . 'There were no tax collectors.' This may not have been a wise policy, because shortly thereafter the city was destroyed by foreign invaders.[12]

Adams further points out that the concept of "[l]iberty came from the Greeks, who believed that tyranny was the consequence of the wrong kind of taxation."[13] The Romans articulated the principle that [i]n any conflict between liberty and taxes, liberty will give ground,"[14] thus underpinning a policy that would run virtually unchecked and eventually prove the undoing of the Empire. From it grew an extremely well-developed and ingrained system of tax evasion among the large landholders, who succeeded in becoming members of the Roman Senate and thus were able to take full advantage of the privilege of tax exemption that such a position afforded them. As a result, the gradual decline in revenue cut across all classes of Roman society, landing hardest upon the lowest strata of the Empire's citizenry, whose members were ill-prepared and poorly equipped to meet the burdens of supporting the Roman state virtually single-handedly.[15]

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12 Adams 2.

13 Adams 3, 53-74.

14 Adams 3, 75-128.

15 *See generally* Adams; also *see generally* Thomas Cahill, *How the Irish Saved Civilisation* (New York: Doubleday, 1995).

Rome employed as tax collectors individuals known as *curialis*, whose position, or more accurately perhaps, whose lot in life, was inherited and rarely escapable. "The tax man, or *curialis*, was born that way, [and led] a life far more miserable than those who suffered his exactions . . . born into a class . . . who were expected to spend their entire adult life spans collecting taxes from their immediate neighbors."[16] That was not the worst however, as "[w]hatever they [the *curialis*] were unable to collect they had to make good out of their own resources."[17] The pressure brought to bear on the empire was astounding, and as the capital could no longer subsidize the Roman legions in the frontiers, borders collapsed, and ultimately the Empire was no more.

Western thought and history has been irredeemably shaped by the Lucian passage regarding Roman taxation policy, "And it came to pass in those days, that there went out a decree from Caesar Augustus that all the world should be taxed."[18] That decree and the ensuing trek to Nazareth typify the relationship of the taxing authority and the taxpayer in ancient Israel. Hebrew loathing of Roman taxation is a mainstay in the four Gospels. Even Jesus was consulted, in hopes perhaps of his currying Roman disfavor through an impertinent or provocative answer, regarding his views on taxes. But it was also Jesus who befriended tax collectors, along with prostitutes and lepers, and it is that pervasive impression that has carried over the centuries, with much in history to support it.

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16 Cahill 25.

17 Cahill 25.

18 Holy Bible, King James Version, Book of Luke, Chapter 1, Verse 1.

In Egypt, taxation was the province of the scribes, and under their authority, "[t]he Egyptians taxed just about everything: sales, slaves, foreigners, imports, exports, businesses. Agricultural production was taxed at 20 percent . . . not just [as] a harvest tax, it included home gardens and crafts–income from every conceivable source . . . To illustrate the tyranny of the scribes in everyday life, consider the tax on cooking oil. The scribes made regular inspections of all kitchens to make sure wives were not using free drippings in place of the taxed oil they were required to use."[19]

"[T]he earliest form of taxation for which records exist"[20] was "[c]ourvée, the mandatory contribution of personal labor to the state."[21] In fact, "in the ancient Egyptian language the word 'labor' was a synonym for taxes."[22]

In the ancient world, taxation, whether oppressive or when it was greeted by sophisticated methods of tax evasion, became a leading cause of the demise of the great empires of Egypt, Babylon, Greece, and Rome. In Europe, the face of the continent and its governance shifted and changed in response to or with the necessity of taxing. Taxes have fostered more than a few rebellions, the Maccabbean revolt and our own revolution among them. The French Revolution was much more a release of the pent-up frustrations of ordinary French citizens at the ruinous taxing and spending policies of the Sun King,

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19 Adams 7.

20 Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986) 21.

21 Webber 22.

22 Webber 22.

Louis XIV, than it was an immediate response to being advised by Marie Antoinette, wife of the equally-doomed Louis XVI, that they "should all eat cake."[23]

The Rosetta Stone, discovered by the soldiers of an adventuring Napoleon Bonaparte, became that tiny keyhole through which we pass into the world of ancient Egypt. Essentially, the inscription on the stone was a tax agreement between the taxing authority of Egypt, the Scribes, as representatives of the Pharaoh, and those against whom taxes were being levied, merchants and common folk alike. Educated speculation has it that the document was set in stone as a measure of its importance rather than relegating it to fragile papyrus, and it is believed that the agreement inscribed on its surface was instrumental in avoiding a tax rebellion.[24]

As dangerous as "terror-taxation"[25] is, so too is the absence of taxation, or the failure of the government, whatever its size, to collect adequate revenues to meet the collective needs of the people, whether those needs are defense or the supply of vital services to secure the order and well-being of the citizenry. In Ancient China, according to Charles Adams, the Emperor was advised to maintain a wise taxing policy in keeping with the teaching of Confucius and the Taoists, lest he lose the Mandate of Heaven, [26] which of course could be the result of taxing too much, fostering rebellion, or too little, succumbing to invasion.

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23 *See generally* George R. Havens, *The Age of Ideas: From Reaction to Revolution in Eighteenth-Century France* (New York: The Free Press, 1965).

24 Adams 17-24.

25 Adams, *generally.*

26 Adams xxii-iii, 45-51.

So taxes can, as Adams' title implies, be either good or evil, and the tax collector either a harbinger of doom or a necessary cog in the machinery of a prosperous and healthy economy. History provides adequate examples from both ends of the spectrum. It is against this historical backdrop that debate now stirs in this country and elsewhere as taxing authorities worldwide look to the burgeoning electronic commerce culture and see opportunities and potential problems. There are the exhortations of those opposed to taxing electronic commerce transactions in any form who, resting on the age-old image of the tax collector as a destroyer of worlds, warn us to leave an infant industry alone and allow it to grow and shape itself before any taxes are imposed. That notion is as fraught with problems as the notion that each and every transaction handled, facilitated, or generated by or through electronic commerce, through "cyberspace,"[27] should be subject to taxation by means of a "bit tax,"[28] a proposal that has been received with uniform skepticism in the U. S. and abroad.[29]

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27 **cyberspace:** the part of human society and culture that exists in networked computer systems rather than in any particular physical location. Downing 113.

28 The "bit tax" is an idea propounded by Canadian Arthur Cordell in which the flow or throughput of information itself is taxed (by a factor of some fraction of a unit of currency, such as .0000001 cents per bit of data), in much the same fashion as water or electricity are billed. The proposal has generally been regarded as unrealistic and unwieldy, as often the resulting tax may exceed by several hundred percent the cost of the item being purchased. For example, a $7.95 movie could by virtue of its size, several hundred megabytes even when compressed, draw a tax twenty times the cost of the product. Cordell's reply has been somewhat simplistic, i.e., "change the rate." *See generally Taxing Cyberspace: Cybertax . . . A Bit of Reason or a Bit Ridiculous?* http://meritbbs.unimass.nl/cybertax/cybertax.html. Also see Arthur J. Cordell, *New Taxes for a New Economy,* Government Information in Canada/Information gouvernemental au Canada, Volume 2, number/numéro 4, spring/printemps, 1996, http://www.usask.ca/library/gic/v2n4/cordell/cordell.html.

29 In Europe, the EC has, to some extent, acknowledged the taxation problems that member countries currently face. For telecom and Internet services, at least, they have amended their "supply of services" rules. Thus, after 1998 non-EU suppliers of telecom and Internet services will have to include VAT charges to their European customers. At the same time, the European Commission

The argument that because an industry is relatively new any form of taxation becomes a form of economic infanticide is equally unworkable and in some sense stretches credulity to the breaking point, as many of the so-called infants have grown, with extreme rapidity, far in excess of older, more established segments of the economy, to the extent that many of them, Microsoft as an example, are worth in the hundreds of billions of dollars. Secondarily, but very importantly, we have, for the most part, become

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has formally rejected the idea of a bit tax. They do so on the basis of the five arguments summarized below:
1. The bit tax triggers double taxation - Communications activities on the Internet are taxed in the same way as communications services and equipment are. The bit tax would thus lead to double taxation.
2. The bit tax would not solve the particular taxation issues raised by electronic transactions - Electronic transactions (and content) may raise issues related to tracing transactions and relevant jurisdictions. Many of these issues have been resolved in terms of on line databases, premium services over telecoms networks and financial transactions. As with the traditional supply of goods and services, with electronic transactions, companies are required to levy the relevant VAT rate or report why it has not been levied.
3. A tax on "physical" transactions is extremely difficult to implement - Here the term "physical" transactions refers to bit throughput as opposed to the actual value of the transaction. The Commission points out that bits are difficult to count and could be hidden by encryption. Counting bits, they argue, will tend to cost more than the revenue raised. They also point out that the bit tax could create incentives for tax avoidance through, for example, compressing data or keeping it in analog form. Also, some online 'goods and services' such as browsing through a virtual bookstore, are not priced at all. A tax on such 'goods and services' therefore seems unfair.
4. A bit tax would inevitably produce very inefficient distortions - Since the Internet offers new forms of goods and services, at times with implicit quality differences (e.g. updated information or customised presentation), Internet suppliers will most likely practice some type of price discrimination. Degrees of substitutability or demand elasticity may vary considerably, for example between software CD and distribution on line. Any taxation on the Internet will induce distortions, but quantity taxes, such as the bit tax, will induce even larger ones.
5. Taxation or subsidy and other Internet development problems? - The main argument here is that Europe is lagging behind the US in terms of Internet development; for this reason the prospect of taxation is considered inappropriate. In addition, other issues, such as security issues, should be addressed first before considering taxation problems.
Most recently, at a conference in Bonn, industry leaders and ministers from 29 European countries, the US and Japan decided that no additional taxes or tariffs should be imposed on transactions using global electronic networks. In addition, Mr. Günter Rexrodt, Germany's economic minister, suggested that products and services specifically associated with the use of the Internet could be traded on a duty free basis. MERIT - Maastricht Economic Research Institute on Innovation and Technology, http://meritbbs.unimaas.nl/cybertax/cybertax.

smarter than that, as even a cursory examination of U.S. tax jurisprudence will demonstrate.

In the American system, demanding as it is of fair apportionment and some reasonable relationship between the taxing authority and the activity or property being taxed, it is virtually impossible to tax any industry into oblivion, most especially an industry the size of, and possessed of the financial weight of, the compendium of businesses involved in electronic commerce. Quite the opposite is true. In fact, it has become a running joke that the "dot com" of the day, with no staff, no product, and only an idea of dubious stamina, can be turned into an initial public offering that will generate millions for speculators in an offering that represents little more than thin air[30]. Furthermore, the influence of electronic commerce players has come to have tremendous influence on our political and legislative processes, to which the ITFA is testament.

Some have likened the financial landscape of at the turn of the century to the 16th century Dutch tulip bulb fiasco. Clearly the peaks and valleys in the performance of many companies resemble an Alpine topographical relief map. "Vapor.coms"[31] are the growth industry of the late 1990s[32], and while this situation is definitely not without its

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30 As the wild swings in the NASDAQ, heavy with technology offerings, in early April 2000 attest.

31 Author's term.

32 *See generally* Erik Larsen, " Free Money: The World of Business," *The New Yorker* 11 Oct. 1999: 76. The article details the phenomenon of the *iVillage* IPO and the reactions to "[a] company as ethereal as air, with deep losses, few physical assets, little proprietary technology, extravagant rates of spending, a high employee 'burn rate,' [Author's note: The principals are currently defendants in a flurry of lawsuits from a number of high level managers over recruiting irregularities.] and powerful emerging competitors."

humorous aspects, the amount of wealth the industry as a whole commands is its virtual guarantee that it will not be taxed into ruination.

A Brief Overview of the Impact of Technology

No one disputes that technology has had profound effects on people, economic systems, governments, trade, and the structure of societies in general. One need only observe the glaring differences in the style and quality of life among emerging nations and those of the most developed ones to see the role that technology or its absence plays, or has played, in either encouraging or stifling enterprise and development. It is interesting, in an almost quaint sort of way, to observe, via television or on our computer screens, scenes of farmers in the Nile Delta operating a foot- or animal-powered water wheel. As a point of irony, at one time a simple, crudely constructed water wheel was a technological breakthrough itself, wielding every bit as important and profound an effect on its society as television and the computer have had on this one.

At each step along the way from a crude water wheel that allowed agricultural production to become more systematic and therefore more reliable, technological developments have created changes in the way people engaged in commerce. As the rudder and tiller were developed and the science of sails improved, ships no longer had to hug coastlines, but could, with the aid of the sextant and the magnetic compass, venture long distances from home ports until the globe was circumnavigated. Trade in goods changed and flourished. Great economic empires arose, and in the midst of that, driven as much by the need for more rapid and reliable means of communication as by the need

for a more permanent method of preserving records, tax and commercial among others, the quill gave way to the printing press.

Transportation, over land and sea, was the primary means of communication, and, naturally, commerce. When engines rather than wind began to propel ships, and diesels rather than steam engines powered locomotives, distances shrank in time. Continents and oceans presented less of an obstacle that they had in the past, and communications were again facilitated. Rather than a letter or business document taking two months to cross an ocean or a land mass, it began to take only weeks or days. Then, the telegraph was developed, and such messages as could be transmitted took mere minutes. The telephone followed shortly thereafter, and the information was transmitted as it arose. Not long after, radio followed, and then television.

In the first few years after World War II, an interesting device was built. Its major purpose at that time was military, as it was initially employed to assist artillery officers in determining the proper sighting criteria for their weapons. That device was a computer, and it worked well enough in its limited capacity, although it was large and slow. It had no capability for storing information beyond performing the calculations put to it by the operator at the moment an answer to a problem was required, "in real time," as the term came to be known. Not long after, a computer capable of receiving and storing information was developed, and since that time computers have gotten smaller, faster, cheaper, and more powerful.

In sum:

> Before the invention of the printing press, almost all storage and communication of information was done manually or personally, often by the same individuals . . . in various media. Given the[ ] limitations on the storage and communication of information, consumption choices were quite limited, especially for the masses--primarily to consumption of tangible products, which could be transported and traded, and of information that was produced and consumed in real time . . . without the benefit of communication . . . , or that was stored manually and communicated . . . in tangible form . . . During the preprint age, there was relatively little commerce in information, as it is known today. Unlike goods, services were consumed almost entirely when and where they were produced; they could not be transported or communicated. Intangible products did not exist.[33]

This is not the case today. As cyberspace has grown, first keeping pace with, eventually eclipsing, and finally forcing expansion of virtually all materials handling enterprises throughout the myriad channels of distribution, so has the availability of all manner of products expanded, both tangible and intangible. Whether communications services, software, or information; popular titles, clothing, consumer goods, music, or digital representations of scientific, financial, and educational material--all are available, and all can be delivered to the desktop or doorstep of anyone who chooses to engage in commerce via electronic means.

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[33] Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Law*, 52 Tax Law Review 269, 1997.

A Brief Overview and Historical Sketch of the Information Age

In his submission to the 1997 Symposium on Taxation and Electronic Commerce, Charles E. McLure, Jr. provides essentially a three-part framework for understanding the information age and thus the development of electronic commerce and what have become the Internet and the World Wide Web. Beginning with the "Age of Print,"[34] McLure writes that "[t]he discovery of the printing press (and subsequently of photography) allowed information to be stored typographically (and photographically) and communicated in printed forms, for example, via books, magazines, and newspapers . . . relatively cheaply . . . The ability to produce catalogs cheaply (and eventually with photographs of products) created the mail-order industry, which disrupted the historically valid presumption that retail commerce was a local activity . . ."[35] From that point, outlining the "Electric/Analog Age," McLure observes that:

> [a]t the dawn of th[is] age, electricity was the only intangible product of any consequence delivered to its users. But the discovery of electricity made possible the invention of new ways to record and utilize information (initially in mechanical forms and subsequently in magnetic analog form) and communicate it. Information stored electronically could be consumed at a different time or place, and the invention of the telegraph, radio, telephone, and television, the hallmarks of the analog age, expanded consumption opportunities to include the possibility of distant real-time consumption of

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34 McLure 285.

35 McLure 285.

> information (two-way and interactive in the case of the telephone and short-wave radio, but commonly one-way and non[-]interactive in the case of commercial radio and television). The combination of the new communications and recording technologies opened the way for recorded information to be communicated electronically--and for information communicated electronically to be recorded by the recipient . . . [36]

thus, ushering in the "Digital Age,"[37] which "add[ed] the possibility of communicating electronically stored information cheaply, easily (for example, using TV set-top boxes and Internet-ready TV sets), and rapidly, increasingly in both directions and interactively, from anywhere to anywhere, using a variety of technologies that produce high-quality signals."[38] The development of low-cost high speed equipment, personal computers ranging from desk-top to hand-held models, faster, more efficient modems, attractive, easy to use software, readily accessible service providers, fiber optics, and a number of other factors "give[ ] rise to electronic commerce, which usefully can be defined as 'the use of computer networks to facilitate transactions involving the production, distribution, sale, and delivery of goods and services in the marketplace.'"[39] McLure enumerates "certain key developments . . . among the hallmarks of digital commerce."[40] Among

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36 McLure 285-6.

37 McLure 287.

38 McLure 287.

39 McLure 287.

40 McLure 287.

them are the fact that the "[c]ommunication of information does not require recording on a tangible medium that enters commerce" and that more complex and sophisticated developments in "[e]ncryption offer[ ] the possibility of making secure payments, including small micro-payments, in real time."[41]

A Brief History of Electronic Commerce

The Birth of the World Wide Web

> Tim Berners-Lee, the inventor of the World Wide Web, writes:
>
> When I first began tinkering with a software program that eventually gave rise to the idea of the World Wide Web, I named it Enquire, that's Enquire with an E, short for *Enquire Within Upon Everything,* a musty old book of Victorian advice I noticed as a child in my parents' house in London. With its title suggestive of magic, the book served as a portal to a world of information, everything from how to remove clothing stains to tips on investing money, not a perfect analogy for the Web but a primitive starting point.
>
> What that first bit of Enquire code led me to was something much larger. A vision encompassing the decentralized organic growth of ideas, technology, and society. The vision I have for the Web is about anything being potentially connected with anything. Unlike *Enquire Within Upon Everything*, the Web that I have tried to foster is not merely a vein of information to the mind, nor is it just a reference or research tool. Despite the

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41 McLure 287.

> fact that the ubiquitous WWW and dotcom now fuel electronic commerce and stock markets all over the world, this is just one part of the Web. Buying books from Amazon.com and stocks from e-Trade is not all there is to the Web. Neither is the Web some idealized space where we must remove our shoes, eat only fallen fruit, and eschew commercialization.
>
> The irony is that in all its various guises, commerce, research, and surfing, the Web is already so much a part of our lives that familiarity has clouded our perception of the Web itself. To understand the Web in its broadest and deepest sense, to fully partake of the vision that I and my colleagues share, one must understand how the Web came to be.[42]

Since the Internet and World Wide Web have been defined above, a brief sketch is all that is in order to appreciate the time spans involved in their development. "The Internet originated in 1969 as ARPANET, a computer network connecting United States Government and research organizations. It was created to facilitate the exchange of information through access to sophisticated hardware and software. Originally, access was restricted to the military, government defense contractors and defense researchers. In 1991, the United States government lifted access restrictions, and, as a matter of economic and social policy, decided to support private development of the 'information superhighway,' thereby giving rise to the recent flood of interest in its commercial

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42 Tim Berners-Lee, *Weaving the Web: The Original Design and Ultimate Destiny of the WORLD WIDE WEB by Its Inventor* (San Francisco: HarperSanFrancisco, 1999) 1.

exploitation."[43] Access to the Internet is usually provided to the general public via on-line service providers (OSPs), which typically provide additional member services such as email, chat rooms, and the like, or via Internet service providers (ISPs), that primarily serve as portals to the Internet or World Wide Web.

Because the Internet is not bound by geographic borders as between states or countries, it has become increasingly popular as a venue for engaging in commerce. As a result it continues to expand in scope, size, and user population. Daily, electronic magazines and news services offer discussions and reports on policy decisions from India, China, Australian, Britain, Mexico, and Latin America, to name but a few.

A critical factor that has allowed for the expansion of commerce in cyberspace is the issue of security, security of transactions. Recognizing the problem of user confidence, Berners-Lee reports that, "[o]ne of the top priorities was network security. Information such as credit card numbers sent over the Web needed to be safeguarded,"[44] necessitating the development of "[e]ncryption software [t]hat [would] protect the confidentiality of serious communications required for commercial transactions."[45] Once the security protocols were set and the products necessary for securing electronic exchanges of information were developed, tested, and released, the "users snapped it up [and t]his [SSL, Secure Socket Locking software] was one of the first protocols that

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43 Anna M Vanderhoff, *The Tax Man Cometh: A Realistic View of the Taxation of Internet Commerce*, 27 Cap. U. L. Rev. 929, 931, 1999.

44 Berners-Lee 97.

45 Vanderhoff 932.

allowed electronic commerce, e-commerce, to gain credibility,"[46] and with that, a certain measure of user comfort was achieved, and business people were reasonably assured that the vast amounts of sensitive information they would be transmitting would be at least relatively safe. It was at that point that the use of the Internet and World Wide Web began its meteoric increase. As it did, it began to shape the way things were done, and reshape many of the traditional methods of transacting business. For example, it made little sense to perform all the steps of a transaction interactively on-line and then be forced to wait a couple of days for signed originals of contracts to be exchanged. Responding accordingly, electronic signature bills were passed that further facilitated the process and brought about a social, albeit legal one as well, change as had been envisioned by the inventor who viewed "the Web [a]s more of a social creation than a technical one. I designed it for social effect to help people work together and not as a technical toy."[47]

But Mr. Berners-Lee, much like the developers of television who saw that medium in pristine informational and educational terms, will have to content himself with the fact that what he envisioned is only partly true. The Internet and World Wide Web are both instruments of social change, on the one hand, and a vast technical playground equipped with all manner of toys, on the other. Like every other medium of communication ever devised, they are also, and this is the inescapable reality, tools for industry and commerce.

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46 Berners-Lee 97.

47 Berners-Lee 97.

The Internet and the World Wide Web have become homes to many new types of businesses and newer forms of older businesses. Those businesses, whether engaged in commercial activity with one another or with the ultimate retail purchaser, are becoming increasingly dependent on the electronic commerce elements of their enterprises. There are few companies of any size that do not have a web presence, and many companies owe their very lives and continued existence to electronic commerce.

CHAPTER III

TAXING ISSUES

Distinguishing Taxes

Essentially, there are three ways that a taxing authority can tax a traditional brick and mortar business establishment (retailer), a levy against its income, its sales, and its property, which generally includes the physical plant and equipment the business owns, if any, and its assets and inventory. It is certainly sensible that where there is no plant nor any equipment, no tangible assets, and no inventory, a taxing authority has no tangible property to tax, and property taxes are generally limited to tangible property, real and personal. But what of the others, income and sales? How is an Amazon.com® or other web-retailer different than, let us say, a Toys "R" Us® outlet in Camden, South Carolina, when Amazon® clearly makes a sale in a given state, and derives income from its business in that state? For that matter, the same can be asked of any remote retailer. Mail order giants like L. L. Bean®, or in earlier times Sears, Roebuck & Company®, are little different in that regard as they make sales and derive income from those sales within the borders of a particular taxing authority. In the final analysis though, how does the mechanism that facilitates that act of commerce distinguish it, at least for purposes of income or sales and use taxes, from a sale made by a retailer with a building, parking lots, and signs directing potential customers to that location, who in turn make purchases in that business establishment? The Internet is, at least in one sense, the placing of sellers in

front of buyers, as advertisers park themselves on more active web sites much the same way as an outdoor advertising firm posts billboards along the busiest thoroughfares. Their purpose is to conduct business with the citizens of the area.

While many electronic commercial transactions presumably escape taxation, they are potentially subject to two different forms of taxation: income taxes, and sales and use taxes. Income taxes, taxes paid on income generated within a taxing jurisdiction, rely on a rather circular definition and are subject to certain jurisdictional rules. Sales taxes are those taxes collected by merchants from consumers on sales transactions made within the taxing jurisdiction. Use taxes, which are complementary to and functionally equivalent to sales taxes, are those taxes imposed on the in-state "use" of goods that the local customer has purchased from an out-of-state vendor. The tax is equivalent to the sales tax the state would have imposed on the customer's purchase had the sale occurred within that state.

The State of State Taxation

Over the last several decades the differences between tax laws and rules, from state to state, and country to country, have by virtue of their differences become increasingly cumbersome and, while not yet serious impediments to the free flow of trade, pose a significant challenge to business people. For a number of years, even before the pressure of lost revenue from Internet sales, there were calls for consistency and uniformity.

In this country, states are afforded wide latitude in formulating and implementing the methods and mechanics by which they taxed transactions taking place within their borders. In an era when travel and communications moved at a quite different and much

slower pace, and individuals and businesses moved around not nearly so much as they do now, the systems worked well enough state to state. However, as the telecommunications industry expanded, the cost and time involved in the transportation of goods contracted, with a corresponding increase in overall wealth and in the amount of business done. One result has been that state and national borders, at least from a commercial standpoint, have become less and less relevant. Yet the state tax regimes remain virtually the same as they have in the years since 1932, when Mississippi became the first state to adopt sales taxes as we have come to know them. Certainly, the regimes have become larger in scope, moving more dollars and collecting more revenue, but they have devoted little if any effort to any form of standardization, especially as it pertains to the most fundamental of jurisdictional issues. A thorny problem has arisen, therefore, in the analysis of forum contacts and what level, and what amount, and of what character they must be in order to establish sufficient nexus to allow a state to impose taxes without running afoul of the Constitution.

University of Georgia Professor Walter Hellerstein provides the following description of the landscape of state taxation (local taxation, at least as it applies to sales and use taxes, is incorporated in this designation):

> [A]t this juncture, the law of nexus is in a state of rapid evolution and considerable uncertainty. One cannot state with certainty precisely what sorts of connections with a state will suffice for sales and use, income, or other tax jurisdiction. Predictions about the future constitutional rules in this area can

> be made with even less confidence. The general trend prior to Quill[48] looked plainly toward expansion of state jurisdictions tax and Quill, while it may have put a finger in the dike for mail-order sellers, provides at most limited comfort to those in other industries. One's thinking about the rules that will and should govern state taxation of electronic commerce should be informed by this untidy reality.[49]

The untidy reality to which Professor Hellerstein refers arises not only out of a confusion over federal nexus restraints, but also by virtue of the fact that forty-five states and the District of Columbia impose various forms of sales and use taxes on retail sales, while Alaska, Delaware, Montana, New Hampshire, and Oregon impose no such taxes. Rates, subjects, and methods of taxation among the forty-six authorities that do impose sales and use taxes differ vastly, and even greater differences are evident when city, county, and other municipal taxing authorities' rates, subjects, and methods are taken into consideration. Two questions arise when considering Professor Hellerstein's "untidy reality": the first, whether any state imposing a general sales and use tax can find legal justification to tax transactions that occur between in-state buyers and remote sellers, and the second, at what rate shall the transactions be taxed, and should that rate be uniform among those authorities seeking to tax in a particular fashion?

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[49] Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 Tax Review 525, 1997.

In Zippo Manufacturing vs. Zippodotcom, Inc. the United States District Court for the Western District of Pennsylvania, further commenting upon the issue, observes that:

> [T]he development of the law concerning the permissible scope of personal jurisdiction based on Internet use is in its infant stages. The cases are scant. Nevertheless, our review of the available cases and materials reveals that the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet. This sliding scale is consistent with well developed personal jurisdiction principles. At one end of the spectrum are situations where the Defendant clearly does business over the Internet. If the Defendant enters into a contract with residents of a foreign jurisdiction, and it involves the knowing and repeated transmission of computer files over the Internet, personal jurisdiction is proper. At the opposite end are situations where a Defendant is simply posting information on an Internet Web site which is accessible to users in foreign jurisdictions. A passive Web site that does little more than make information available to those who are interested in it is not grounds for the exercise of personal jurisdiction. The middle ground is occupied by interactive Web sites where a user can exchange information with the host computer.[50]

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[50] 952 F Supp 1119, W.D. Pa 1997.

The reliance upon the conduct of a particular seller as a determinant for jurisdiction to tax is articulated in a long body of cases. Scripto, Inc. v. Carson,[51] (where in-state representatives of the out-of-state vendor solicited sales on its behalf); or Tyler Pipe Industries, Inc. v. Washington Department of Revenue,[52] (where the Supreme Court observed that the crucial factors governing nexus are whether activities performed in the state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in the state for the sales.)[53]

While such a factual examination is appropriate and in keeping with more than forty years of jurisprudence, it has a rather sizable downside. Nearly every case has the potential of being litigated, an expensive and time-consuming process that does not always yield a clear result. Such an open-ended examination of facts provides wide avenues for discussion that will inevitably revolve around the size, nature, and practice of an OSP, an ISP or a vendor engaged in electronic commerce, first to determine whether it is an OSP, or if its Web site is passive, active, or interactive, and then whether the entity has purposefully availed itself of a market within a particular taxing jurisdiction, much of which is left to the subjective analysis of the trier of fact.

But What of Quill?

The favorite, and somewhat troublesome, case relied upon by those opposed to taxation of electronic commerce (and the mail-order industry) is Quill, decided in 1992.

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51 362 US 207 1960.

52 483 US 232 1987.

53 Tyler Pipe 250, quoting the decision below, 105 Wash 2nd at 323, 715 P.2d at 126, 1986.

Taxing authorities hoped through Quill to settle finally the problems that had plagued them since the 1967, when National Bellas Hess, Inc. vs. Department of Revenue of Illinois[54] was decided. Responding to the growing popularity of the mail-order industry, state taxing authorities looked to overturn the proposition set forth in National Bellas Hess, that remote sellers' use of common carriers or mail to transport goods into a state did not create sufficient minimum contacts with the forum required to establish nexus and therefore jurisdiction to tax those sellers so engaged. But Quill did not do that. Instead, the United States Supreme Court ignored the very cogent arguments of the Supreme Court of North Dakota, which recognized that "'the tremendous social, economic, commercial, and legal innovations of the past quarter-century have rendered its [National Bellas Hess] holding obsole[te].'"[55]

The Supreme Court instead used the case as an instructional opportunity to spell out its views on the distinctions between Due Process and Commerce Clause considerations. It found that the taxes North Dakota attempted to impose passed Due Process muster, yet not that of the Commerce Clause, because the Quill Corporation contacts with the forum were insufficient to confer jurisdiction for purposes of taxation. The Court held that a physical presence in the state was still needed. However, the Court did not specifically prohibit the collection of taxes the State of North Dakota envisioned imposing upon the Quill Corporation. Rather, and this is the portion of the case that the anti-tax camp conveniently forgets, the Supreme Court, resting on *stare decisis,* called for

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54 386 U.S. 753 1967.

55 National Bellas Hess 300.

uniformity, declaring that Congress was better suited to create that uniformity than was the Court.

The issue of nexus is, and will continue to be unless overturned judicially or redefined legislatively, at the core of any litigation involving taxation of transactions handled via electronic commerce. There is, however, no clear definition of presence, and little to define dispositively what is meant by "sufficient contact." Some courts have held that simply having a sales representative is sufficient, while others have held that more is required. With borders meaning little to any participant in electronic commerce, whether providing a good or a service, some discussion of presence is warranted.

"What is 'sufficient contact?' That is the $3 billion question. U. S. Supreme Court decisions in the 1940s and 1950s clearly established that if a company had a physical presence in a state, such as a retail store, warehouse, or regular salespeople, the company could be required to collect from customers and remit the applicable use taxes."[56]

At least part of the problem, a large one and certainly not a new one, is that of the law being outpaced both by technological development and by the economic response to that development:

> Electronic commerce is a unique, exciting, and important part of this vast stride toward economic efficiency. It delivers the goods and services people want and need without many of the costs imposed by traditional, or 'analog,'

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56 Michael Mazerov and Iris J. Lav, *A Federal Moratorium on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households?* Center on Budget and Policy Priorities 11 May 1999, http://www.cbpp.org/512webtax.htm.

> commerce . . . From the unabashed newness of life in the digital age, we now turn to the distinctly contrasting continuity we see in government. Indeed, in government, everything is old. By this, we mean that the main actors are the same. The people and institutions are the same, so the fundamental problems are the same. In addressing regulation of electronic commerce, one might assume that the issues are technological, and in some respects, of course, they are, but we must focus on who does the regulating as much as the interesting problems they will tackle. The most important questions turn on human and institutional behavior, not technical challenges.[57]

What is Presence?

When borders are immaterial, when there is no need for storefronts or salespeople, what constitutes presence? As a general proposition, well before the advent of easy credit, plastic cash, and widespread and increased availability of telecommunications and personal computers, the requirement of a presence within a forum was not at all unreasonable. Admittedly, it had its shortcomings, tending as it does to favor out-of-state sellers over in-state ones. But generally speaking, commerce between states operated in as unfettered a fashion as possible under the auspices of the negative Commerce Clause.[58]

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57 Rep. George W. Gekas and James W. Harper, *Annual Regulation of Business Focus: Regulation of Electronic Commerce*, 51 Admin. L. Rev 769 Summer 1999.

58 See generally Tyler Pipe Industries v. Washington State Department of Revenue, 483 U.S. 232, 107 S.Ct. 2810 1987, for Justice Antonin Scalia's assessment of the "quagmire" of the negative Commerce Clause. Scalia asserts that unless a state law affecting interstate commerce is facially discriminatory, then it does not violate the Commerce Clause. The Justice further argues "that uncertainty in application has been attributable in no small part to the lack of any clear theoretical

Economic growth was fostered and there was a certain balancing between states. If a company wanted to do business within a state, it sent in representatives and built or rented warehouses, offices, or factories in order to serve its customers.

Electronic commerce, by contrast, depends not all on a particular location and is, in the main, indifferent to manufacturing and distribution sites. A vendor can assemble a file server, or rent space on one located nearly anywhere there is telephone access (and that is rapidly changing as bandwidths and satellite installations increase), rendering, at least in that narrow sense, state or national boundaries obsolete, and obviating the need for any presence at all within a particular forum. It is this new and peculiar situation that creates the quandary confronting states that rely on taxing transactions that take place within its borders. After all, once there is a return to earth from cyberspace, fire trucks still need to operate, and police need to answer calls, and children still need to go to school. It is this erosion, first with mail-order, which is projected to become *de minimis* when compared to e-commerce, and now with electronic commerce.

So then, what is an appropriate response to "presence" and the problems it presents to state and national taxing authorities? Must we redefine it? Or is it redefining itself, being redefined *de facto*?

It is difficult to sustain an argument that an individual at a computer in her home or office in the State of Georgia, who gains access to a vendor via the Internet or World

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underpinning for judicial 'enforcement' of the Commerce Clause." He further states that the Commerce Clause "on its face. . . is a charter for Congress, not the courts, to ensure 'an area of trade free from interference by the States,'" and that "our applications of the doctrine have, not to put too fine a point on the matter, made no sense."

Wide Web and then makes a purchase of goods to be shipped to her, has not made a buying decision within the state, arguably using funds earned there and sending those in-state funds elsewhere. It is further difficult to argue that were it not for such access to her by a remote seller not subject to tax in her jurisdiction (and this goes for mail order as well), she might very well have made her purchase locally where it would be taxed.

The implausible premise in all this is that legally the remote vendor is not "there" in Georgia. According to conventional wisdom, the vendor has no presence in the state, despite all the obvious contacts with the state. What, then, are taxing authorities to make of this alternative, where an otherwise taxable event takes place, yet there is no presence at all under the law?

On that account then, perhaps it is wise for courts and Congress to consider defining alternative forms of "presence." Among those postulated are virtual presence, cyberspace-only presence, or single-point presence. In addition, courts have begun finding that a Web site alone is sufficient to confer jurisdiction in certain circumstances.[59]

Virtual presence is that "view of the Internet . . . as a fixed network which exists in all places where a . . . connection may be made, includ[ing] all the physical components which comprise the Internet . . . appear[ing] as a spider web, [where] each

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[59] See Gary Scott International, Inc. v Baroudi, 981 F. Supp. 714 1997, Stomp, Inc. v. Neato, LLC, 1999 WL 635460 C.D.Cal. 1999, Telephone Audio Productions, Inc. v. Smith, II, 1998 WL 159932 N.D.Tex. 1998, inter alia, where courts in disparate areas of the country have found that Web presence alone is sufficient to confer jurisdiction on parties otherwise without any other contact with the forum. For further detail on the erosion of the nexus standard, *see* John C. Blase and John W. Westmoreland, *Quill Has Been Plucked! MTC States Are Slowly Eroding the Substantial Nexus Standard*, 73 N.D. L. Rev. 685 1997, where the authors set forth in detail the erosion of the nexus standard as a requirement, citing, among others, California statutes that follow an "engaged in business" standard.

person who places his message on the Internet places his presence at every point on the virtual web."[60]

The theory of virtual presence is not without its difficulties. It can be anywhere, as long as the computers are turned on. By the same token, when the computer is otherwise engaged or unplugged, then there is no presence of any kind.

Because the Internet and the World Wide Web comprise a network of connected computing devices, a reticulum, the constituent parts of which can be located anywhere, it cannot be determined with any accuracy through which jurisdictions a transmission traveled, or what discrete parts of the network were involved, except perhaps a vendor's server (and even that is not guaranteed) and the purchaser's computer.

> It accomplishes nothing to conclude that, because a transmission cannot be traced, it takes place everywhere. Similarly, while it is true that material placed on a Web page is available to anyone who chooses to access it, the program which stores the Web page is on the computer of a regional server at a definable node within the network. It does not exist at all points in the network.[61]
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> The connection, and therefore also the locus, is elusive and often indeterminable. Practically and theoretically, then, the idea of virtual presence is an inappropriate way to view the location of an Internet purchase

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60 Anna M. Vanderhoff, *The Tax Man Cometh: A Realistic View of the Taxation of Internet Commerce*, 27 Cap. U. L. Rev. 929 1999.

61 Vanderhoff 934.

> or the presence of a vendor or purchaser on the Internet, and to determine a state's power to collect sales and use taxes. Virtual presence has no counterpart in the current scheme of state taxation of commerce from which one could derive a coherent scheme for state taxation of Internet commerce.

There is a perspective that would treat a cyberspace, the Internet and the World Wide Web as a world of its own, "a unique realm over which no state has jurisdiction the theory that the Internet is a 'cognitive habitat that is conceptually separate from the real space that we physically inhabit.'"[62] If one pursues that theory, it follows that "[t]he simplicity of concluding that the Internet exists only in a cyberspace is appealing. The problem of attempting to determine which states could tax transactions would be obviated. If the Internet could be viewed as a jurisdiction unto itself, then no state could claim the power to tax any transaction that occurs via the Internet."[63]

The view, while appealing to those engaged in the exploitation of the medium, is in the end unusable. For if the predictions that practically every type of transaction will eventually be handled digitally are even remotely accurate, and no state is able to reach those transactions to tax them, then the attendant revenue losses will begin to be felt in profound ways. However, technological developments tend to lend some support to the idea. Satellites may replace wire and fiber-optic cables, expanded bandwidths will make interactive television possible to the extent that content will be delivered without need for

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62 Vanderhoff 935.

63 Vanderhoff 935.

ground-based systems like video stores, software outlets, or big booksellers. For the moment, many of the replacement innovations are developing, making ground-based technology an essential component of electronic commerce. That situation frames the central flaw in the cyberspace-only theory where the reality is that hardware is in fixed locations around the U. S. linked by wire and fiber-optics connecting computer hardware in one or more states, where various services are provided that facilitate the network, and the commerce conducted over it.

Additionally, the notion of a cyberspace-only presence provides no method of determining the situs of either a sale or a purchase and therefore renders every state unable to collect sales and use taxes. For without a point of reference for the transaction, which the cyberspace-only theory relegates to an ethereal realm, no logical connection can be found to any jurisdiction.

More reflective of the current method by which electronic commerce is conducted is the "single-point presence"[64] theory which:

> recognizes the Internet as a connection that facilitates the travel of information bits from one point to another . . . [U]sers of the Internet [are] located at only one point at any particular time during the connection . . . [T]h[is] view . . . is the most consistent with the reality of Internet use. Merchandise and services offered for sale on a Web page are available from anywhere to anyone who chooses to access the Web page. But the computer program which 'serves up' the Web page is on a regional server computer

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64 Vanderhoff 936.

> located at a single definable node within the network. Likewise, the purchaser accesses the vendor's Web page from a single computer located at a definite node within the network, and the vendor, who creates a Web page to offer goods or services for sale, receives the access from the vendor's server from a single terminal in a fixed location where the vendor is physically present. Each of these nodes is, therefore, a point in real space that is recognized and experienced by at least one of the commercial actors.[65]

The single-point presence theory, cognizant as it is of the current architecture of the Internet and the World Wide Web, is not dispositive of the issue of nexus as it is traditionally viewed. In that context, nexus has required more than mere presence via a remote terminal. The flaw in the single-point presence theory is that it presumes that all sales take place at the server location, and within that assumption it further assumes that the file server containing the Web page is located in some state within the United States where the transactions it fosters can be taxed. This condition which may sometimes be true, but not always, as there is little to stop a Webmaster[66] or a company from pulling up stakes and resettling out of the reach of any taxing authority, yet continue to do business anywhere. Clearly, something must be done with the legal definition of nexus and with the requirement for it before a taxing authority can reach a vendor operating within its borders virtually, but not physically.

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65 Vanderhoff 936-7.

66 **Webmaster:** The person who has principal responsibility maintaining a site on the World Wide Web and updating some or all of the Web Pages. Downing 504.

The State of South Carolina dealt with a very similar problem in Geoffrey, Inc. v. South Carolina Tax Commission[67] where the issue was tax on income generated through the use of an intangible asset, in this case a corporate logo. South Carolina's Supreme Court took the position that because the Toys "R" Us® logo, owned by the defendant Geoffrey Corporation, generated revenue from the pockets of the citizens of South Carolina, it was subject to taxation, even though Geoffrey had no tangible asset in the state. The Court's opinion went on to distinguish Quill's physical presence test as applying only to sales and use taxes, in a very short analysis, not otherwise offensive to the Commerce clause, and therefore inapplicable in the case before it.[68]

In essence then, the question is purely a jurisdictional one. It is abundantly clear that states have authority to tax and, in many cases, have authority to tax non-residents. It is well tested and settled that businesses neither domiciled nor resident in a particular taxing authority will nonetheless be taxed under one regime or another. Unanswered at this point is the absolute extent of that authority over what classes of individuals, businesses, persons, and transactions. It is almost simplistic to recognize that a company headquartered in New York with an outlet in North Carolina where North Carolina residents make purchases of goods produced by that company in California, Nebraska, Texas, or anywhere else, or even imported items, will at the counter in that physical

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67 31 S.C. 15, 437 S.E.2d 13, cert. denied, 510 U.S. 992, 114 S.Ct. 550 1993.

68 *See generally*, Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and The State Taxation of Income*, 23 Hofstra L. Rev. 407 Winter 1994 for an analysis of the effect Geoffrey has on Quill; Blase and Westmoreland for an alternative to the state taxation disunity problem and how that is affecting the notion of nexus; and Julie M. Buechler, *Virtual Reality: Quill's "Physical Presence" Requirement Obsolete When Cogitating Use Tax Collection in Cyberspace*, 74 N.D. L. Rev. 479 1998.

establishment pay any applicable sales tax imposed by the taxing authority. The problem is as much semantic as anything else, i.e., the failure to settle upon a clear definition of presence.

In every body of law, copyright as an example, definitions play a crucial role in determining when rights begin and end and what rights are conferred. Our Constitution provides copyright protection to authors for their "writings." In the early days of the Republic, harkening back to the Licensing Acts and Stationer's Copyrights, writings were narrowly defined as "books, maps, and charts," which must have been published and registered in order to receive any protection whatsoever from the law. With each new technological innovation, the courts and Congress faced expanding the definition of writings to include musical compositions, paper rolls for player pianos, recorded live broadcasts of events such as speeches from famous civil rights leaders, and football games, to computer programs and graphic displays on computer terminals. Thus, a parallel can be drawn between that broadening definition of writings and a broadening definition of nexus. If copyright protection can be extended to an array of pixels on a cathode ray tube monitor attached to a computer that accesses a remote file server in some remote area of the World Wide Web, then it does not defy logic to suggest that the wares of a manufacturer or merchant that are available, whether as digital depictions of information later reduced to text such as in technical manuals, books, periodicals, and the like, or as some tangible physical object that will later be mailed or shipped via common carrier. Logic is not strained by the suggestion that the computer terminal over which

such a transaction is effected constitutes legal presence within a forum sufficient to confer jurisdiction for a variety of purposes.

CHAPTER IV

ADDRESSING THE ISSUE

The Advisory Commission on Electronic Commerce

In October1998, Congress passed the Internet Tax Freedom Act and with it created the Advisory Commission on Electronic Commerce[69] assigning that body to study the issue of the taxation of electronic commerce.[70] The Commission experienced a

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69 The Act provides:
SEC. 1102. ADVISORY COMMISSION ON ELECTRONIC COMMERCE.

(a) Establishment of Commission.--There is established a commission to be known as the Advisory Commission on Electronic Commerce (in this title referred to as the ``Commission"). The Commission shall-- (1) be composed of 19 members appointed in accordance with subsection (b), including the chairperson who shall be selected by the members of the Commission from among themselves; and (2) conduct its business in accordance with the provisions of this title.

70 The Act further provides:
SEC. 1102. ADVISORY COMMISSION ON ELECTRONIC COMMERCE.
(g) Duties of the Commission.--
(1) In general.--The Commission shall conduct a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate or international sales activities.
(2) Issues to be studied.--The Commission may include in the study under subsection (a)--
(A) an examination of--
(i) barriers imposed in foreign markets on United States providers of property, goods, services, or information engaged in electronic commerce and on United States providers of telecommunications services; and
(ii) how the imposition of such barriers will affect United States consumers, the competitiveness of United States citizens providing property, goods, services, or information in foreign markets, and the growth and maturing of the Internet;
(B) an examination of the collection and administration of consumption taxes on electronic commerce in other countries and the United States, and the impact of such collection on the global economy, including an examination of the relationship between the collection and administration of such taxes when the transaction uses the Internet and when it does not;
(C) an examination of the impact of the Internet and Internet access (particularly voice transmission) on the revenue base for taxes imposed under section 4251 of the Internal Revenue Code of 1986;
(D) an examination of model State legislation that--
(i) would provide uniform definitions of categories of property, goods, service,

stuttering start[71] during which state and local taxing authorities challenged the makeup of the panel as heavily weighted in favor of the industry and anti-tax Republican interests. Amid threats of and even actual, though short-lived, litigation, the Commission underwent a slight restructuring in an effort to achieve some greater degree of balance between electronic commerce industry representative, anti-taxation factions, and state and local tax administration interests. When the Commission finally held its first meeting in June of 1999, there was almost no mention of it in either the popular or the business press, with the notable exception of the June 21, 1999 issue of *USA Today*.

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or information subject to or exempt from sales and use taxes; and
(ii) 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 sales;

(E) an examination of the effects of taxation, including the absence of taxation, on all interstate sales transactions, including transactions using the Internet, on retail businesses and on State and local governments, which examination may include a review of the efforts of State and local governments to collect sales and use taxes owed on in-State purchases from out-of-State sellers; and

(F) the examination of ways to simplify Federal and State and local taxes imposed on the provision of telecommunications services.

[71] See generally Bloomberg News. *Lawsuit could trip up Net tax panel.* CNET News.com: March 1, 1999. http://www.news.com/News/Item/0,4,33102,00.html; *Local agencies want a say on Net taxes*. CNET News.com: June 17, 1999. http://www.news.com/News/Item/0,4,38008,00 .html; Greenberg, Paul A. *Business Leaders Seek to Break E-Tax Deadlock.* E-Commerce Times: February 10, 2000. http://www.ecommercetimes.com/news/articles/990702-3.html; Hardesty, David, *E-Commerce Commission Focuses Its Work.* E-Commerce Tax News: August 17, 1999. http://www.ecommercetax.com/doc/081799.html; *E-Commerce Commission Calls for a New Tax System.* E-Commerce Tax News: September 20, 1999. http://www.ecommercetax.com/doc/ 092099.html; *Tax Plans - Final Criteria.* E-Commerce Tax News: October 17, 1999. http://www. ecommercetax.com/doc/101799.html; *Web Server in Another Country - Proposed Rules.* E-Commerce Tax News: October 20, 1999.http://www/ecommercetax.com/doc/102099 .html; *Tax-Free Internet Plans Will Be Fiercely Opposed.* E-Commerce Tax News: November 20, 1999. http://www/ecommercetax.com/doc/112099.html; *E-Commerce Tax Plan Summaries.* E-Commerce Tax News: December 1, 1999. http://www/ecommercetax.com/doc/120199.html; *Can a Web Server Alone Cause Taxability in a Country.* E-Commerce Tax News: February 20, 2000. http://www/ecommercetax.com/doc/022000.html.

In addition to placing a three (3)-year moratorium[72] on the ability of states and local governments to tax certain Internet and related activities, the Internet Tax Freedom Act (ITFA) banned taxes on Internet access, a victory for ISPs, OSPs, and any other entity providing a conduit through which the Internet is accessed. ITFA also banned taxes that discriminate by taxing products and services unique to electronic commerce, multiple taxes, and bit taxes, and it permanently relieved electronic commercial networks of responsibility for compliance with Federal Communications Commission fees and regulations imposed upon telecommunications. In effect then, Congress has said that the Internet, World Wide Web, and electronic commerce in general are unique and worthy not only of special treatment, but apparently a body of law all unto themselves. However, it should be noted that, other than placing a moratorium on any "new" taxes on electronic commerce, ITFA has limited substantive impact.

In fact, and the results of the effort bear this out, it is quite likely it was never intended to have any impact. One need look little farther than the composition of the ACEC to surmise that such a panel could hardly help but reach a stalemate, which is in fact exactly what happened. ITFA specified that the ACEC would comprise nineteen (19)

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[72] The Act provides:
SEC. 1101. MORATORIUM.
(a) Moratorium.--No State or political subdivision thereof shall impose any of the following taxes during the period beginning on October 1, 1998, and ending 3 years after the date of the enactment of this Act--
(1) taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and
(2) multiple or discriminatory taxes on electronic commerce.

members drawn from a cross section intended to be representative of all sides of the issue.[73] Therein lies the problem, as became painfully evident.

Among the ACEC members were individuals from industry and government, including Chief Executive Officers from America Online (AOL) and Netscape (who later resigned when his company was purchased by AOL), and curiously one representative from a state that imposes no sales or use taxes of any kind. The balance, if it can be termed that, of the Commission virtually guaranteed that consensus was an impossibility, which proved to be true from the outset. The participants were and remained so evenly divided that from the outset unwavering lines were drawn, and on April 2, 2000, Governor James Gilmore of Virginia, a source of much of the discord, dissension, and dissembling of the Commission, reported to Congress (as mandated by ITFA) that The ACEC, after having reviewed a plethora of proposals, could come to no substantive

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[73] The Act provides:
SEC. 1102. ADVISORY COMMISSION ON ELECTRONIC COMMERCE.
(b) Membership.--
(1) In general.--The Commissioners shall serve for the life of the Commission. The membership of the Commission shall be as follows:
(A) 3 representatives from the Federal Government, comprised of the Secretary of Commerce, the Secretary of the Treasury, and the United States Trade Representative (or their respective delegates).
(B) 8 representatives from State and local governments (one such representative shall be from a State or local government that does not impose a sales tax and one representative shall be from a State that does not impose an income tax).
(C) 8 representatives of the electronic commerce industry (including small business), telecommunications carriers, local retail businesses, and consumer groups, comprised of--

(i) 5 individuals appointed by the Majority Leader of the Senate;
(ii) 3 individuals appointed by the Minority Leader of the Senate;
(iii) 5 individuals appointed by the Speaker of the House of Representatives; and
(iv) 3 individuals appointed by the Minority Leader of the House of Representatives.

conclusions whatsoever.[74] Instead there was a majority report which did propose the enactment of what became known as the "Business Caucus" proposal. But that proposal did not rise to the level of a Commission "recommendation" as it lacked the two-thirds majority required by ITFA, a built-in assurance that little of substance would come of ITFA and the ACEC.

Under ITFA, Congress assigned the ACEC to focus upon transactions involving Internet use and access, state and local taxation, remote sellers, administration and collection issues (including third-party collection regimes), and uniformity. In addition, Congress charged the ACEC with the responsibility for formulating and drafting proposed federal legislation to address not only the foregoing, but to define, among other things, nexus. To that end, the ACEC requested proposals from any party or parties who chose to submit them. Its purpose was to glean from those proposals a workable amount of data and opinion that would allow it to report to Congress by the April 2000 deadline imposed by that body.

However, on April 2, 2000:

> Disregarding the views of opponents, Governor Gilmore of Virginia last week presided over a final vote that sends to Congress the report of the Advisory Commission on Electronic Commerce. The report, which was approved 10 to 8, comes from a Commission no closer now to agreement on the issues plaguing taxation of electronic commerce than when it was

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74 David Hardesty, *E-Commerce Tax Commission Issues One-Sided Final Report*, April 2, 2000 E-Commerce Tax News: February 20, 2000. http://www/ecommercetax.com/doc/0402000.html.

> formed a year ago. Gilmore, who opposes taxation of electronic commerce, squandered the opportunity to deliver to Congress a strong report, by making no real attempt to lead the ACEC to a solution that addresses the concerns of both online vendors, and the states that seek to tax them. The report will be worthless as a document upon which Congress can act.[75]

For many engaged in electronic commerce, especially those whose adamant opposition to taxation in any form is well-known, this result is good news. But many online vendors, while not at the time of this writing paying taxes, are not as far out of the woods as Gilmore and others would have them believe. Part of the difficulty faced by online retailers is that the territory in which they operate is fraught with uncertainty. Hellerstein's untidy reality makes itself apparent again, but this time "[t]he only thing the ACEC seems to agree on is that, for the foreseeable future, Internet *access* [emphasis supplied] should remain free of sales tax, and there should be no multiple or discriminatory taxes on e-commerce [bringing] us right back to where we were in October of 1998, when the ITFA was passed . . . "[76] Thus, the untidy reality continues.

A consensus that Internet "access" should remain tax-free provides almost nothing in the way of an answer to any of the questions Congress posed to the ACEC at the outset. Online vendors still face the dilemma of whether to collect tax. Some may fall back on *Quill*, but that may not be a satisfactory solution to the problem. It may, in fact,

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75 Hardesty.

76 Hardesty.

exacerbate the negative aspects of the situation facing e-commerce merchants. David Hardesty, articulating in his online publication *E-Commerce News* the continuation of the problems faced by online vendors, observes that:

> Doing business online involves enough risk and uncertainty without the added problem of taxation. The ACEC had an opportunity to help e-commerce by addressing, head-on, the issues that make e-commerce taxation difficult. Unfortunately, the ACEC never got beyond politics and factional bickering, and business is left to cope with taxes as best it can.[77]

The major tax problem with which online businesses must contend is the risk that is associated with not collecting tax. A business that does not collect tax in a state, and is later found to be required to do so, is liable for those back taxes. Generally, in a situation where a business fails to file a sales tax return, there is no statute of limitations on its liability. States that successfully prosecute delinquent business often demand years of back taxes, along with interest, statutory penalties, and legal fees. For a company that loses a fight with the tax collectors, payment of back taxes can become a crushing burden, especially a company is pursued by more than one state, which within the environment of electronic commerce is a distinct possibility.

As a result,

> [t]ax risk is particularly acute for online businesses, because Internet business models have not been tested in the courts. Some say, for instance, that the case Quill Corp. v. North Dakota, does not apply to online sellers . . . [but

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[77] Hardesty.

> t]he Quill decision related to a mail order company, not an online company . . . There is no doubt states will raise this argument at some point in the future.[78]

Citing some examples where arguably presence exists, Hardesty notes that, "Online sellers of computers, which provide in-state warranty services, are at risk because half of the states claim such services represent physical presence. This claim has yet to be fully tested."[79] However, as many online computer sellers ignore state tax laws, the issue will almost surely be litigated, testing the strength and applicability of the Quill decision to electronic commerce.

While little hard data exists on the issue, it is safe to assume that sales tax is often the deciding factor for consumers purchasing computers online. As a result, an online computer vendor, in order to stay competitive, may have little alternative but to accept the risk that failure to collect taxes in the future may make it liable for those taxes. The practice simply becomes an accepted part of engaging in online retailing. Still, the presence of any facility for potential tax purposes, whether a retail store, a distribution or service center, or even a technician, is troublesome for online retailers, whether they are exclusively so or are electronic adjuncts to existing brick and mortar businesses.

As a precautionary measure, a traditional retailer expanding its business to the Internet or World Wide Web often forms an independent company to operate exclusively online. The new enterprise travels under the premise that although its affiliate has a retail

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78 Hardesty.

79 Hardesty.

outlet in a state and therefore must collect sales tax in that state, the new company is an independent entity engaged in online sales only, and is thus unaffected by the presence of a store that it does not itself own. Hence, "[f]ormation of an independent online business unit is a business model that is very common in e-commerce. For instance, the bookseller, Barnes and Noble[®], sells online through bn.com[®], an online company that does not collect sales tax in most states, despite the existence of Barnes and Noble[®] stores throughout the country."[80] Forming a separate e-commerce arm then is becoming common practice. It is questionable, though, how long such strategies will be tolerated. Tax administrators, both here and abroad, are carefully scrutinizing the technique, with many arguing that the practice is little more than a tax avoidance tactic, rather than the sound business decision it is often touted to be.

It is clear that if the practice of separating online from traditional businesses is to survive, parent companies must be extremely careful in the forms of business and customer service each of the retailers offers and provides. As Professor Hellerstein has asked, what happens to an online vendor with a brick and mortar presence within a particular state, that allows refunds, exchanges, or returns to be made in that brick and mortar outlet for purchases made from its online counterpart? Is such activity sufficient to find nexus? Does a practice such as servicing a product, issuing a refund, or allowing a return or exchange evidence a connection between the physical retail outlet and the online company sufficient for a state to take the position that the online company is simply an extension or integral part of the company that clearly has a very real and very

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80 Hardesty.

physical presence within the state? It is questions such as these that the ACEC failed to answer.

While the ACEC, and apparently designedly so, has substantively failed to carry out its Congressional mandate, the Commission has not been a total loss. There have been some beneficial aspects to its short, tumultuous life. As a direct result of the debate, and in response to a number of the proposals submitted, tax administrators and government officials in the various states imposing sales and use taxes have recognized what tax scholars have been telling them for years, i.e., that a large part of the problem is within and because of the state tax system itself. To that end states have at last committed themselves to efforts aimed at simplifying and standardizing sales and use tax laws, while at the same time forming alliances to press the issue with electronic commerce.

Aside from bringing the debate forward into much more public view than ever before, ITFA and the ACEC have produced an educational benefit. Prior to ITFA and the ACEC, few, even in government, had any idea of the extent of the tangled and tortured system of state taxation. That problem has in large measure been, while not alleviated, ameliorated to a great degree, providing each side of the debate with valuable insight and arguably a much greater appreciation of what it will take to solve the problem.

The Proposals

Although there is some overlap in many of the proposals submitted to the ACEC, with many calling for a streamlined, more efficient and more predictable system of taxation, a reworked definition of nexus, or some combination of the two, coupled with a

necessary technological solution, the proposals appear to group themselves into three broad categories. The first group puts forward Retooling and Simplification Solutions, while the second suggests various Technological Solutions. The third group of proposals are best titled Agenda Proposals, to identify those that have been submitted as much to further the debate as for any other reason, with no clear objective in mind apart from creating a workable system of sales and use taxation in a world where a new method of engaging in commerce is rapidly growing and reshaping the way commerce is conducted.

Some of the proposals that at first glance seem to fall under the Retooling and Simplification category reveal, when more closely considered, that they may be more accurately characterized and placed among those in the Agenda column. That designation is reserved for proposals that set out recommendations calculated to further a particular and stated goal or policy, as well as those proposals, such as one submitted by the eCommerce Coalition,[81] that seem to say the right things, yet leave important questions unaddressed or only partially answered, propound solutions that can only take more rather than less time to complete, and have lofty-sounding, yet poorly-designed goals that take on the cast of conditions precedent to addressing the problem, i.e., we must solve this problem before we can solve that one, the intellectual equivalent of "you can't get there from here." Careful examination of the sources of the proposals and scrutiny of the

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81 The Coalition members include America Online, Inc., Andersen Consulting LLP, Bank One, Cisco Systems, Inc., Citigroup, First Data Corporation, The Gap, Inc., Intuit, Inc., Microsoft Corporation, Sears Roebuck and Co., and Wal-Mart Stores, Inc. Time Warner, Inc. is also a member of the Coalition, but has abstained from participation in th[e proposal process] due to its role on the Advisory Commission on Electronic Commerce. *Disclaimer on the face to the proposal submitted to The ACEC.*

language contained in them is necessary in determining how, or even if, the proposals offer any real solutions or if they are at their core obstructionist and obfuscating.

Retooling and Simplification Solutions

Two types of proposals fit in this category: academic proposals that do a creditable job of recognizing and addressing the myriad concerns of government, business, and the consumer, including suggestions for collection and enforcement, and which attempt to answer the questions Congress has asked, and commercial proposals, i.e., those proposals prepared and presented by individuals or entities engaged in or serving those with economic interests in the outcome of the debate. One example of the latter is the study prepared for the eCommerce Coalition by the accounting firm of Ernst & Young LLP.

Released in June of 1999, the lengthy report is titled *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*[82]. The essence of the treatise, intoning as it does a fireside-chattiness with a few charts and graphs to lend an appropriate air of authority, is that states really have nothing to fear from the Internet because their losses of revenue were *de minimis,*[83] hovering around a

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82 Robert J. Cline and Thomas S. Neubig, *The Sky Is Not Falling: Why State and Local Revenues Were Not Significantly Impacted By The Internet in 1998,* Ernst & Young LLP: Economics Consulting and Quantitative Analysis 18 June 1999: http://www.ey.com/global/gcr.nsf/US/Insights~Tax_Strategy_-_eBusiness_-_Ernst_&_Young_LLP.

83 The collective and individual agenda of those tenaciously clinging to the emaciated physical presence requirement articulated in Quill should be recognized. ISPs, OSPs, and Big Five accounting firms virtually chant it as a mantra and lobby strenuously for its survival. From these same quarters come the observations that not only are the tax revenues lost to electronic commerce by the states *de minimis,* but also that the lost revenues are not much greater than the losses in prior years. As Professor Hellerstein has pointed out numerous times, that argument is analogous to discussing telecommunications tax losses one year after Alexander Graham Bell developed the telephone.

mere One Hundred and Seventy Million Dollars ($170,000,000.00), a fractional slice of the One Hundred and Fifty Billion Dollar ($150,000,000,000.00) pie that is the aggregate state sales and use tax figure.

By contrast, in March 2000 Forrester Research, Inc.[84] released its report,[85] after taking into account, as did the Ernst & Young report for 1998, the year-end sales figures for 1999. Accordingly, 1999 state sales and use tax revenue losses were pegged at Five Hundred and Twenty-five Million Dollars ($525,000,000.00),[86] a greater than threefold increase. The trend, which appears likely to continue and at an increasing rate, should yield revenue losses that handily top the billion-dollar mark by the end of 2000 and the three billion-dollar mark at the end of 2001, following that upward spiral indefinitely. At that rate, states will not have to wait long before they begin to feel a real economic pinch, with no alternative but to make up that lost revenue from some source.

The e-Commerce Coalition proposal, citing as it does on its front page the Ernst & Young study, states in its Executive Summary:

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84 Forrester is a leading independent research firm that analyzes the future of technology change and its impact on businesses, consumers, and society. http://www.forrester.com/ER/Company/0,1391,0,FF.html.

85 Mary Hillebrand, *Report: $525M in E-tail Sales Tax Not Collected in 1999*, E-Commerce Times 25 February 2000, http://www.ecommercetimes.com/news/articles2000/000225-5.shtml.

86 "The Internet tax debate was injected with a measure of reality this week as Forrester Research, Inc. claimed that local and state governments in the United States passed up $525 million (US$) in 1999 tax revenues from Internet sales. The market research firm estimated that nearly $13 billion in taxable retail goods were sold over the Internet in 1999, but sales taxes were collected on only 20 percent of that amount. 'If left as is, taxation issues will only get worse as online retail sales grow to $184 billion in 2004,' said James McQuivey, research director of Forrester's Technographics Data & Analysis." Hillebrand.

The current sales and use tax system is a burden on interstate commerce for all sellers. The complexities surrounding sales tax compliance in almost 7,500 individual taxing jurisdictions result in significant compliance expense for companies both large and small. In recognition of this burden, as well as for other related reasons, the Supreme Court has prohibited any jurisdiction from forcing vendors with no substantial nexus with that jurisdiction to collect the jurisdiction's use tax.

Simplification of this complex system is crucial if any meaningful progress is to be made toward addressing the issues surrounding the taxation of remote commerce, including leveling the playing field for all forms of commerce. Due to the impact of taxation on the emerging competitive realities of electronic commerce, it is important that these issues be settled sooner rather than later. However, it is worth noting that the present situation is not a significant drain on state revenues—states and localities have overestimated their current revenue losses due to Internet sales, and the economy is thriving in large part as a result of electronic commerce. Thus, rather than trying to make a complex and broken system fit into a new economic environment, now is the time for states and localities to make the sales and use tax system less complex by enacting appropriate simplification measures and to level the playing field for all forms of commerce.[87]

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87 e-Commerce Coalition proposal to the ACEC 1.

The Coalition, comprised as it is of members who have all registered opposition to e-commerce taxation in any form and who are heavily involved in electronic commerce, cannot and does not stray from its inherent bias. The Coalition offers a set of solutions that at best pleads the obvious and at worst has the potential of fostering years of debate, if not litigation, on the issue, a situation that plays neatly into the natural disinclination of its members to be held accountable in any meaningful way for collection of sales and use taxes.

A more balanced approach is presented in proposals submitted by Charles E. McLure, Jr. from Stanford University. Titled *Radical Simplification of State Sales and Use Taxes: The Prerequisite for an Expanded Duty to Collect Use Tax on Remote Sales A Proposal to the Advisory Commission on Electronic Commerce*, the work sets forth a foundation upon which a taxation system can rest, and offers alternative plans to meet special situations. Recognizing the myriad problems within the state taxation system, McLure summarizes his plan as follows, proposing that:

> There would be a single uniform nationwide base for sales and use tax. The base would consist of all consumption spending by households. Tangible products, services, and intangibles would pay the same tax. Local merchants and remote vendors would collect the same tax. All business purchases would be exempt in all states. There would be a nationally uniform exemption certificate. Compliance would be simplified and made less costly for vendors (two options):

1. Forms and payments would be filed with one state (base-state approach). De minimis rule would eliminate the duty of some to collect use tax. Realistic vendors' discounts would facilitate 'zero-cost' compliance.

2. Trusted third parties (TTPs) would calculate/remit tax (TTP approach). Taxpayers would be subject to joint audits on behalf of all states. Software would be used to determine the situs of sales and state and local tax rates. States would certify software and provide it without charge to vendors or TTPs. A 'hold-harmless' clause would protect vendors who rely on the software. In addition to these 'primary proposals' there are several 'fallback positions' that some may find more politically realistic. The primary proposals provide a benchmark against which to judge other proposals the ACEC may receive, as well as the fallback positions. Because the proposed system is vastly simpler than conceptually defensible alternatives, the need for simplification may drive decision-makers toward it, despite the conventional wisdom that it is politically unrealistic.[88]

Another potentially workable proposal is that submitted by the American Institute of Certified Public Accountants (AICPA), which specifies simplification as a prerequisite for redefinition of nexus. Setting forth a nine (9)-point plan, the AICPA summarizes its proposal as follows:

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88 Charles E. McLure, Jr., *Summary Statement*, Proposal to The ACEC - Part II.

The AICPA believes the following describes the optimally simple corrective to the current sales/use tax system while balancing the interests of business and government:

1) Vendor remains responsible for collecting and remitting sales/use taxes

2) One harmonized sales/use tax rate per state

3) Rationalization and standardization of nexus rules

4) Uniform, multistate definitions of tangible or digitized products and services

5) Each state continues to determine the taxability of particular tangible or digitized products and taxable services within its borders

6) Uniform, multistate sourcing rules for tangible or digitized products and taxable services

7) Uniform, multistate reporting requirements

8) One sales/use tax return per state (i.e., no separate local returns)

9) Uniform, multistate audit procedures, including uniform record-keeping and retention requirements and a uniform statute of limitations and appeals process.[89]

Interestingly, the AICPA proposal is one of the few submitted that actually attempted to address and answer the eighteen (18) questions put forth by the ACEC. Following are the ACEC questions, grouped under the delineated headings:

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89 *Summary*, AICPA Proposal to The ACEC.

Simplification

1. How does this proposal fundamentally simplify the existing system of sales tax collection? (Some examples may be: common definitions, single rate per state, clarification of nexus standards, and so forth)

2. How does this proposal define, distinguish, and propose to tax information, digital goods, and services provided electronically over the Internet?

3. How does this proposal protect against onerous and/or multiple audits?

Taxation

4. Does this proposal impose any taxes on Internet access or new taxes on Internet sales?

5. Does this proposal leave the net tax burden on consumers unchanged? (Does it impose an obligation to pay taxes where such an obligation does not exist today? Does it reduce or increase state and local telecom-unication taxes? Does it reduce or increase taxes, licensing fees, or other charges on services designed or used for access to or use of the Internet?)

6. Does the proposal impose any tax, licensing or reporting requirement, collection obligation or other obligation or fee on parties other than those with a physical presence in a particular state or political subdivision?

7. What features of the proposal will impact the revenue base of federal, state, and local governments?

Burden on Sellers

8. Does this proposal remove the financial, logistical, and administrative compliance burdens of sales and use tax collections from sellers? Does the proposal include any special provisions with respect to small, medium-sized, or start-up businesses?

Discrimination

9. Does the proposal treat purchasers of like products or services in as like a manner as possible through the implementation of a policy or system that does not discriminate on the basis of how people buy?

10. Does the proposal discriminate against out-of-state or remote vendors or among different categories of such vendors?

International

11. How does this proposal affect U.S. global competitiveness and the ability of U.S. businesses to compete in a global marketplace?

12. Can this proposal be scaled to the international level?

13. How does this proposal conform to international tax systems, including those that are based on source rather than destination? Is this proposal harmonized with the tax systems of America's trading partners?

Technology

14. Is the proposal technologically feasible utilizing widely available software to enable tax collection? If so, what are the initial costs and the costs for required updates, and who is to bear those costs?

Privacy

15. Does the proposal protect the privacy of purchasers?

Sovereignty/Local Government Autonomy

16. Does this proposal respect the sovereignty of states and Native Americans?

17. How does this proposal treat local governments' autonomy and their ability to raise a greater or lesser amount of revenues depending on the needs and desires of their citizens?

Constitutional[ity]

18. Is the proposal constitutional?[90]

To be sure, there are other proposals that address these concerns, such as that offered by Utah Governor Michael Leavitt, writing on behalf of the National Governors' Association, who summarizes his proposal in this fashion:

> Substantial changes are necessary if the sales tax is to continue as an integral part of the state and local revenue system. Sales tax laws must be made significantly more uniform across the states, and the administration of the tax must be substantially overhauled and simplified . . . [yet] preserve[ ] state and local sovereignty, and enhance[ ] the ability of U.S. firms to compete in the

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90 Kendall L. Houghton and Walter Hellerstein, *State Taxation of Electronic Commerce: Perspectives on Proposals for Change and Their Constitutionality*, _____ Brigham Young Univ. L.R. _____ 2000.

global and information economy . . . retaining current law with regard to nexus, and mov[ing] to a uniform system over the longer-term."[91]

Technological Solutions

Among the many proposals submitted to the ACEC, a number offer a purely technological response and series of solutions. Technology should and must play a role in the collection of any tax on electronic commerce or on transactions that take place through the medium of electronic commerce. However, a purely technological solution will fall far short of the mark in terms of addressing the central questions of the issue. The offering of such a solution is, under nearly any set of conditions, implausible.

A major objection voiced by those opposed to taxation, many of whom are involved in electronic commerce, is the potentially burdensome task of collecting and transmitting taxes to the appropriate taxing authorities. The argument that state tax rules are in a state of disarray has some validity, but it will not carry the day. While it may be somewhat difficult, it is not impossible to determine and thus program and execute different tax formulae for each of the jurisdictions to which taxable products or services are sold. If a clothing manufacturer or seller can keep on file sizes of trousers, skirts, belts, hats, shoes and the like, and Amazon.com can keep old and new addresses, credit card numbers, and reading preferences, state sales tax rates should present no real problem.

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[91] National Governor's Association proposal to the ACEC.

A representative proposal is that submitted by Global Crossing, Ltd., which could just as easily fit into the category below for Agenda Proposals.[92] In this case, the Global Crossing, Ltd. proposal, before outlining its web positioning strategy, provides in the Background segment of its proposal the following information and insight into both its technological solution and its agenda:

> Global Crossing is building and offering telecommunications and Internet services over the world's first independent global fiber optic network. We have already announced the deployment of 92,700 route miles connecting 5 continents, 24 countries, and more than 170 major cities. The Global Crossing network and its product offerings will be available to over 80 percent of the world's international communications traffic. Through our subsidiary, Global Center, we are also a major provider of web hosting services. We have already constructed web hosting facilities and offer services in California, Arizona, Virginia, and New York and we plan to extend our operations to other States in the near future. To date, we host 40 of the top Web 100 companies, such as Yahoo, ToysRUs.com, and USAToday.com, and our network facilitates 60 percent of all Internet searches, resulting in nearly 2 million hits per minute.
>
> In general, web hosting facilities, or Media Distribution Centers ("MDC") as we call them, are the hubs around which the Internet operates. These facilities contain the necessary software, servers and routers that are used to

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92 Author's Note: This can be said of the majority of proposals submitted.

> store and retrieve information 'on the Internet.' Global Crossing is not alone in constructing web hosting facilities, MCI Worldcom, AT&T, Exodus and Intel all have plans to introduce or expand their web hosting operations. (Each has its own unique descriptive name for what we call MDCs.) As a result, the market for web hosting services is expected to grow from $2 billion in 1999 to $14.7 billion in 2003.[93] Because the web hosting industry is still in its infancy, however, it is crucial that state and local governments not impose tax burdens on web hosting facilities or their operations that would inevitably stunt their growth or drive some percentage of them elsewhere. State and local government officials that understand this simple principle will likely attract web hosting facilities, which will serve as economic magnets for a broader array of businesses.[94]

Global's proposal, like many others, pays very little attention to the questions those making proposal were asked to address. Rather, like the majority of documents submitted, the proposal demonstrates an inherent flaw in the practice of taking proposals from the public to assist in the formation of policy or legislation. On the one hand, one must question the sincerity and commitment of the parties making the request, and on the other, any proposal that reduces itself to a clear promotional statement in favor of addressing the question put to it is equally suspect. The problem with the Global

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93 James Lindsay Freeze, "Internet Services Hypergrowth," Forrester Report Feb. 1999:5.

94 Global Crossing, Inc. proposal to the ACEC 1.

proposal is that it contains precious little about taxation, and an abundance of salesmanship touting the technology in which it is so deeply invested.

A like proposal, this one submitted by M P P & W Consultants - Information Systems, Inc., reads more like the typical data processing needs-analysis preamble contained in a sales proposal to a large corporation, perhaps because that is precisely what it is, propounding as it does a combination of readily available and proprietary technical systems. The difficulty here, as mentioned at the beginning of this segment, is not with technology, which can and must be utilized to its fullest extent in the implementation, administration, and execution of any tax plan ultimately devised. But technology is not the solution in and of itself; in fact, any attempt to employ a technological solution without solving the legal, legislative, and uniformity difficulties would likely compound matters to the point of chaos.

Agenda Proposals

As noted above, proposals such as those submitted by the eCommerce Coalition are more properly included in this category as much due to the subtlety with which the agendas are put forth as to the composition of the group. But there are other proposals that have not couched their positions in such terms. Among them are:

> *Radically restrictive proposals.* We view as 'radically restrictive' those proposals that would not merely define the terms under which electronic commerce could be taxed (e.g., prescribing minimum nexus standards or simplification requirements) or prohibit taxes on a narrow category of transactions (e.g., Internet access), but rather would ban such taxation

altogether as applied to a broad range of transactions. We would place in this category such proposals as the Internet Tax Elimination Act, cosponsored by Representatives Kasich and Boehner of Ohio, and the proposal to prohibit all sales and use taxes on business-to-consumer Internet transactions, advanced by Governor Gilmore of Virginia. The Internet Tax Elimination Act would prohibit the states and their political subdivisions from imposing '[a]ny sales or use tax on domestic or foreign goods or services acquired through electronic commerce.' The definition of 'electronic commerce' for these purposes is all-encompassing. It embraces "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access. Consequently, the Act would cut a broad swath of tax immunity across state sales tax regimes. It would presumably immunize from tax not only the typical remote sale (e.g., the purchase of a book from Amazon.com[®]), but also the local purchase of goods and services as long as the transaction was 'conducted . . . through Internet access.' Thus, a customer presumably could purchase a car tax-free if, after negotiating the deal in the showroom, the dealer directed the customer to a convenient on-premises kiosk where the customer could consummate the transaction (indicating his or her acceptance) 'through Internet access' with a click of a mouse."[95]

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95 Freeze 5.

While an automobile may not be the best example of the tax avoidance possibilities available under proposals such as those outlined above[96], it is certainly true for other hard goods such as consumer electronics, household appliances, books, recorded music, clothing, and food, to name a few. Under such plans, the kiosk scenario, could potentially deprive state and local governments of significant portions of their tax revenue, with little remedy available to them other than perhaps increasing or levying other forms of tax, such as personal or corporate income tax.

Houghton and Hellerstein further comment that, "Other than simplicity, the Internet Tax Elimination Act and kindred proposals have little to offer from the standpoint of sound tax policy. Indeed, a more appropriate name for the Internet Tax Elimination Act would be the 'Sales Tax Elimination Act.'"[97] Because, "[o]nly those vendors who failed to steer their sales through an Internet-connected device would still be required to collect sales tax."[98]

But what has really happened with the ACEC? From all appearances the Commission was doomed to failure from its inception, and the in-fighting and machinations of its participants who opposed taxation or any even-handed review of the problem, chief among them the chairman, James Gilmore, made sure that failure occurred. The result, then, is that just as there are geographic tax havens, there has now

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96 Author's Note: The reason for this is that where automobiles, as well as boats, motorcycles, and other forms of mechanical conveyance, are concerned, a state has a second bite at the apple so to speak, in that every state and the District of Columbia require that automobiles be registered before they are permitted on the road. As a result, and many states do this now, sales and use tax can be calculated, levied, and collected at that point.

97 Houghton and Hellerstein 2000.

98 Houghton and Hellerstein 2000.

been created a temporal tax-fee zone that will last as long as ill-conceived legislation such as ITFA and the children like the ACEC that it bears continue to appear to study an issue they do not want to tackle.

Alternatives Available to States

Let us suppose for a moment that a state tax administrator concerned with maintaining an uninterrupted stream of revenue from sales of goods and some services to consumers in her state is confronted with a gradually shrinking tax base brought on in significant measure by her inability to reach remote sellers to force them to collect sales taxes on the purchases made by citizens in her state. She has seen any number of brick and mortar retailers in her state introduce electronic commerce components into their businesses that have drained off even more tax revenue. Faced with this situation, the tax administrator has some alternatives.

When deciding her response to electronic commerce, a tax administrator may consider whether to make an effort to tax such commerce or in what fashion it may peacefully coexist with a growing segment of the economy that causes a drain on revenues. One alternative is to do nothing, that is, accept as inevitable the burgeoning environment of electronic commerce and essentially allow it to flourish unmolested by any annoying requirement that it collect and remit sales and use to the state. However, adopting such a policy requires the clear recognition that the state still costs the same amount to operate as it did before, and any shortfall lost to e-commerce will have to be captured elsewhere, in income taxes or higher in-state sales tax rates.

Many of the pieces of work consulted or cited in this thesis call for congressional action that either redefines nexus legislatively or recommends to Congress that it devise a uniform state sales tax intended to be administered and collected by the Federal Government and parceled out to the states through one apportionment scheme or another. A view toward block grants in public assistance funding should point up the level and character of difficulties inherent in that approach. In the meantime, were our hypothetical tax administrator to patiently wait for direction from Congress, the ITFA/ACEC debacle is not likely to increase her level of comfort. Such a scenario, i.e., a Federal state tax agency, will take years, perhaps even decades, to formulate, and in all likelihood will be so rife with compromise as to be ineffective. It is one of those proposals, and there were a few such submitted to the ACEC, that sounds good rhetorically, but is virtually unattainable in reality.

Then there is the case for a uniform state sales tax along the lines of the Uniform Commercial Code. This approach has some promise, as the states are the ones with the strongest incentive to see such a proposal through to the end. Again, such a process will take a great deal of time, not as long certainly as waiting for Congress to act, but long enough. And, once devised and adopted, there is the inevitable tweaking that each state will not be able to resist, leading to some disuniformity, certainly not on the order as now exists, but something that will have to be addressed.

In any case, whether the result is a federally controlled tax or a uniform state tax code (with special deviations), technology will be an integral part of the solution. Because technology is as pervasive, inexpensive, and flexible as it now is, and because

the technological solutions required to track, record, and remit whatever tax is mandated, while grand in scale, are not conceptually terribly difficult. The solutions should be as transparent to the process as possible. Technology, as discussed earlier, is not a solution in and of itself, but merely a means of affecting whatever solution is ultimately forged.

A final scenario that a state tax administrator may consider is the case for taxing and litigating. Although litigation is an expensive process, consuming large amounts of resources, time, and money, some situations call for it. Our tax administrator may do well to consider sending a tax bill to an Amazon.com® or a Microsoft®, await the inevitable court case, and then prepare to test Quill and other cases in court. Given the morass that is state taxation and the apparent ineffectiveness of Congress to devise any workable tax policy for sales and use taxes, litigation may present the shortest route for a state seeking to halt the erosion of its revenue base.

Perhaps states would do well to consider a page from the short yet turbulent history of tobacco litigation and band together, pick a class of defendants, Amazon.com®, bn.com®, and other high profile players in the e-commerce arena, make some reasonable calculations, and send out the tax bills. It is at least possible that, just as Philip Morris and others came to the table, so too might significant elements of electronic commerce. And were they to do so, electronic commerce itself would have a much greater hand in its fate than were it simply to respond to either federal or state legislation. In addition, were the states *en masse* to forge a settlement with e-commerce, the settlement would virtually guarantee two things: uniformity, as the states would all agree to the same things; and a stopping before it starts of endless rounds of litigation that

would surely greet any legislative attempts. Furthermore, because many of those companies which are subject to taxation rely upon or are deeply integrated in the latest technology, often as inventors and developers, there would be little need to outsource such work as would be required to effectuate the systems formulated.

Enforcement Issues

Lewis Mumford, the American writer and urbanist, when presented with a series of challenges, has been quoted as saying, "I am very optimistic about the possibilities but pessimistic about the probabilities." Many tax authorities feel the same way about the Internet, World wide Web, and electronic commerce in general. To continue with our tax administrator, let us further propose that under some legislatively created regime, or one hammered out in litigation, she now has the authority to tax electronic commercial transactions in her state in much the same fashion as she has historically taxed transactions conducted in brick and mortar establishments. Nexus requirements thus relaxed, the revenue department seeks to enforce and collect the revenue that is generated. The questions, though, are myriad. How is collection to take place, and from whom? And by whom? And how do we prevent evasion and avoidance?

As the communication revolution has opened up new possibilities for tax administrations to improve the efficiency of their operations, the technology has also created new "probabilities" for tax evasion and avoidance. The challenges posed to tax systems by electronic commerce are real, and governments will need to focus on how to address them in a spirit of collective cooperation. The allocation of taxing rights must be based upon mutually agreed principles and a common understanding of how these

principles should be applied. Even if such a consensus is achieved, governments may find that their ability to enforce taxation may be diminished. Without such a consensus, the Internet, World Wide Web, and other new communication technologies may pose a serious challenge to governments in maintaining their revenue bases.

In addition to the need for consensus among governments, there is also a need for cooperation between governments and business. Governments, the U.S. Government in particular, will have to conduct a far more serious review of the impact of electronic commerce on their tax systems than the political dog and pony show put on by the ACEC. Such a serious review must resist all temptation to solicit proposals from the public and instead focus upon legislative and administrative regulations, implementation and audit practices, and the effect on international taxation regimes. All the major sources of revenue must be included in this review, including taxes on income and consumption. This is the approach of the work being undertaken by the Committee on Fiscal Affairs (CFA), the main tax policy body of the Organisation of Economic Cooperation and Development OECD).

The Committee on Fiscal Affairs of the OECD articulated its position in the introduction to its report[99] presented at the Turku, Finland Roundtable. Focusing on the major influences that electronic commerce has had on the operation and administration of various taxing systems rather than upon the mechanics of the Internet and World Wide

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[99] Organisation of Economic Cooperation and Development (OECD), *ELECTRONIC COMMERCE: THE CHALLENGES TO TAX AUTHORITIES AND TAXPAYERS: An Informal Roundtable Discussion Business and Government Organisation for Economic Cooperation-Development Report of Conference Taking Place in Turku, Finland November 18, 1997.*

Web, the OECD recognized the positive and extensive impact that electronic commerce has and will continue to have on business and the way it is transacted and the potentially huge increases to the bottom lines of businesses engaged in electronic commercial activities. The report also recognized that certain aspects of electronic commerce have a serious and negative impact on the operation of taxing systems. Among the negatives are the lack of any user control as to the location of activity, little if any means of identification of users, a paucity of information for reporting and withholding institutions, and little if any control over payment systems. Perhaps more clearly than many of the articles written on this subject, the OECD Roundtable report recognizes those activities that are more suited and less suited to Internet and World Wide Web activity. In addition, the report goes on to state that:

> while revenue authorities typically have extensive powers to compel disclosure of information and production of documents, their writ usually runs only within their own jurisdiction and they must rely on cooperation under applicable treaty provisions with other jurisdictions [to obtain such necessary information]. The elimination of 'middle men' disintermediation that results from electronic commerce may cause problems in the collection and administration of cross-border withholding taxes resulting in revenue losses. . . . [I]t is now possible for individual and relatively unsophisticated taxpayers to engage in cross-border transactions [where they] may be unfamiliar with their withholding obligations and the current technology does

> not provide a mechanism for computing and paying such taxes, although such a mechanism seems technically feasible.[100]

Another problem taxing authorities encounter is that of identification of parties. Identification is not particularly difficult if a taxing authority encounters Barnes & Noble® or Amazon.com® and needs to determine its whereabouts. The difficulty lies in properly and adequately identifying a less recognizable vendor operating in electronic commerce and verifying its claims to residency. As an example, a company disseminating electronic information or services performed only through electronic commerce may claim residency in a particular jurisdiction because it has a favorable treaty or other legal structure that renders the tax burden on that vendor much lower than it would be under a revelation of the company's actual whereabouts. Further, it is nearly impossible for a taxing authority to determine via electronic commerce the exact location of any vendor, should that vendor not want to be discovered. As an example, consider that:

> Even where the ownership of a Website or Internet address is established, tax administrations will encounter great difficulties identifying and tracing electronic transactions because of factors such as encryption, the fragmentation of transmissions, and the use of remote control in diverting mechanisms. Taxpayers may conduct their business in cyberspace for

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100 OECD 11.

> increasingly long periods of time. Electronic trails may be inadequate, especially where several taxing jurisdictions are involved in a transaction.[101]

The development of electronic cash as opposed to credit card systems will probably further facilitate both electronic commerce and tax evasion since payment no longer leaves a paper but is rather anonymous and untraceable. Today tax inspectors can check reported income and spending against bank and credit card statements. At present, 90%, by volume, of all financial transactions with respect to consumption take place using cash, cheques and credit cards. These systems usually involve intermediaries such as banks, credit card companies or other financial institutions that leave an audit trail of payment. In the world of the Internet, such an audit trail may not exist.

The Internet and World Wide Web, while on the one hand creating virtual tax havens, also have the potential to reduce the role of intermediaries, an important resource for taxing authorities as they report financial transactions. Intermediaries allow tax inspectors to compare interest income declared by an individual with interest paid by banks. The Internet and World Wide Web to some degree remove the middleman and thus the source for cross-checking. Furthermore, it will be increasingly easy for the average citizen to access offshore financial institutions in cyberspace, often paralyzing tax collectors.

Although electronic commerce is in its earliest stages, it enjoying and will continue to enjoy rapid expansion. As more cryptology programs are developed, such as the IBM® software product Cryptolope®, designed to protect every type of digitally

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[101] OECD 11.

transmitted data, consumer and vendor confidence in electronic commerce will certainly increase and with it electronic commerce sales, as payment information is protected and business people are assured payment for their products and services. It is estimated that within the next thirty (30) years on-line consumer sales could represent as much as thirty percent (30%) of all consumer buying activity.[102]

That prediction, if it develops, and all indications are that it will, presents a serious problem of collection for the tax administrator. Should she begin searching for a new tax collector? As vendors are far-flung, often difficult if not impossible to find, a wall of tax regulations is going to be of little assistance. Within the new world of electronic commerce then, the retailer as the tax collector may no longer be appropriate. The key question therefore is: Who should the new tax collection intermediaries be?

One proposal is that financial institutions assume the role. The argument is that because most immediate payment transactions utilize banks, credit card companies, or other financial intermediaries that leave broad and detailed audit trails, and because electronic payment systems, i.e., debit and credit systems, also leave audit trails and involve intermediate entities to carry out or record the transactions, it simply makes economic sense to consider tapping that source that already yields both information and cash. Electronic debt system funds are stored in accounts of financial institutions using encrypted credit card numbers unique to the credit card owners. Considering that nearly all electronic commerce transactions utilize some form or other of payment described

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102 *See generally* OECD.

above that leave clear, easily-obtained information, such a solution presents a logical and most efficient method of accurately and equitably administering a taxing regime.

There are some exceptions, of course, electronic money for one. Utilizing digital "tokens," e-money transactions leave little in the way of an audit trail, relying instead upon deposit accounts that allow one individual to transfer e-money to another. Creating a usable audit trail requires nothing more strenuous than requiring that each account established be identified by tax registration numbers:

> In the case of the [European Union]'s VAT, suppliers of goods and services from outside the EU would be required to register for VAT and would be given a unique tax registration number. This information would be held in a central data bank which financial institutions would have to check before a payment is made outside the European Union. If the validation would not be successful then the banks would levy a withholding tax. Banks would thus play the role of intermediary.[103]

Other entities, in agency with taxing authorities, telecommunication operators or ISPs perhaps, could collect taxes on goods and services ordered via the Internet or World Wide Web, while software manufacturers could provide solutions to the problem of tax collection by building control systems into browsers or other e-commerce transaction software.

Each of these suggestions has met stiff resistance, bolstered by insistent allegations that such solutions are technologically infeasible, too expensive, or too

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[103] OECD 11.

complicated to be of much use. Much of that line of argument is self-serving, of course, for no one company or group of companies wants to align itself with the tax collector, none wants to become a modern, highly technical *curialis.* However that line of argument is also patently absurd, for the inescapable fact is that software systems are already in existence that can and do calculate applicable taxes on goods sold around the world. Daily, software companies, accounting firms, and various financial institutions conduct research and collect data that, massaged in a slightly different (and not at all impossible) manner, would create a sales and use tax (in the US) or a VAT compliance system which could manage the requisite collection and remittance process. Such a program would:

> provide Internet suppliers of goods and services with a facility to register for [sales and use tax or] VAT compliance worldwide in conjunction with an automated service bureau which could collect and remit local . . . taxes to the appropriate authority or, assuming support from tax authorities, provide Internet suppliers of goods and services with a clearing facility where local taxes are collected and remitted by this software system without the need for the vendor to register for tax purposes in all countries of the world. The argument that taxes should not be levied on Net commerce because its 'too difficult' is perhaps becoming a less credible one.[104]

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104 OECD 15.

CHAPTER V

CONCLUSION

In observing and commenting upon the phenomenal growth of electronic sales, many accept as a foregone conclusion that the logical result will be a supplanting of traditional brick and mortar retailing. While it is certainly reasonable to expect that electronic commerce in the broad spectrum will continue to grow, it does not necessarily follow that the millions of acres of mall parking lots will suddenly, or even gradually, become empty.

It further does not necessarily follow that cash and carry retailing establishments will be reduced to showrooms equipped with kiosks where goods will be ordered electronically solely to facilitate the purchasers' desire to avoid a sales tax and the merchants' having to collect it. That is not to say that electronic commerce will not have an impact on traditional retailing, nor is it to say that electronic commercial establishments will not make inroads and carve out market segments of their own, but it should be noted that by year-end 1999, fewer than two percent (2%) of business transactions of the character at issue here were performed electronically.

Electronic commerce may or may not turn out to stimulate commerce in general, and there is at least some reasonable argument to be made for the proposition that electronic commerce and traditional means of doing business will peacefully co-exist, each stimulating the other. The lunatic fringes are at a loss to explain or provide any

meaningful support for their hysteria, whether that hysteria manifests itself in the premise that taxing any transaction on the Internet will immediately bring about its demise or in the position taken by many state and local governments that they are in danger of going out of business.

A less impassioned, more sober approach should be to recognize that certainly there will be some loss of revenue, although how much is yet to be determined. Also yet to be determined are the responses of the individual states to that loss of revenue. Should it prove to be any more than *de minimis* compared to present-day levels, or should states find themselves in the predicament of not being able to send out the fire trucks, then quite obviously, something must be done.

Both sides present some arguments that upon close examination may be disingenuous, at least at the extremes. For example, the argument that the losses of revenue experienced by the states to electronic commerce is only a fraction, and a very small one at that, of the aggregate revenue collected, and also only a fraction more than the revenue loss experienced under the same conditions in the first few year of the electronic commercial revolution, is simply unsupportable. It ignores completely that condition economists term "the helmsman's dilemma," that characteristic of large ships, and large economies, that requires incremental adjustments, well in advance of any major change in course. Attendant to and included in the dilemma facing helmsmen and in this case, tax administrators worldwide, is that a small change in course has long-term and much broader effects than the change itself.

That notwithstanding, subscribers to the foregone conclusion mentioned earlier, that the assault on retail and the ability of states to collect sales and use taxes will be all pervasive and permanent in this alteration of the way business is conducted, may also be taking the case a bit too far. While the argument is not without some support in a traditional economic model where individuals tend to follow self-interest, it may not result in the emptying of movie theaters and state coffers simultaneously. The end result may well be simply that the consumer may be in much greater charge of the commercial process than he or she has every enjoyed before:

> The principal difficulty in developing an electronic commerce taxing regime is that the Internet is still a new medium whose full ramifications are not close to being understood. Accordingly, at least for now, governments at all levels are not eager to commit to rules that could potentially erode their tax bases. Business is not pushing for new rules either, since existing rules can be interpreted favorably. Thus, it seems that electronic commerce tax law will not be a radical departure from existing rules, but instead will develop piecemeal and reactively to cure perceived taxpayer abuses or revenue misallocations.[105]

As avenues of communication have opened more and more broadly, the adhesion cast of consumer and seller relations that has plagued both sides is, it would appear, in critical condition. Consumers even now in the earliest stages of the electronic

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105 Rep. George W. Gekas and James W. Harper, *Annual Regulation of Business Focus: Regulation of Electronic Commerce*, 51 Admin. L. Rev 769 Summer 1999.

commercial revolution, if in fact it is a revolution, have virtually squeezed the life out of the old take-it-or-leave-it posture so fondly remembered by retail establishments and in force not all that long ago.

Today, a consumer looking for a car or a camera, an air fare or a stockbroker, can spend a little time surfing the Web, turning up whatever that consumer needs at the sharpest price he or she can find. That more than anything cannot help but put tremendous pressure on merchants and manufacturers of every sort. This translates to unprecedented power being placed in the hands of the consumer, and in the end it may make very little difference to a consumer how or even if the transaction is taxed. To all this discussion of taxing Internet transactions is an underlying presupposition that individual consumers will, in slavish Pavlovian fashion, make their buying decisions solely, or at the very least heavily weighted, based on whether or not they pay a sales tax. To be sure, many consumers will consider the tax issue. But will they all consider that issue? And will it be the sole determining factor? Much remains to be seen on the tax front, but regardless, much needs to be done as well.

States need to streamline and make uniform their policies; the law needs to decide with some degree of precision what constitutes appropriate connections with any given jurisdiction; financial institutions need to be drawn into the mix in a much larger way than they now experience; and huge ISPs and OSPs like America Online® must make a concerted attempt to be more responsible corporate citizens in this regard than their conduct to this point has shown them to be. Their simple "no" answer to the question of taxing e-commerce will no longer suffice. In short, there is no one segment of law,

government, business, or the economy that can solve the problem, and there is no one segment of law, government, business, or the economy that can or should bear all the burden of solving it. Just as e-commerce is a reticulum, a network of cybernetic, economic, mechanical, and physical elements, so too must the solution be an inter-connected set of disciplines, strategies, and techniques in order to achieve an efficacious and equitable result.

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