

Taxation of E-Commerce

Introduction

Electronic Commerce ("Ecommerce") presents unique challenges to federal and state tax authorities. Ecommerce involves commerce using the Internet: typically purchases and sales through computers. Because Ecommerce involves computers communicating with each other at the speed of light, transactions are both instantaneous and largely anonymous. In contrast, mail order and telephone solicitation, two traditional forms used by remote sellers, involve the delivery of goods from a specific physical location to a specific location by means of a common carrier.

Although states and local jurisdictions have wrestled with the issue of collecting taxes from out-of-state mail order sellers and telephone solicitors for decades, the internet allows almost any small business to sell to customers in different states and countries.

The concept of taxation involves jurisdiction. From the Boston Tea Party Rebellion in which tea was taxed as it physically landed on American shores, to sophisticated concepts in international taxation, a government's authority to tax has always been based on territory and jurisdiction. For instance, the U.S. government taxes its residents on their world-wide income because they are connected with the U.S. through citizenship and residency. Also, the U.S. taxes foreign individuals and businesses who are receiving income from U.S. sources. But the U.S. cannot tax a foreign citizen who is not a U.S. resident on earnings from a foreign source.

With the internet, a business can move to so-called tax haven jurisdictions and conduct business outside the taxing jurisdiction of any country. Also, because of the speed in which transactions occur and the absence of a traditional paper trail, especially with intangible property transmitted by computer such as software, digital music or books and services, it will be very difficult, if not impossible to apply traditional notions of jurisdiction to tax these transactions.

While governments who rely on an income tax to fund themselves will have great difficulty taxing Ecommerce, states and local jurisdictions that rely on sales and property taxes to fund their operations are in steep trouble. As discussed below, the U.S. constitution requires a sufficient physical connection with the state or local jurisdiction by a company to burden the business with a tax obligation, and merely selling property, services or goods to a customer who resides in a state is not sufficient nexus.

In short, it will take a Constitutional amendment to change the commerce clause, and it is extremely doubtful that U.S. citizens will vote to tax themselves on internet transactions. In fact, outside of pressure from state and local tax authorities, there is little ground swell for internet taxation by politicians. According to a Gallup Poll, 73% of active internet users oppose an internet sales tax, compared to 14% in favor (Source: San Francisco Chronicle, September 15, 1999, page D2). According to 36% of the respondents who use the internet, they would be less likely to vote for a politician who voted to tax internet transactions. But brick and mortar retailers who sell their products in physical locations, contend that internet taxes are needed to equalize the tax burden for competitive reasons.

Some of the unique features of Ecommerce include:

Computer-to-Computer transactions without a paper trail;

Anonymous transactions, especially if a new form of electronic cash takes hold;

Lack of information on the location of the seller and purchaser;

Electronic delivery of goods (books, CDs and movies in electronic form) and services (brokerage or accounting services); and

Bundling of taxable and non-taxable items, such as taxable goods with tax-exempt services.

Also, unless a tangible product is delivered by common carrier, it would be impossible for a taxing jurisdiction to know that an Ecommerce transaction occurred. For instance, if a consumer downloaded a computer game off a server located in a foreign country for \$19.95, paying for it by a credit card, how would a taxing jurisdiction know that such a transaction occurred? How would it determine the physical location of the seller? What if the purchase had an ISP in a foreign country as well? Would the receipt of a computer game in electronic

form convert it into a non-taxable intangible item, whereas the same purchase of the game on a physical CD at a local computer store would be taxable as a tangible product?

If an actual newspaper has an exemption from sales tax, will a newspaper that is downloaded in electronic form receive the same exemption? If not, would the tax levied on the electronic version of the newspaper be a discriminatory tax in violation of the commerce clause?

Electronic money - a type of debit card, but where the card itself keeps track of the remaining balance, rather than a third party bank, could be the equivalent of cash transactions for the internet. Use of electronic money would make the transaction anonymous and further frustrate the ability of states and local jurisdictions to tax it.

Suppose you have an uncle living in Nevada, a state that does not have a sales tax. Your Uncle downloads the computer game then ships it to you as an email attachment. The next time you see your Uncle, you reimburse him with cash. How will your state or local jurisdiction monitor this transaction? These are some of the issues that make the taxation of Ecommerce so difficult.

Current Law - A Moratorium on Internet Taxes

Currently, under the Internet Taxation Freedom Act ("ITFA"), passed in 1998 there is a 3-year moratorium on federal and state taxation imposed on internet transactions. The moratorium began on October 21, 1998 and remains in effect until October 21, 2001. ITFA's purpose is to halt the rush by states to tax transactions occurring on the internet until Congress has had the opportunity to study the issue and make recommendations.

Congress realized that the internet needed time to grow as a viable medium for commerce, without being subjected to taxing regimes imposed by the states. Congress noted that the internet was inherently susceptible to multiply and discriminatory taxation in ways that traditional commerce was not. Congress was concerned that because internet transactions

involved a number of computers and routers, routing transactions throughout the country and even throughout the world, potentially dozens of jurisdictions could attempt to tax a single transaction. Thus, ITFA would protect internet business from being taxed in complicated and unexpected ways by remote jurisdictions.

Definitions

Internet Access

ITFA applies to taxes on internet access that were not generally imposed or actually enforced prior to October 21, 1998. The ban applies to states or political subdivisions from imposing new taxes on internet access. Internet access means, in general, any computer or telephone communications facilities, equipment or operating software which comprise the internet (the interconnected world-wide network using Transmission Control Protocol/Internet Protocol known as TCP/IP). But telecommunications without TCP/IP is excluded from this definition, so traditional taxation of telephone services is not suspended.

Example: ITFA bars a tax on monthly ISP services provided by AOL, CompuServe or a company like Earthlink, but the taxes on telephone services used to connect to your ISP are not prohibited.

Electronic Commerce

The key provision of ITFA applies to electronic commerce ("Ecommerce") which is defined as:

"any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer or delivery of property, goods, services or information, whether or not for consideration, and includes the provision of Internet access."

ITFA bars states or political subdivisions from imposing any "multiple or discriminatory" taxes on transactions involving Ecommerce, including income and franchise taxes, property, sales and use taxes, as well as a seller's obligation to collect and remit such taxes.

Discriminatory Taxes

A discriminatory tax traditionally involved a tax that favored local commerce over interstate commerce, but the definition under ITFA has been broadened to include the coverage of the tax, its application or a differential tax rate. In other words, if an ecommerce transaction is subject to a tax that is any different from a tax imposed on similar property, goods or services through other means, then the tax is discriminatory.

Example: If the purchase of a book over the internet is subject to a tax that is different from purchasing a book in a bookstore, the tax is discriminatory. The same would be true if the taxing authority charged a higher rate of tax for ecommerce purchases of books. However, it is permissible to charge a lower rate on an ecommerce transaction. In other words, a taxing jurisdiction may discriminate in favor of ecommerce.

Ecommerce conducted by out-of-state vendors do not have an obligation to collect sales taxes if traditional remote sellers, such as mail-order and telephone solicitation vendors do not collect sales taxes. Sales tax cannot be levied on because the purchaser uses ecommerce to access the seller's computer to acquire property, goods or service. Also, states cannot use an "agency nexus" theory to claim that a purchaser's ISP is an in-state agent for the seller.

Example: If a purchaser in California uses his computer to connect with a bookseller's computer located in Nevada, no state or political subdivision may levy a sales tax, even if the purchaser used a California ISP to connect to the internet.

Example: If a Nevada-based seller hosts his website on a California computer and a California resident purchases a book, California cannot claim there is an agency nexus to tax the transaction.

In addition, if a remote seller in one state, uses a computer in another state for internet access or online services, there is no agency relationship between the remote seller and the company providing the access or online services.

Example: A New Hampshire company, with no physical presence in California, hosts its website with a California ISP, California cannot impose a sales tax on transactions because a California ISP was involved.

If books, magazines, newspapers or forms of tangible information are not subject to sales tax, then downloads of that same information cannot be taxed. A tax obligation cannot be imposed on a different entity such as a credit card company, if the vendor selling the product, service or property would be the entity responsible to collect sales tax under conventional commerce.

Multiple Taxes

Multiple taxes on the same transaction or service either in the same taxing jurisdiction or two or more taxing jurisdictions are prohibited. There is an exception if the tax is imposed by a state and a local subdivision, such as California's sales tax and San Francisco County's add-on sales tax for its Bay Area Rapid Transit. This could occur if a state taxed internet access services as telecommunications services and then taxed located telephone services as well. Unless a credit is given to eliminate any double-taxation, such a tax would violate the prohibition against multiple taxation.

Exceptions to ITFA transactions.

Vendors who knowingly conduct ecommerce involving obscene or materials that are otherwise harmful to minors cannot rely on ITFA as a defense against taxation. However, the vendor can use ITFA as a defense if he uses credit card verification or procedures to insure he is dealing with persons over age 17. The exception does not apply to internet information and search services such as Yahoo, Lycos or Alta Vista or ISPs that host such websites or telecommunication companies that transmit information over the internet.

Bundled software that includes protected ecommerce or internet applications are protected under ITFA, but only in proportion to the ecommerce or internet applications.

Taxation of Ecommerce - The Significant Issues

While ITFA has provided a moratorium against new internet taxes, the key question is whether the internet should be subject to taxation at all and if so, how?

Nexus - The Foundation of State and Local Taxation

The Interstate Commerce Clause of the U.S. Constitution prevents the states and their political subdivisions from imposing taxes that unduly burden interstate commerce. The key issue is whether the company that is being taxed as sufficient connection (nexus) with the taxing authority.

Example: A company that operates in Nevada and does not sell products in California or to California residents cannot be taxed by California. Converse, both California and San Francisco have the right to tax a company physically located in San Francisco, such as a hotel, even though the guests might reside in another state.

The problem comes when a business is not physically located in California, but sells to California residents. Under what circumstances may California levy a tax on sales to California residents?

In Quill v North Dakota, 504 U.S. 298, 1992, the U.S. Supreme Court held that a remote seller could be required to collect sales taxes only if the seller had the requisite nexus with the buyer's state. Quill corporation sold office furniture products through a catalogue. Although it was not physically present in North Dakota and did not have a sales agents in the state, the North Dakota Supreme Court held that by selling its product to North Dakota customers, Quill established an economic presence in North Dakota which created nexus for sales tax purposes.

The U.S. Supreme Court held otherwise and ruled that a state could impose a requirement that a company collect and remit sales taxes, the company had to have substantial connections (a physical presence) with the state. Under the commerce clause, a mail-order company without a physical location, employees or sales agents in North Dakota could not be compelled to collect sales tax on its sales to North Dakota customers.

It is the commerce clause's concept of nexus that prohibits most ecommerce transactions from being taxed. In general, the duty to collect a sales or use tax depends on where the sale is located and whether the buyer is a consumer or a business. Three general rules apply:

1. Retail sales by vendors to in-state consumers are subject to sales tax on the purchase, but the vendor has the obligation of collect and remit the tax to the tax agency.
2. Out-of-state vendors making consumer sales are not required to collect and remit sales taxes, unless the vendor has sufficient nexus under the commerce clause with the purchaser's state to require collection.
3. If the out-of-state vendor cannot be required to collect the tax, then the consumer is legally obligated to pay a self-assessed tax directly to the taxing agencies on the purchase. This is usually referred to as a "use" tax, instead of a sales tax, since the consumer is paying a tax for the use of the property. As a practical matter, this is virtually impossible to enforce, hence the emphasis on requiring out-of-state vendors to collect and remit the tax.

The absence of nexus in the mail order cases is profoundly greater in the Ecommerce context. Not only do internet companies not have physical presence in the taxing jurisdiction, often then can be located outside the jurisdiction of the U.S. altogether. Even if a transaction can be theoretically taxed, in reality, Ecommerce transactions

occur instantaneously and without identity of the seller's or buyer's location. Because the sales tax is destination based, unless a state or locality can pinpoint the physical location of the seller and buyer, it is impossible to determine jurisdiction for sales tax purposes.

Example: California wants to apply a sales tax to the sale of software to its residents. In order to California to levy the tax, it must determine that the purchase is a California resident and that the seller has sufficient nexus with California to be required to collect and remit the sales tax. Without ascertaining the location of the seller or buyer, California cannot determine whether the purchaser was a California resident and whether the seller had sufficient physical presence in California.

Note: If the goods or property purchased are tangible, such as an actual book, CD or a shirt, then the traditional notions applicable to mail order taxation could be applied since it could be ascertained where the goods were shipped and where they were delivered.

Will Ecommerce Really Erode the Tax Base for States and Localities?

Although state and local tax officials express grave concern that the Ecommerce will decimate the ability for states and localities to levy taxes on these transactions, this response might be overblown. Currently, states and localities cannot tax remote sellers anyway, unless they have sufficient nexus with the state. This means that mail order and telephone solicitation commerce by remote sellers is not subject to tax. Unless the Supreme Court drastically alters its reading of the Constitution's commerce clause, or there is a constitutional amendment allowing taxation of remote sellers, Ecommerce merely continues the trend to avoid taxes by engaging in remote selling without a physical presence.

Most services and intangible products are not currently subject to sales taxes anyway. In California, services, such as legal, accounting, and medical costs, are not subject to sales taxes. Neither are food or medicine. Therefore, Ecommerce involving intangible goods or services will not cause an erosion of the tax base.

Even if a remote seller is not subject to sales tax rules, a state's citizen is supposed to self-assess a use tax which is equal to the sales tax, but the states have been lax in enforcing this requirement. The answer to Ecommerce taxation in particular and remote selling in general, is to require a state or locality's resident to self-assess the tax that should have been collected by the remote seller. There is no prohibition against the use tax; the problem lies in enforcement. Therefore, although Ecommerce prevents states from forcing remote sellers from collecting and remitting sales tax, the ultimate tax liability is not affected since in-state consumers have the legal tax liability to self-assess and pay the tax anyway.

Although Ecommerce is rapidly growing, as of 1988, it represents much less than 1% of total consumer spending. Remember that business-to-business sales are subject to use tax payments by in-state businesses, and approximately 80% of current Ecommerce is business-to-business.

To the extent Ecommerce is merely a substitute for other remote seller transactions, Ecommerce does not affect the tax base since remote sales involving mail order or telephone solicitation are exempt from sales tax under the commerce clause.

There is evidence that even if all Ecommerce was subject to sales taxes, the revenue generated to the states and localities would represent about one-tenth of one percent of all sales and use taxes collected. Also, sales and use taxes continue to grow, despite Ecommerce.

The Future for Ecommerce Taxation

The Commission on Electronic Commerce, created by the ITFA legislation, has not been able to make any headway in the taxation debate, but several members have voiced support for Internet taxes, provided the tax is simple to calculate for businesses. This could mean a uniform tax rate agreed to by all the states, or technological advances that would allow businesses to calculate the sales tax simply and without a large investment in time and resources.

Unfortunately, the current state and local tax systems, which number close to 7,500 throughout the U.S., are notoriously parochial minded when it comes to defending their jurisdiction. In Texas alone, there are more than 1,300 separate sales tax jurisdictions. These numbers could be significantly increased if states and local jurisdictions were allowed to tax Ecommerce.

Small businesses would be buried in costly paperwork attempting to comply with all these rules. That is precisely why the commerce clause in the Constitution prohibits taxes and are an undue burden on interstate commerce.

To gain agreement among this diverse group will be difficult at best. Also, how does one apportion internet taxes among the competing jurisdictions? Does California which accounts for 15% of the country's business receive 15% of the internet tax revenue, or would California argue for a larger share? How would it calculate the proper percentage?

Conclusion:

Given the outdated and overly complex mechanisms used by thousands of jurisdictions to tax traditional transactions, it is clear that a fundamental restructuring of our current sales tax laws is needed to simplify tax collection, to decrease the burden of compliance on business and to deal with the increasingly integrated economy of Ecommerce. Then again, it is far from certain that voters will permit politicians to tax internet transactions or that the supposed loss in sales tax revenues is really significant, given the numerous exemptions from sales taxes that currently exist.

Even if our politicians decide that an internet tax is needed to provide parity with brick and mortar retailers, whether the thousands of taxing jurisdictions will give up their fiefdoms for a national solution remains to be seen. Also, whether Ecommerce transactions flying around the internet at the speed of light are susceptible to taxation, when both the location of seller and purchaser are unknown and the medium of payment could very well be untraceable, perhaps poses the biggest hurdle to the

taxation of Ecommerce debate. In short, will governments be able to keep pace with the technology as newer, faster and different forms of commerce emerge?