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

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Summary

The proposed "Internet Tax Freedom Act" would prevent states and localities from levying taxes on many communications and transactions made over the Internet for a minimum of three years. This "moratorium" on taxation of Internet and electronic commerce could have far-reaching effects on state and local revenues.

- States and localities could experience significant erosion of sales tax revenues and telecommunications tax revenues if the Internet Tax Freedom Act were to be enacted. Under some versions of the proposed legislation, revenues from corporate profits taxes also could be affected. Some revenue losses would be immediate; others would depend on how broadly various provisions in the legislation are interpreted by the courts.

- If the moratorium continues for a number of years or ultimately is made permanent, a likely outcome of this legislation, revenue losses would grow. Projections suggest that in future years a significant proportion of consumption will shift from "Main Street" businesses to purchases over the Internet. The inability to tax such purchases under state and local sales taxes — which account for nearly one-quarter of all state and local tax revenues — could significantly impair the ability of some states and localities to meet needs fully for education funding and other traditional state and local government functions along with their new responsibilities for devolved health and welfare programs.

- Higher-income households that can afford computers and modems — the disproportionate users of the Internet — would be the major beneficiaries of the tax reductions. To the extent states and localities raised sales or

telecommunications tax rates to replace the lost revenues on Internet commerce, the increased burden would fall disproportionately on low- and moderate-income households.

- State and local governments have been working with the electronic commerce industry to hammer out an agreement on the fair taxation of Internet transactions. The proposed federal legislation could thwart efforts to reach an equitable, permanent solution because it would remove much of the incentive for negotiation that brings the parties to the table.

Four major versions of the Internet Tax Freedom Act currently are under consideration. The Senate version of this proposed legislation, S. 442, was approved in amended form by the Commerce, Science, and Transportation Committee on November 4, 1997.[1] The House version, H.R. 1054, was approved in amended form by subcommittees of both the Commerce and Judiciary Committees on October 9, 1997.[2] A new Senate version (S. 1888) called the "Internet Fairness and Interstate Responsibility Act" is essentially a modified version of the Internet Tax Freedom Act as it was originally introduced.[3] A new House version of the Internet Tax Freedom Act intended to implement a compromise agreement between state and local government organizations and the original House sponsor, Representative Christopher Cox (R-CA), has been introduced as H.R. 3529.[4] These four different versions of the proposed legislation will be referred to respectively as the "Senate Committee," "House Committee," "new Senate," and "new House" versions.

The House Committee, Senate Committee, and new Senate versions of the Internet Tax Freedom Act are structured as blanket prohibitions on the power of states and localities to levy any types of taxes on the use of the Internet or on-line services for communication or transactions.[5] The blanket prohibition is followed by a list of specific taxes that are preserved under certain conditions.[6]

The new House version of the Internet Tax Freedom Act is structured differently from the other three. Rather than being framed as a prohibition on all state and local taxes on Internet-related transactions not specifically preserved, the new House version prohibits six specific categories of state and local taxes: taxes on Internet access; taxes on online services; multiple taxes on electronic commerce; discriminatory taxes on electronic commerce, and two specific types of taxes on data traffic and data carrying capacity that have never been used in this country.[7]

Despite their varying structures and text, all four versions of the "Internet Tax Freedom Act" would have some common effects. All would take away substantial existing authority of state and local governments to impose sales taxes on one or more aspects of "electronic commerce": goods ordered over the Internet but delivered by the

Post Office or private carriers (comparable to catalog sales); goods and services delivered *over* the Internet (such as on-line databases and software); and taxation of "Internet access" itself (for example, the typical $20 per month fee a subscriber pays to America Online or a local Internet service provider). In addition, the legislation would potentially prevent states and localities from levying various types of existing taxes on telecommunications services, such as the high-capacity, fiber-optic lines comprising the "backbone" of the Internet. Finally, several versions of the legislation could threaten existing taxes on corporate profits earned through electronic commerce.

Many of the taxes threatened by the Internet Tax Freedom Act are not imposed on Internet commerce specifically but could be challenged by taxpayers in court because vague wording in the legislation could be construed as applying to a broad range of taxes and circumstances. If the Internet Tax Freedom Act were to be enacted, lawyers for Internet businesses would scrutinize the law looking for every possible justification it would hold to cease paying a tax or to challenge state and local taxes for which such businesses are currently liable.

The short-term impact on state and local revenues of the Internet Tax Freedom Act cannot be determined with certainty because the extent and outcome of litigation challenging state and local taxes under the bills' provisions cannot be predicted. Nonetheless, the potential of the proposed legislation to undermine the long-term fiscal stability of state and local governments cannot be ignored. As some taxable purchases now made in stores increasingly shift to purchases made through the Internet, and as communications over the telephone shift to communications over the Internet, states and localities will likely be left with a growing hole in their sales tax and telecommunications tax revenues because of various practical and legal difficulties they face in taxing many Internet sales.

The importance of these issues has been acknowledged by state and local governments and by the industry. Constructive efforts have been undertaken over the past year to develop a government-industry agreement on how to remove constraints and update existing taxes so that they may be applied to electronic commerce in a manner that does not unduly burden business. Such an agreement could prevent the future erosion of state and local tax bases that is likely to occur in the absence of appropriate procedures for taxing electronic commerce. Enactment of the Internet Tax Freedom Act could interfere with the efforts of state and local governments and the electronic commerce industry to reach such an agreement, because it removes some of the key incentives the industry now has to negotiate.

The following summarizes a number of the ways in which state and local revenues would be affected by the proposed legislation.

The Internet Tax Freedom Act Could Have Far-Reaching Impacts on a Wide Range of Existing State and Local Taxes

- **The House and Senate Committee and new Senate versions of the Internet Tax Freedom Act appear to preserve a wide range of state and local taxes. In practice, however, many of the taxes that appear to be preserved could be prohibited or eroded, because the language describing the protected taxes in the legislation is vaguely-worded and/or subject to conditions that cannot be met.**

For example, language in two versions of the legislation says that sales taxes imposed on Internet purchases are preserved so long as sales taxes are also levied on "similar sales" not using the Internet. The term "similar sales" is not defined in the legislation, however, and the absence of a definition is likely to lead to substantial litigation that could invalidate sales taxes on many Internet transactions. Companies that sell information or provide services only over the Internet would have particularly strong grounds for challenging sales taxes.

Take, for example, a publisher of a specialized newsletter that is only available on-line and not in printed form. The intention of the "similar sales" language would appear to be to allow a state to tax an on-line publication if it taxes printed publications. However, an on-line publication can incorporate features that cannot be included in a printed one sold by mail or in a store. Many Internet publications now allow users to search back issues for particular words or phrases, re-arrange articles so that subjects of particular interest to the reader appear first, and provide links to information on related topics available elsewhere on the Internet. The inclusion of features like these in an on-line publication that could not be provided in a printed one would give the publisher strong legal grounds for arguing to a court that his newsletter is not a "similar sale" to the sale of a printed version not using the Internet and therefore cannot be subjected to sales tax. This is just one small example of how the vague wording of clauses purporting to preserve taxes in the House and Senate Committee and new Senate versions of the Internet Tax Freedom Act could be used to challenge existing, non-discriminatory state and local taxes.

- **The new House version of the Internet Tax Freedom Act has a different structure than the other three versions. The new House version is intended to more narrowly prohibit "discriminatory" state and local taxes on Internet commerce while leaving other taxes in place. But the new House version could still invalidate a significant number of existing state and local taxes on electronic commerce because it includes broad definitions of prohibited taxes on "Internet access" and "online**

services" as well as broad definitions of prohibited "multiple" and "discriminatory" taxes on "electronic commerce."

The new House version inherently poses less risk of unintended consequences than do the other three versions, because it not structured as a general prohibition of all state and local taxes except for taxes specifically preserved. Nonetheless, the wording of some provisions of the new House version is sufficiently vague that it could lead to successful taxpayer legal challenges to existing state and local taxes the bill's sponsors may intend to preserve. For example, a literal reading of the bill's definition of online services leads to the conclusion that Bell Atlantic company could become an "online services" company like America Online simply by offering to consumers its local phone service and Internet access service as a package for one price. States and localities would then be prohibited from raising sales taxes on Bell Atlantic's local phone service for three years. It seems unlikely that the bill's sponsors wish to constrain state and local taxes on ordinary telephone service, but that is the result the specific wording of the new House version of the Internet Tax Freedom Act could produce.

- **The Internet Tax Freedom Act's prohibition of taxes on "communications . . . using the Internet" and "Internet access" could place a substantial share of the telecommunications tax base of state and local governments at risk in the near future because merging of the Internet and the telephone system has already begun**.

Some experts predict that more than one-third of all telephone calls could be made over the Internet by 2002, which would be well within the moratorium period in the House and Senate Committee versions of the Internet Tax Freedom Act.[8] Taxation of calls made over the Internet appears to be prohibited or questionable under all four versions of the proposed legislation.

- **Some of the sponsors of the Internet Tax Freedom Act have expressed a willingness to tighten the language to prevent unintended impacts from occurring. It may not, however, be possible to craft such language.**

Experience with analogous legislation enacted in the past shows that taxpayers can often successfully litigate to their benefit even language that appears to foreclose litigation opportunities and will attempt to do so if the potential tax savings appear sufficiently large. Once states and localities are prohibited from levying certain types of taxes, taxpayers will seek to expand that prohibition to related areas through litigation. State and local government experience with Section 306 of the Railroad Revitalization and Regulatory Reform Act of 1976,

which regulates and prohibits certain forms of state and local taxation of railroads, illustrates well the potential litigation risks of legislation like the Internet Tax Freedom Act. Railroads have brought litigation based on Section 306 that has succeeded in invalidating state and local taxes that the legislative history of Section 306 demonstrates Congress intended to preserve. Moreover, while the legislation was pending in Congress the railroads repeatedly assured state and local governments that they had no intention of using Section 306 to challenge their property tax valuations or exemptions granted to non-railroad property. After the legislation was enacted, the railroads reneged on these commitments.[9] Similar potential for aggressive taxpayer litigation is inherent in the Internet Tax Freedom Act.

All Versions of the Legislation Raise Questions of Future Revenue Adequacy

- **If Internet commerce expands to the levels and at the pace currently being forecast — high technology market expert Forrester Research, Inc. projects U.S. sales over the Internet will be almost $350 billion by 2002 — and if states and localities are effectively barred from taxing this growing segment of consumption, financing essential state and local programs and services may become increasingly difficult.**

General sales taxes alone supply nearly one-quarter of all the tax revenues that states, cities, counties, and school districts use to support the programs and services they provide; in 11 states, sales taxes account for more than one-third of all tax dollars. (See box, next page.) While state and local governments already confront certain legal and practical problems in taxing some of this on-line trade (as they do in the case of mail-order catalog sales), the proposed legislation would compound these difficulties. For example, to varying degrees, all versions of the proposed legislation threaten the ability of states to collect sales taxes from in-state businesses on the purchases these businesses make over the Internet. States can collect sales taxes on such purchases under existing law. Business purchases over the Internet are expected to account for the vast majority of Internet sales in the near future, so loss of this taxing power would be very likely to erode sales tax bases and sales tax revenues.[10]

The Reliance of States on Sales Taxes Potentially Affected by The Internet Tax Freedom Act Varies Substantially

Combined State and Local General Sales Taxes as a Share of Total State / Local Taxes
(Fiscal Year 1995. Source: Census Bureau)

Tennessee	46.1%	North Dakota	22.4%
New Mexico	41.8	West Virginia	22.2
Louisiana	40.5	Iowa	21.7
Nevada	38.5	Maine	21.2
Hawaii	37.6	Indiana	21.2
Washington	36.5	Ohio	20.9
Arizona	35.7	Kentucky	20.7
Arkansas	35.5	Minnesota	20.0
Mississippi	35.3	Dist. of Columbia	19.9
Florida	34.5	Connecticut	19.6
South Dakota	33.6	Illinois	19.5
Texas	32.3	Pennsylvania	18.9
Utah	32.2	Wisconsin	18.7
Alabama	30.9	New York	18.0
Georgia	30.4	Rhode Island	17.3
Oklahoma	30.1	Virginia	16.4
Missouri	28.8	New Jersey	15.8
Colorado	27.9	Maryland	14.0
Kansas	27.1	Massachusetts	13.7
California	26.8	Vermont	12.0
South Carolina	26.1	Alaska	4.0
Michigan	25.0	Delaware	0
Wyoming	24.2	Montana	0
Idaho	24.0	New Hampshire	0
Nebraska	23.4	Oregon	0
North Carolina	23.0		

Failure to Tax Internet Commerce Would Increase Inequities

- **The current and future reductions in state and local taxes resulting from this legislation would primarily benefit affluent segments of the population that are the principal users of the Internet and would be especially likely to use it to make purchases.**

The *Wall Street Journal* recently reported that 80 percent of households with incomes over $100,000 have personal computers, while personal computers can be found in only 25 percent of households with incomes under $30,000.[11] *Web Week* magazine has reported that the average annual income of people who make purchases through the Internet is $76,000 for men and $60,000 for women.[12] If Internet purchases are not subject to sales taxes, a person with sufficient means to have a credit card, a computer and an Internet access account will be able to avoid taxation on the purchase of a good or service that would be taxed if a person without such resources purchased the same or similar good or service from a neighborhood store.

- **The avoidance by affluent consumers and businesses of sales taxes on Internet purchases could mean higher sales taxes or reduced public services for low- and moderate-income households.**

If, as expected, some *existing* store sales shift to Internet purchases and a substantial portion of consumption *growth* is concentrated in Internet purchases, states and localities might have to raise their sales tax rates on non-Internet sales to maintain sales tax revenues. Because sales taxes are regressive — they absorb a larger share of the incomes of lower-income households than of more affluent households — the cost of sales tax rate hikes would fall most heavily on the lower-income households without the resources to get on-line and avoid them. The legislation could create a vicious cycle leading to an ever more regressive sales tax. The erosion of the sales tax base resulting from on-line purchasing by businesses and affluent consumers would force states and localities to raise sales tax rates, encouraging more on-line buying, forcing further rounds of rate increases, until the lowest-income population groups unable to buy on-line would be left paying an ever-greater share of sales taxes.

Alternatively, if state and local governments cut programs and services to compensate for diminished revenue, a broad array of vital services — from education, to child care, to aid for the poor — could be adversely affected. Recent history suggests that when declining revenues lead states to reduce services, programs serving low- and moderate-income families and individuals tend to be hit disproportionately.

The Need for the Legislation Is Questionable

- **There is no objective evidence that state and local taxes are stifling the expansion of the Internet or electronic commerce in any way; both the Internet and electronic commerce are experiencing explosive growth.**

For example, International Data Corporation estimated that electronic commerce revenues *quadrupled* between 1996 and 1997, from $2.6 billion to $10.6 billion.[13] Media Metrix estimated that World Wide Web sites devoted to product marketing and electronic commerce were the fastest-growing segments of the Web, growing 500 percent in 1997 as compared to 130 percent for the Web overall.[14]

- **Nor are state and local governments "singling out" or "discriminating against" the Internet in their tax policies.**

The 12 states that are taxing monthly fees for Internet access, for example, are doing so because the Internet access service satisfies the definition of taxable telecommunications, data processing, information services, or another element of their existing tax structure. Such states are not singling out Internet access services for taxation.

Internet access is a close substitute for other services that many states already tax. One citizen of a state may choose to pay an Internet service provider $20 per month to be able to send unlimited documents across the country by e-mail and to view the CNN World Wide Web site; another citizen may choose to send his documents cross country by fax and to subscribe to cable TV to watch CNN. If the state taxes the long distance telephone calls the fax machine uses and cable TV service, there is nothing discriminatory about its also taxing the $20 Internet access charge.[15]

- **If anything, the failure so far of states to update their tax systems to cover electronic commerce is more likely to result in discrimination *in favor* of it than against it.**

For example, while all states with sales taxes impose them on "canned" software sold on disks in stores, almost half of the states do not tax any software that is downloaded.[16] The popular income tax preparation program, Turbotax, would be taxable if purchased in a store in any state with a sales tax, but the sale would be exempt in many states if a customer downloaded the program from the Intuit company's Web site.

A Comprehensive Solution to Issues Raised by State/Local Taxation of Electronic Commerce Could Be Thwarted

- **State and local officials appreciate that greater interstate uniformity in the taxation of electronic commerce is desirable, both to reduce compliance burdens generally for multi-state companies and to minimize the potential for double taxation that would exist if taxation of online services became widespread.**

State and local government organizations are actively participating in a National Tax Association-sponsored project aimed at developing a uniform approach to taxing electronic commerce. (The National Tax Association is the leading professional association for economists and attorneys interested and active in tax policy issues.) State and local governments do not need the Internet Tax Freedom Act "stick" to encourage them to make reasonable compromises with industry to achieve greater interstate uniformity in the taxation of electronic commerce, because U.S. Supreme Court decisions limiting their taxing authority already supply substantial incentives to do so. The Court's 1967 *Bellas Hess* and 1992 *Quill* decisions relating to mail-order sales have placed major roadblocks in front of state and local government efforts to tax most out-of-state companies lacking a physical presence within the state or local government's borders; this is a category that includes many Internet merchants. These Supreme Court decisions suggest that state and local governments will not be legally capable of taxing a large share of electronic commerce — at least not without years of expensive new court battles they might lose — unless the electronic commerce industry consents to federal legislation reversing these decisions. The industry can likely block federal legislation and will attempt to do so if states and localities do not commit to substantial standardization and simplification of their taxation of electronic commerce.

- **A moratorium is unlikely to facilitate a government-industry agreement on fair taxation of electronic commerce; just the opposite is likely to be true.**

Internet merchants often do business in ways that are different from how mail-order companies do business. For example, Internet merchants sometimes pay commissions to other businesses for directing Internet users to their World Wide Web sites or place duplicate computer servers in multiple locations around the country in case one should fail. In other words, many Internet merchants and service providers have a presence in many states. Many legal experts have suggested that despite their failure to get legal authority to require mail-order sellers to charge sales taxes, states might be able to prevail in court if they attempted to require out-of-state Internet merchants to charge sales taxes because of these different ways of doing business.

Presently, the most significant incentive that exists for the Internet industry to reach an agreement with state and local governments on simpler and more standardized rules for taxing electronic commerce is the possibility that states could prevail in this kind of litigation and be authorized by the courts to require Internet sellers to charge sales tax. However, enactment of the Internet Tax Freedom Act would eliminate this incentive by clarifying that states could not assert taxing jurisdiction over Internet merchants based on their Internet activities. For example, all four versions of the legislation appear to foreclose the ability of states to argue that a company owning a Web server computer located within its borders is obligated to charge sales tax on purchases by the state's residents.

In other words, enactment of the Internet Tax Freedom Act in effect would guarantee most Internet sellers the same tax-exempt legal status that most mail-order companies enjoy. This would not bode well for achieving a subsequent agreement allowing states and localities to tax Internet sales under simpler, standardized rules. The effective "moratorium" on taxation of mail-order sales provided by the Supreme Court's 1967 *Bellas Hess* decision has encouraged the mail-order industry to this day to oppose all federal legislation requiring catalog companies to collect sales taxes under any circumstances. Enactment of the Internet Tax Freedom Act would make a replay in the electronic commerce industry of the mail-order stalemate highly likely.

- **The 2004 ending date of the moratorium in the Senate and House Committee versions of the Internet Tax Freedom Act is particularly problematic. By that time, the electronic commerce industry will have settled into ways of doing business that will be based on the absence of a requirement to charge sales tax on Internet sales. It is unlikely the industry would reverse course and agree to collect sales taxes, regardless of how simplified the tax collection process might be at that time. There is a significant risk that the electronic commerce industry would seek to make the moratorium permanent when it is scheduled to expire.**

In the next few years the electronic commerce industry will be making enormous investments in the infrastructure for making on-line transactions, such as billing systems and systems for making secure on-line payments. If these systems have not been constructed from the outset to incorporate tax collection mechanisms, Internet merchants are likely to resist incurring the costs of retrofitting them at the time the moratorium expires. Like mail-order companies, Internet merchants will also have enjoyed a long period in which they will have had a price advantage over Main Street retailers from not having to charge sales tax. The Internet merchants may be reluctant to give up that advantage, just as mail-order sellers have been. In sum, the longer the moratorium from state and local

Public Law 86-272--Another "Temporary" Moratorium on State and Local Taxation: 38 Years Old and Counting

State tax officials have good reason to fear that, once enacted, the moratorium on state and local taxation of electronic commerce imposed by the Internet Tax Freedom Act might be made permanent. They are all too familiar with the history of Public Law 86-272, enacted by Congress in 1959 to place limits on when a state may impose a corporate income tax on an out-of-state corporation.

Public Law 86-272 was enacted as a temporary measure pending the outcome of a congressional study of state and local tax practices aimed at achieving greater uniformity in state taxation of multi-state corporations. Public Law 86-272 provides that a state may not impose a corporate income tax on a corporation selling goods to its residents (including businesses) if the seller's activities within the state's borders are limited to "solicitation." This standard allows a corporation making a billion dollars of sales in a state to avoid corporate income taxes if it can sell through retailers or wholesalers whom it visits only for the purpose of soliciting orders. The "out-of-state" corporation can avoid the corporate income tax even if its sales force is permanently located in the state, so long as the salespeople work out of their homes. In contrast, a small corporation with only a few thousand dollars of sales in a state would be subject to corporate income taxes if it enters the state to engage in any activity beyond solicitation, for example, helping its customer install a piece of equipment the customer had purchased.

Once protected from corporate income taxation by Public Law 86-272, corporations had little incentive to negotiate with states a more reasonable rule regarding when they could be subjected to corporate income taxes. Indeed, they convinced the congressional study committee established by Public Law 86-272 to recommend a limitation on the states' authority to impose income taxes on out-of-state corporations even more restrictive than the "temporary" standard based on "solicitation." That recommendation was so adverse to state interests that states succeeded in blocking federal legislation that would have implemented it. However, Public Law 86-272's "solicitation" standard remains on the books and has engendered enormous amounts of litigation. It took over 30 years for taxpayers and states to receive any guidance from the U.S. Supreme Court on what business activities were encompassed in "solicitation" — a term not defined in Public Law 86-272. Overall, Public Law 86-272 has thwarted rather than encouraged greater interstate uniformity in the taxation of multi-state corporations; corporations arguably have focused more energy on structuring their activities to take advantage of Public Law 86-272 than they have on working constructively with states to improve their corporate tax systems.

This experience makes state and local government representatives skeptical when they hear the Internet Tax Freedom Act characterized as a "temporary moratorium" that will be lifted as soon as a federal study commission issues recommendations on appropriate rules for taxing electronic commerce. They understandably fear that enactment of the legislation could encourage the electronic commerce industry to dig in its heels and then seek a permanent prohibition on state and local taxation of Internet-related activities if state and local governments do not agree to the industry's terms. Given the history of litigation under Public Law 86-272 and the possibility that the Internet Tax Freedom Act could become an essentially permanent feature of federal law, state and local governments have been pressing for substantial tightening-up of the language of the proposed legislation so that key terms are defined and the potential for unintended consequences is minimized.

taxation of electronic commerce is in place, the greater is the likelihood that the electronic commerce industry will seek to make it permanent. Given the anticipated growth in electronic commerce, a permanent moratorium on taxation could erode state and local sales taxes and telecommunications taxes beyond repair and leave low-income households bearing an ever-larger share of the sales tax burden.

I. The Internet Tax Freedom Act Would Affect a Broad Range of *Existing* State and Local Taxes

All four versions of the proposed Internet Tax Freedom Act would prohibit states and localities from levying taxes on many communications or transactions made over the Internet or on-line services.[17] Two different approaches to imposing this "moratorium" on state and local taxes are taken in the four versions of the proposed legislation.

The House and Senate Committee versions of the Internet Tax Freedom Act and the new Senate version are structured as general prohibitions on the power of states and localities to levy any types of taxes on the use of the Internet or on-line services for communication or transactions. The general prohibition is followed by a list of specific taxes that are preserved under certain conditions. Businesses immediately would be free to stop complying with numerous taxes they believe are — or might be — prohibited by the legislation. It would be

How Long a Moratorium On State and Local Internet Taxes?

- New Senate version
  S. 1888 (Gregg-Leiberman)
  3 years from date of enactment

- New House version
  H.R. 3529 (Chabot)
  3 *years from date of enactment*

- Senate Committee version
  S. 442 (Wyden), as reported by Commerce Committee
  Until January 1, 2004

- House Committee version
  H.R. 1054 (Cox), as approved by subcommittees of Commerce and Judiciary
  Minimum 6 years from date of enactment

up to states and localities to discover the non-compliance and prove to a court that the tax was, in fact, "preserved."

Barring all taxes on an industry except those specifically permitted is an unprecedented way for federal legislation affecting states' authority to raise revenue to be written. It simply is not possible for Congress to write a tax preservation clause that will affect, predictably and evenly, state and local tax law in each of the 50 states.[18] As a result, taxpayers will likely be able to convince courts that some states and localities are barred from levying certain types of taxes that the drafters of the Internet Tax Freedom Act intend to protect. Over time, a patchwork of state and local case law will develop regarding which taxes can be levied on electronic commerce and which taxes cannot — precisely the situation this legislation purports to cure.

The new House version of the Internet Tax Freedom Act also could have far-reaching adverse impacts on state and local taxes. While the New House version does not impose a moratorium on *all* state and local taxes on Internet commerce, it does prohibit all "multiple" and "discriminatory" taxes on "electronic commerce" and all taxes on "Internet access." Given the broad and somewhat vague definitions of these terms in the draft, the potential reach of the new House version also could be wide, albeit not as wide as that of the other three versions.

State and Local Sales Taxes

State and local sales taxes on most sales through the Internet or on-line services would effectively be disallowed by both the House and Senate Committee versions of the Internet Tax Freedom Act and the new Senate version. The respective preservation clauses for sales taxes contain several conditions on the application of the preservation clauses that it will be difficult or impossible to satisfy. As a result, these three versions of the proposed legislation will prevent state and local governments from imposing sales taxes on Internet transactions in instances in which they *can* currently levy and collect such taxes.

First, these three drafts of the legislation would interfere with the power states now have to require businesses that *purchase* goods through the Internet to pay the use taxes that are legally due state and local governments on such purchases. (A use tax is a substitute for the sales tax and is imposed on the purchase price of goods purchased out-of-state but brought into the state for consumption.) For example, a small business purchasing a computer from Dell Computer Corporation's Web site is legally obligated to pay use tax on the purchase to the state in which the computer is used. Even if Dell does not collect the tax on such a computer purchase, most businesses would themselves remit the tax to the state because they are aware of their legal obligations.

Sales Taxes, “Use Taxes,” and “Nexus” — A Primer

Most people are familiar with sales taxes, the charge that is added to the cost of goods and some services purchased in retail stores. Sales taxes are imposed on sales transactions that occur *within the boundaries of the taxing jurisdiction*. Sales taxes are collected from the purchaser by the seller at the time of sale, and then remitted by the seller to the government(s) imposing them. In about two-thirds of the states that levy sales taxes, the tax rate that applies to a given purchase may be the sum of a statewide rate and one or more local government rates. Throughout the country, sales taxes typically amount to five to eight percent of the purchase price.

Use taxes are less familiar. All states (and many local governments) imposing sales taxes also impose "use taxes." Use taxes are charged on the purchase price of goods *purchased out-of-state* but brought into the state for consumption. The purpose of use taxes is to remove the incentive to purchase goods out-of-state where they might be taxed at a lower rate or not at all. If use taxes were not imposed and some consumers did have opportunities to buy out-of-state on a no-tax or lower-tax basis, state and local governments imposing sales taxes would lose revenues. In addition, merchants required to charge sales taxes would lose business—to the detriment of the local economy and employment.

The order form of mail-order catalogs is one place use taxes can be noticed. Many include a sentence like the following: "Residents of California, New York, and Illinois, please add applicable sales taxes." If, as an example, this mail-order company is located in California, the company is probably charging its New York and Illinois customers their states’ "*use* tax" and its California customers the California *sales* tax. The seller will remit these taxes to the respective governments of the states in which these customers are located. Why is the seller collecting and remitting the New York and Illinois use taxes when it is based in California? Because the mail-order company has established what tax lawyers term "nexus" with those states. "Establishing nexus" means that the California-based seller has made sufficient contact, not only with California, but also with New York and Illinois, for those states to have legal power to require the company to collect and remit their respective sales and use taxes.

What is "sufficient contact?" 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 presence of traveling salespeople, the company could be required to collect from customers and remit the applicable use taxes. However, in its 1967 decision in *National Bellas Hess* vs. *Illinois*, the U.S. Supreme Court ruled that a mail-order company could *not* be required to collect and remit a state’s use tax if the company’s only activity in that state consisted of sending in by U.S. mail or common carrier (like UPS or Federal Express) its catalogs and the goods sold to in-state purchasers. This decision was reaffirmed by the Court in *Quill Corp.* vs. *North Dakota* (1992).

Even when a seller is not required to collect and remit use taxes, purchasers remain legally obligated to pay use taxes directly to their state and local governments. Although this remittance obligation is typically unknown or ignored by individual consumers, many businesses that make out-of-state purchases on which use tax has not been collected are aware of their obligation and do remit the use tax themselves.

Throughout this report on the Internet Tax Freedom Act, the term "sales tax" is generally used to refer to both sales taxes and use taxes, since the use tax simply compensates for the sales tax and is usually imposed at the same rate and on the same items. Readers interested in a more in-depth discussion of sales and use taxes and the "nexus" issues that apply to them as a result of the U.S. Supreme Court’s *Bellas Hess* and *Quill* decisions are referred to Appendix A.

Businesses are also aware that states audit businesses for use tax compliance and that they could be subjected to penalties for failure to pay the proper amount of tax at the time it is due. However, use taxes on Internet purchases may not meet the standard in the House and Senate Committee and new Senate versions of the Internet Tax Freedom Act for preservation of sales and use taxes — which requires that sales and use taxes be "generally collected." States are unable to collect a *majority* of use taxes owed by purchasers *collectively* because states cannot legally require the seller to collect the tax and cannot effectively enforce the payment of use taxes by *individual* consumers. Therefore, a business purchaser of a Dell computer from the Dell Web site could argue to a court that the required condition in these three versions of the Internet Tax Freedom Act that the use tax be "generally collected" is not satisfied and that the business therefore is not obligated to pay use tax on its computer purchase.

The House and Senate Committee and new Senate versions of the legislation would also likely restrict the states' ability to require Internet *sellers* to charge sales taxes in instances in which states could legally impose this responsibility now. Under current constitutional standards, a state can require a seller that has a physical presence within its borders to collect sales and use taxes on sales to its residents. A computer server or bank of modems located within the state for the purpose of providing customers with local phone call access to the on-line service would almost certainly constitute sufficient physical presence to satisfy this so-called "nexus" requirement.[19] However, three of the four versions of the bill provide that Internet-related property such as this cannot be used by a state to assert that "nexus" exists, and the fourth — the new House version — appears likely to have the same result.[20] Such a result cannot be justified. Valuable Internet-related equipment is enjoying the benefits of state and local government services (e.g., police and fire protection) just as surely as a traveling salesman's car or a street vendor's pushcart. There is no reason why federal legislation should limit a state's taxing jurisdiction over a business that has consciously established a physical presence within its borders.

Even if the Internet Tax Freedom Act did not adversely affect the ability of states to require Internet sellers to collect sales taxes, states would still have great difficulty in proving that services or information provided over the Internet meet the standards in the proposed legislation that the sales be "similar sales" to sales "not using the Internet" or to sales "effected by mail order, telephone, or other remote means." Satisfaction of this "similar sales" standard is another precondition (in addition to establishing taxing jurisdiction over the seller) for applying sales taxes stated in the House and Senate Committee versions of the legislation and the new Senate version. Unfortunately, none of the bills provides a definition of "similar sales." The absence of a definition effectively places the legal burden on a state to prove, for example, that a database containing information on mutual funds sold as a taxable CD-ROM in a store is "similar" to a version of the same database that is searchable on the Internet. But what if

America Online, Nexus, and the Internet Tax Freedom Act

Connecticut has assessed America Online, Inc. more than $2 million in tax for allegedly failing to fulfill a legal obligation in 1995-96 to charge sales tax on its Connecticut members' subscription fees and to pay use tax on the purchase price of its modems located throughout the state. While America Online is contesting Connecticut's assessment on numerous grounds, nexus is a key issue. (See: *Appeal from Department of Revenue Services, America Online, Inc.* v. *Gene Gavin, Commissioner of Revenue Services*, Superior Court, Judicial District of Hartford-New Britain at Hartford, April 17, 1997.) America Online is taking the position that the presence in Connecticut of computer modems constituting its local "points of presence" is not a sufficient basis for Connecticut's assertion of "nexus" over the company — that is, Connecticut's position that the company is required to charge sales tax on its subscription fees.

America Online's ownership of the modems appears to be in dispute; the company's court filing seems to imply that it is renting the modems from a telephone company or other third party. In any case, the company asserts the U.S. Constitution protects it from the taxes that Connecticut seeks to impose. In citing the Constitution, the company is apparently relying on the U.S. Supreme Court's 1992 *Quill* decision holding that under the Commerce Clause mail-order companies cannot be required to collect a state's sales tax if they do not own property or have personnel within the state's borders.

America Online appears to have taken this "no nexus" position with respect to its obligation to charge sales tax in all of the states that currently tax Internet access or online services. Its "Terms of Service Agreement" states: "[Billed] rates do not include any *sales, use*, value-added, personal property, or other governmental tax or levy imposed on goods or services billed to Member's account. You are responsible for any such taxes." (Emphasis added. Source: legal.web.aol.com/policy/aolpol/terms.html.)

America Online may ultimately prevail in its litigation with Connecticut. Until it does, many tax administrators would probably agree with Connecticut that the physical presence of owned or leased property essential to the taxpayer's core business activity — in this case, providing access to America Online's own proprietary information content and the Internet — establishes nexus for sales and use tax purposes. Indeed, the company's home state of Virginia has taken this same position. (See: private ruling P.D. 97-306, July 18, 1997.)

America Online supports the Internet Tax Freedom Act. (See testimony of Michael Liddick at www.house.gov/cox/nettax/liddick.html.) It appears that all versions of the proposed legislation will, once enacted, protect the company from any *future* assertion of nexus by states in which its physical presence is limited to the modems and other equipment comprising its "points of presence." (See note 20.)

the on-line database is updated much more often or provides features not available on the CD sold in the store? Or worse, what if the database is only provided on-line and

has no non-Internet or mail-order counterpart? Vaguely defined or undefined terms like "similar sales" scattered throughout the legislation provide substantial opportunities for taxpayers to challenge in court legitimate taxes that the sponsors may intend to preserve — just as taxpayers have done under analogous legislation, such as the "4-R Act." (see note 9). In the absence of clearer language, judges, not Congress, will determine whether sales taxes applied to on-line sales that are "similar" to retail store purchases are, in fact, preserved.

Enactment of the new House version of the Internet Tax Freedom Act would likely have fewer adverse consequences for state and local sales taxes than the other three versions. The principal reason for this conclusion is that sales taxes on *goods* ordered over the Internet would only be banned if they fell under the definition of prohibited "discriminatory" or "multiple" taxes. "Discriminatory tax" is defined as any tax "that is not generally imposed and legally collectible. . . on similar goods or services

The New Senate Version of the Internet Tax Freedom Act, S. 1888: Back to Square One on State and Local Sales and Property Taxes

The Internet Tax Freedom Act as originally introduced prohibited states and localities from "indirectly" taxing the "use of the Internet." State and local officials immediately pointed out that this language could invalidate sales and property taxes on all equipment comprising the telecommunications and computer infrastructure of the Internet and all hardware used to access the Internet — even something as mundane as a modem-equipped personal computer. They feared that a court could reasonably find that a sales tax on the purchase and a property tax on the ownership of a computer used to access the Internet are prohibited "indirect" taxes on the computer owner's "use of the Internet."

The sponsors of the Internet Tax Freedom Act apparently gave the analysis of state and local officials sufficient credence that they removed the prohibition on "indirect" taxation from the proposed legislation when it was marked-up in committee. In addition, the sponsors included clarifying language in the preservation clauses covering sales and property taxes apparently aimed at reducing the likelihood that taxes on Internet-related hardware could be prohibited by the act.

The newly-introduced Senate version, S. 1888, however, reverts to the old language prohibiting "indirect" taxes on the "use of the Internet," and the preservation clauses covering sales and property taxes are worded in such a way that these taxes on Internet-related hardware would rarely if ever be preserved. For example, the preservation clause for sales taxes applies — if at all — only to computer equipment *ordered* over the Internet. The preservation clause for property taxes is nullified if states exempt any kind of business equipment or inventory — which all or nearly all of them do. The Direct Marketing Association, which has been a major supporter of the Internet Tax Freedom Act from its inception, has now apparently abandoned its support of versions of the legislation that took care of these problems and given its endorsement to S. 1888. (See box, p. 23.)

not using the Internet, online services, or Internet access." This reference to "similar goods and services" rather than the much more vague term, "similar sales," contained in other versions likely would preserve the obligation of purchasers to pay use taxes on purchases of goods ordered over the Internet. It would be difficult for a purchaser of a computer from Dell's Web site to argue that his computer is not a "similar good" to the same computer ordered by mail or telephone. With respect to the continued ability of states to tax services and digital content actually *delivered* over the Internet, however, the problems created by the other three drafts are present in this one as well. Indeed, the ability of states to tax such services and content may be even more in doubt, since the new House version defines as discriminatory any tax imposed on any online services "that by their nature are so related to the Internet or online services that substantially the same service is not offered via means other than the Internet or online services." Under this definition, states could not tax the Lexis/Nexis information service, for example, if the service were only provided over the Internet — providing a great incentive, of course, for the company to provide its service in precisely that manner.

State and Local Taxes on Internet Access Services

The sponsors of all four versions of the Internet Tax Freedom Act have indicated it is their intention to roll back the current taxes imposed by 12 states on monthly Internet access charges and/or to prevent the imposition of taxes on Internet access by additional states and localities while the moratorium is in effect.[21] Two major arguments have been offered in support of this policy.

The first rationale offered for prohibiting taxation of Internet access is that such taxes unfairly "discriminate" against, "target," or "single out" the Internet. This argument has little if any validity. First, none of the states that are taxing Internet access enacted a statute expressly subjecting it to taxation; rather, state tax agencies made a good-faith administrative determination that Internet access service satisfied the state's existing definition of taxable "telecommunications," "information services," "data processing," or similar service. In some instances these determinations were issued at the request of Internet service providers seeking guidance on their obligation to charge taxes on their services. State legislatures are free in these instances to clarify that Internet access is not to be taxed, and, indeed, Internet service providers in a number of states have convinced legislatures to exempt Internet access from taxation.

Such an exemption is not necessarily wise, however, and may in itself be discriminatory. Internet access is a substitute for many goods and services states already tax. For example, paying $20 per month for Internet access enables an individual to send documents by e-mail that if transmitted by fax would engender

large long-distance telephone bills that would be subject to taxation in many states. It allows free access to on-line issues of magazines that would be taxed if purchased at the corner newsstand. It allows access to information posted by cable television networks on their Web sites that would be taxed if it were obtained through subscription to a cable television service. It allows people located across the world from each other to carry on interactive "conversations" using their keyboards (so-called Internet Relay Chat) that would be taxed if made by telephone. Indeed, software is now freely available that allows individuals to carry on voice conversations over the Internet using their computers' microphones and speakers. In sum, there is nothing inherently discriminatory or unfair about taxing Internet access, if a state also taxes some of the modes of obtaining information or communicating for which Internet access is a substitute.

Some sponsors of the Internet Tax Freedom Act have also argued that taxation of Internet access fees is unfair "double taxation" because many Internet service providers pay tax on the telephone service they use to link their subscribers to the Internet.[22] It is unfair, the argument goes, to tax again the full price of Internet access, which effectively resells the telephone service that has already been taxed.

Almost all tax experts would agree that preventing such "pyramiding" of a sales or gross receipts tax is a desirable tax policy goal. But it is a goal that is rarely achieved in state tax systems. Pyramiding is a widespread problem with sales and gross receipts taxes, yet no one in recent memory has suggested it is serious enough to warrant federal action with respect to the sale of tangible goods. Even assuming that federal legislation were appropriate, the approach embodied in the Internet Tax Freedom Act violates the principle of "technological neutrality" that proponents of the legislation espouse. Public finance experts generally agree that the appropriate means of preventing pyramiding is to tax the full selling price of the good or service but to allow the seller to purchase inputs tax-free. For example, retailers charge sales taxes on the full price of the goods they sell but usually purchase these goods free of sales tax under a "sale for resale" exemption. In contrast to this usual procedure of exempting inputs and taxing final sales, the House and Senate Committee versions of the legislation would prohibit taxation of Internet access charges but preserve the taxes on the telephone service that Internet service providers purchase.[23]

The violation of the technological neutrality principle this approach represents would have significant consequences for closely competing technologies. It would, for example, provide a significant competitive advantage for e-mail as compared to voice-mail, which undoubtedly are two competing technologies. Local telephone companies would have to charge tax on the full price of voice-mail services, while Internet service providers providing e-mail accounts would only have to pass through the taxes on their purchased telephone service, typically a fraction of their total costs.[24]

In a major "white paper" issued two years ago, the telecommunications industry itself acknowledged that the appropriate solution to potential pyramiding in taxation of Internet access and other "information highway" services was to tax the final service and grant a "sale-for-resale" or "manufacturing [input]-type" exemption for the purchase of other services that constitute "inputs" to the final service. The white paper recommended:

> *a. Only final sales of taxable information highway services should be taxed.* . . . To the extent a jurisdiction taxes information highway services, we urge that tax exemptions in the context of the sale of information highway services be designed and construed to ensure that only the final sale of a taxable information highway service can be subject to tax. This means that any sale of an information highway service should be exempt if there is a subsequent transaction to another purchaser, in which the cost of the first service is reflected in the price of the final sale of a taxable information highway service.[25]

Now, however, many of the same companies that endorsed the white paper position two years ago are taking the opposite position in supporting the Internet Tax Freedom Act.[26]

State and Local Taxes on Telecommunications Services Underlying the Internet

Even if the approach of prohibiting taxation of Internet access charges while preserving taxation of the telecommunications services that Internet service providers use could be justified, none of the four versions of the Internet Tax Freedom Act has clearly achieved this result. The legislation could have the effect of preventing states and localities from taxing *both* the access fees charged by Internet service providers to their customers *and* the underlying telecommunications services ISPs purchase, because the tax on the telecommunications services is not unambiguously preserved by the preservation clause language.

The preservation clauses covering telecommunications taxes in both the House and Senate committee versions of the act are both vaguely-worded and subject to numerous conditions. For example, the Senate and House committee bills preserve telecommunications taxes imposed on a telephone company "acting in its capacity as a common carrier" and "providing common carrier services," respectively. Neither bill defines these terms, however. The lack of a definition is likely to invite litigation by companies providing Internet-related telecommunications services, because the applicability in the Internet context of federal law defining and regulating "common carriers" is currently a matter of great uncertainty and controversy.[27]

The new Senate version of the Internet Tax Freedom Act does not contain a preservation clause for telecommunications taxes at all. Since this draft borrows from previous versions that contained such a provision, a prohibition of taxes on telecommunications services underlying the Internet may be intended by the sponsors.

Current taxes on telecommunications services purchased by Internet service providers may also be threatened by the new House version's prohibition of taxes on "Internet access." "Internet access" is defined, vaguely, as "the offering or provision of the storage, computer processing, and delivery of information that enables the user to make use of resources found via the Internet." There is no further definition of "information," "user" or "resources." Is an Internet service provider a "user?" Is a routing computer owned by a telephone company through which a Web surfer's request for a particular Web page is passed a "resource found via the Internet?" Does that router arguably "store" that request for a few nanoseconds? If so, taxation of the telecommunications services that the telephone company provides to the Internet service provider may be prohibited by this version of the legislation as well, because the telecommunications services will themselves satisfy the definition of tax-exempt "Internet access."

These questions and circumstances illustrate the extent to which the consequences of the Internet Tax Freedom Act could extend beyond the loss of state and local revenue on the typical $20-a-month Internet access fee or the telecommunications services purchased by Internet service providers. Enactment of the legislation could threaten all state and local taxes imposed on ordinary telephone services, because the Internet is becoming ever more closely entwined with such services. AT&T has announced plans to offer Internet-based telephone service using regular telephones on both ends of the connection.[28] The "father of the Internet," MCI executive Vint Cerf, has recently written, "the Internet and [public switched telephone network] will intertwine and begin to work together—merging, melding and blurring the distinctions between the two."[29] A prominent computer-industry columnist has cited estimates that 35 percent of phone calls will be made over the Internet by 2002, well within the moratorium period of the Senate and House Committee versions.[30] In short, "Internet access" may soon be essentially *synonymous* with telephone service.[31] In light of this, the attempt of the sponsors of the Internet Tax Freedom Act to preserve state and local telecommunications taxes on telephone services while prohibiting taxation of "Internet access" is unlikely to be workable.[32] A substantial share of the telecommunications tax base of state and local governments—taxes on $200 billion in annual receipts of local and long-distance telephone companies—could be at risk.[33]

General Business Taxes

The House Committee and new Senate versions of the Internet Tax Freedom Act appear to *ban imposition of state corporate income taxes* on profits from the provision of Internet access and the on-line sale of goods and services. Both versions contain clauses preserving income taxes, but limit the application of the clauses to income taxes imposed on "all businesses" or "all business entities." Since, by definition, corporate income taxes are only imposed on businesses organized as corporations, rather than on "all businesses," the preservation clause is nullified.[34] This result may not be intended. Nonetheless, the potential impact of the language in the House Committee version was identified nearly eight months ago, before the subcommittees of the House Commerce and Judiciary Committees approved the legislation. The California Franchise Tax Board, which *supports* the Internet Tax Freedom Act, was sufficiently concerned about the provision to direct its Washington, D.C. lobbyist to seek to clarify the issue.[35] To date, no House sponsor or co-sponsor has publicly acknowledged the problem or expressed a commitment to fixing it. The new Senate version includes similarly problematic language and was introduced only on March 31, 1998.

The new House version of the Internet Tax Freedom Act could also threaten corporate income taxes paid by electronic commerce businesses. The new House version's prohibition of "discriminatory" taxes on "electronic commerce" appears intended to apply only to state and local taxes on individual transactions — such as a sales tax on a computer ordered over the Internet or an excise tax on Internet access services. (An excise tax is a tax on the sale of a specific product or service.) The prohibition does not appear to be intended to apply to broad taxes on business operations, such as a state corporate income tax. Nonetheless, the language is ambiguous on this matter; rather than banning "discriminatory *transaction* taxes," the new House version bans "discriminatory taxes on electronic commerce," with the latter defined as "any transaction comprising the sale. . . of goods or services. . . via the Internet." An Internet business, such as an Internet service provider, could reasonably argue that any tax that includes the value of its gross electronic commerce sales (i.e., its "transactions . . . via the Internet") in the base of the tax is a tax on "electronic commerce" that could potentially be found discriminatory under the new House version. A corporate income (or profits) tax could fulfill the condition of having electronic commerce sales in its base for these companies, because it is calculated as gross sales minus expenses. The "discriminatory" condition may also be met. The new House version defines as discriminatory any tax on any services "that by their nature are so related to the Internet or online services that substantially the same service is not offered via means other than the Internet or online services." Internet access would seem to satisfy this definition, as would any type of online information or entertainment service. Therefore, corporate income taxes on Internet service providers, online information service providers, and perhaps other types of corporations providing

Internet-related services appear to be at risk under the new House version of the Internet Tax Freedom Act as well.

Some 45 states have corporate income taxes to which an exemption of profits resulting from the sale of Internet access or other on-line services could apply. If corporate income taxes were prohibited by the new Senate and/or House Committee versions of the Internet Tax Freedom Act, a broad range of corporations could benefit. For example, AT&T would be able to exclude from its taxable income for state income tax purposes any profits attributable to its WorldNet Internet access service. Similarly, the on-line stock broker E*Trade would not have to pay corporate income taxes on its profits derived from on-line brokerage services.

Other types of general business taxes based on gross income or other measures would also be prohibited or questionable because of conditions placed on the operation of the preservation clauses for business taxes in the House Committee and new Senate versions of the legislation and the definition of "discriminatory" taxes in the new House version. Such threatened taxes would include the value-added type taxes levied by Michigan and New Hampshire, taxes on corporate "capital stock" or earned surplus levied by Texas, Louisiana, Pennsylvania, Ohio, and New York, and the gross receipts taxes collected by Washington, Indiana, and Delaware. Moreover, the inability to tax income from these types of activities would not be limited to corporations for which the primary business is Internet services; it could extend to the portion of a regular corporation's earnings that is derived from providing Internet-related or on-line services. For example, banks could claim an exemption for ATM fees, and airlines could claim an exemption for fees received from other airlines in connection with the operation of their reservation systems.

II. The Internet Tax Freedom Act Would Reduce State and Local Government Revenues

No one knows how fast electronic commerce will grow or how large a segment of the economy will be associated with electronic commerce three to five years from now. Furthermore, if any version of the Internet Tax Freedom Act were to be enacted, it is unclear how broadly the prohibition on state and local taxation would be extended as a result of industry using the legislation to challenge in court various features of existing taxes. Finally, the extent to which entertainment companies, publishers, etc. would restructure their operations to take advantage of the moratorium is difficult to predict.[36] Despite these uncertainties, the effect of the Internet Tax Freedom Act on state and local finances certainly would be significant and would grow over time.

Potential Revenue Impact of Prohibition on Taxation of Internet Access Services

The clearest and most direct impact on state and local revenues would arise from the ban on taxation of Internet access fees, which currently are taxed by 12 states (see box, next page). The Congressional Budget Office recently has estimated that the annual loss of revenue in these 12 states from a prohibition on taxation of Internet access services would be "close to $50 million."[37] However, the CBO appears to have made a conservative estimate in the absence of specific information on the relevant tax revenue. It is possible that the revenue loss from the prohibition on taxing Internet access fees would be up to 10 times larger than estimated by CBO, based on industry projections of Internet growth. (CBO based its estimate on current state revenues from taxing Internet access and did not consider projections for growth in this service.) The 12 states taxing Internet access represent 20 percent of the U.S. economy (as measured by personal income). Internet service provider receipts from providing Internet access

services *nationwide* are forecasted to reach $50 billion annually by 2000.[38] If the residents of the 12 states taxing Internet access services were to purchase such service in proportion to their personal income, then Internet service providers would be selling approximately $10 billion in taxable Internet access services in those 12 states in 2000 (i.e., 20 percent of $50 billion equals $10 billion). At just an average tax rate of 5 percent (lower than the current average state sales tax rate), sales tax and telecommunications tax revenues attributable to the provision of Internet access in these 12 states could be approximately $500 million annually.[39] These revenues would be lost if any of the four proposed versions of the Internet Tax Freedom Act were to be enacted.[40]

CBO also reported that a few of the states that tax information and data processing services, which could also be prohibited under the legislation, were able to provide data on current revenues attributable to the taxation of such services. These few states estimated revenues from taxation of such services to be $35 million to $45 million annually. Some portion of these revenues would also be lost were any version of the Internet Tax Freedom Act to be enacted.

States Taxing Internet Access Services

Colorado
Connecticut
District of Columbia
Iowa
New Mexico
North Dakota
Ohio
South Carolina
South Dakota
Tennessee
Texas
Wisconsin

Source: Vertex, Inc., at www.vertexinc.com

Potential Impact on Sales Tax Revenues

By far the most significant revenue loss in future years would result from the legislation's limiting the ability of state and local governments to collect sales taxes on goods and services sold through the Internet. States and localities currently raise approximately $170 billion per year from general sales taxes. These revenues supply nearly one-quarter of all the tax revenues that states, cities, counties, and school districts use to support the government programs and services they provide.

As discussed above, the extent to which states could, under current laws, effectively tax sales of goods and services ordered and/or delivered through the Internet is a complicated and unsettled matter.[41] To oversimplify, states can clearly require retailers to collect and remit taxes on sales made to state residents only if the retailing company has some property in the state or employees or authorized

representatives in the state acting on its behalf.[42] This is why mail-order companies have largely been able to avoid collecting state and local sales taxes on merchandise sales. But Internet companies are not fully analogous to mail-order companies. Unlike mail-order companies that may sell to consumers across the country from an office in a single state, some Internet and on-line services providers and other Internet merchants own or lease property in multiple states that enables them to provide local connections to the Internet. Many Internet businesses are also engaging in a variety of partnership arrangements with companies located outside their home states. It is not yet clear whether or when these of Internet connections, partnership arrangements, or any other circumstances allow states to tax on-line sales under existing law. It is clear, however, that *if state and local sales taxes are to survive as a means to support government programs and services in the future, a means must be found to treat all sales to consumers in a comparable manner — whether the sale takes place in a neighborhood store or through the Internet*.

As noted above, the high technology market research company Forrester Research, Inc. projects U.S. Internet sales of goods and services will grow to $344 billion by 2002.[43] Just one company, Dell Computer Corporation, recently speculated that it could be selling $13 billion worth of products annually over the Internet by 2000.[44] Other estimates of annual Internet commerce in that time frame range as high as $1.5 *trillion*.[45] Using the more modest Forrester Research estimate of future Internet sales and assuming that just half of such sales would be subject to sales taxes, state and local sales tax revenue on these sales would be approximately $10 billion annually.[46] This figure represents 6 percent of current state and local sales tax collections of approximately $170 billion.[47]

It is not implausible that enactment of the House Committee, the Senate Committee, or the new Senate version of the Internet Tax Freedom Act would prevent state and local governments from collecting virtually all of this potential sales tax revenue.[48] As discussed above (see pp. 2,4), all three of these versions of the legislation appear to invalidate the obligation of purchasers to pay use taxes on goods and services ordered over the Internet. All three drafts also appear to prevent states from requiring sellers to charge sales and use taxes in instances in which states can currently enforce that requirement (see note 20). The sales tax revenues that would be lost if the new Senate version of the legislation were to be enacted would be even larger, since this version prohibits state and local taxes that "indirectly" tax the "use of the Internet." Under this prohibition, a state arguably could not even impose a sales tax on a modem-equipped computer purchased in a store, if the purchaser asserted she planned to use the computer to "use. . . the Internet." (See box, p. 6.) International Data Corporation has forecasted that U.S. companies and individuals will spend $92 billion in hardware, software, and services to use the Internet in 2000; most of these purchases would normally be subject to sales taxes in most states.[49] The prohibition on "indirect" taxation of the "use of the Internet" under the new Senate version of the legislation could

therefore cause additional sales tax revenue losses on the order of $5 billion annually by that time.[50]

Revenue Losses Could Deplete Current State Surpluses

At the present time, state fiscal conditions are strong. This could lead some people to conclude that revenue losses resulting from the ban on sales taxation of Internet-related purchases of the order of magnitude just described would not be a major problem for states and localities. Such a conclusion, however, would not reflect the reality of state and local finances, which only now, after several years of unusually strong economic growth, have reached a point approaching fiscal health in a majority of states.

The National Conference of State Legislatures reports that states, on average, ended state fiscal year 1997 with surpluses equal to 7.3 percent of their general fund spending.[51] These balances, fueled largely by a surge in revenues in the second quarter of 1997, are higher than in any year since 1980. This is only the fourth year since 1980 that balances in aggregate have exceeded five percent. Even so, there remained 20 states that ended fiscal year 1997 with balances of less than the prudent five percent level. Because states have limited ability to borrow for operating expenses and generally must balance their budgets, the maintenance of at least five percent of spending as a budgetary reserve is considered prudent to minimize the need for tax increases and spending cuts if the economy turns down.

The significance of the potential annual sales tax revenue loss that could result from enactment of the Senate Committee, House Committee, or new Senate versions of the Internet Tax Freedom Act can be gauged in comparison to the size of accumulated state reserves at this point in the business cycle, following years of strong economic growth. Accumulated aggregate state reserves equal $28 billion. The annual loss of revenue of $10 billion by 2002 from an inability to tax Internet sales estimated above would thus deplete a comparable level of reserves in about three years. The additional loss of revenue on Internet access charges and the potential loss of revenue on voice telephone services provided through the Internet discussed above would accelerate the depletion of the states' reserves in the absence of offsetting spending reductions or tax increases.

Some may argue that a revenue loss of this magnitude would be avoided because the moratorium will expire before Internet commerce grows to these levels. As will be discussed below, however, the possibility exists that elements of the Internet commerce industry could seek to extend the moratorium indefinitely.

III. A Moratorium on Taxation of Internet Sales Would Benefit Affluent Consumers at the Expense of Those with Low and Moderate Incomes

People who make purchases through the Internet are, on average, more affluent than those who do not. This stands to reason, since a person making an Internet purchase generally must have a personal computer with a modem, a connection to the Internet through a service provider, and a credit card with which to pay for the purchase. Most lower-income households would lack the equipment to access the Internet, the training to use the equipment, and/or the financial stability and credit rating required to maintain a credit card.

The *Wall Street Journal* notes that income and education are linked to the ownership of personal computers. According to the *Journal*, 80 percent of households with incomes over $100,000 have personal computers, while personal computers can be found in only 25 percent of households with incomes under $30,000.[52] Media Metrix reports that Internet users own the most powerful and expensive computers.[53] International Data Corporation pegged the average household income of Internet users at $70,400 and of non-users at $38,700.[54] *Web Week* magazine reports that the average annual income of people who make purchases through the Internet is $76,000 for men and $60,000 for women.[55] Indeed, the relative affluence of Internet users is often touted by the industry as a selling point for advertisers.[56]

Moreover, the Internet is increasingly being used to make purchases of luxury items. A recent article describes how the Internet is especially well-suited for consumers who want to customize their purchases of golf clubs and bicycles from hundreds of possible specifications.[57] Sales of specialty wine and beer over the Internet are exploding, much to the consternation of state tax officials concerned about erosion

of alcohol tax revenues and of regulatory officials concerned about preventing sales to minors.[58]

The relatively more affluent segments of the population who use the Internet would benefit disproportionately from the effective repeal of many state and local taxes resulting from enactment of the Internet Tax Freedom Act. A person with sufficient means to have a computer and Internet access could, for example, avoid taxation on the purchase of a good or service that would be taxed if a person without such access purchased the same or similar good or service from a neighborhood store. But the tax break for the affluent would likely come at the expense of higher taxes or fewer services for state residents of more modest means.

As Internet sales become a more significant share of consumption, states and localities will likely see taxable sales — and sales tax revenues — diminish under this legislation. States and local governments could raise their sales tax rates to maintain revenues if they were unable to tax Internet sales. But sales taxes are regressive; they absorb a larger share of the incomes of lower-income households than of wealthier households. Sales tax rate increases could set off a vicious cycle leading to ever more regressive sales taxes. As tax rates rose, higher-income households and businesses with Internet access would have ever greater incentives to make their purchases on-line to avoid taxes, while lower-income households without sufficient resources to get on-line would remain liable for the taxes. Sales tax liability would be more and more concentrated among the lowest-income segments of the population.[59]

Similar inequities for low-income households would be created if, instead of raising taxes, state and local government programs were reduced to compensate for diminished revenues. History suggests that in time of fiscal shortages, services for lower-income families and individuals tend to be cut disproportionately.

These scenarios may occur to some degree even if the Internet Tax Freedom Act is not enacted because of the legal loophole freeing many out-of-state businesses — including many Internet merchants — from an obligation to charge sales taxes. In fact, the mail-order loophole is already shifting the overall sales tax burden toward low and moderate income households, because mail-order and telephone purchases also are disproportionately made by upper-income households.[60] The inequitable impact of the mail-order loophole on the distribution of the sales tax burden is one major reason why a new federal law is needed to permit states to require most large interstate businesses — including large Internet merchants — to collect sales taxes. Enactment of the Internet Tax Freedom Act would make a bad situation worse, by preventing state and local governments from requiring some Internet sellers over whom they *do* have taxing jurisdiction to collect sales taxes, and by interfering with their current authority to require *purchasers* to pay taxes on out-of-state purchases on the Internet.

IV. Enactment of the Internet Tax Freedom Act Could Interfere with Efforts of Government and Industry to Reach Agreement on Fair Taxation of Electronic Commerce

State and local government officials appear to appreciate that greater interstate uniformity in the taxation of electronic commerce is desirable. Public officials recognize that greater uniformity would both reduce compliance burdens generally for multi-state electronic commerce companies and minimize the potential for double taxation that would exist if taxation of online services using different taxing standards in different states became widespread.[61] All of the major organizations of state and local elected officials, including the National Governors' Association, the National Conference of State Legislatures, the U.S. Conference of Mayors, the National League of Cities, and the National Association of Counties, are actively participating in a project sponsored by the National Tax Association aimed at developing a uniform approach to taxing electronic commerce.[62]

The National Tax Association project got underway in early 1997 and is proceeding positively and deliberately. Numerous trade associations representing a broad swath of the electronic commerce industry are participating along with the government organizations.[63] In January 1998, the industry participants submitted to the government representatives a constructive list of desirable simplification measures for sales taxes and a proposed approach to sales taxation of electronic commerce that, if implemented, could lead to industry consent to collect sales taxes on Internet sales. The government representatives responded positively to nearly all of the industry proposals. More recently, the National Governors' Association adopted a policy resolution agreeing to several of the electronic commerce industry's key demands, including an ability to collect sales taxes on electronic commerce at a single uniform rate within each state, uniform definitions across all states of taxable and exempt

The Proposed Federal Study Commission on State and Local Taxation of Internet Commerce: H.R. 3529's Approach

All four versions of the Internet Tax Freedom Act propose some type of Executive Branch-led study commission on state and local taxation of Internet commerce. In every case, the commission would include broad membership and/or consultation of state and local government and Internet industry representatives and would be charged with formulating policy recommendations that ultimately or directly would be transmitted to the Congress.

For reasons discussed extensively in the accompanying text, imposing any type of moratorium on state and local taxation risks hindering current negotiations between government and industry aimed at developing a comprehensive solution to Internet commerce taxation issues. This observation would apply with equal force to negotiations that might be conducted within a federal forum, such as a study commission established by the Internet Tax Freedom Act. Nonetheless, if it is not coupled with a moratorium, the formation of such a commission is desirable in its own right. Any realistic solution to state and local tax issues posed by electronic commerce will entail federal legislation. The solution preferred by state and local governments would require federal legislation to reverse the U.S. Supreme Court's *Quill* decision and permit states and localities to require at least large corporations selling over the Internet to charge sales taxes in exchange for simplification and standardization of such taxes. An alternative preferred by some members of the industry would be federal legislation authorizing states to require Internet merchants to report purchases by the states' residents so states could effectively collect use taxes directly from consumers. In either case, the recommendations of a federal body would likely be more assured of congressional consideration that the recommendations flowing from a private group, such as the National Tax Association electronic commerce project.

H.R. 3529, introduced by Representative Steve Chabot to implement a compromise on the Internet Tax Freedom Act negotiated between Representative Christopher Cox (the original House sponsor) and Governor Michael Leavitt of Utah (on behalf of the National Governors' Association) contains the best proposal on the composition and mandate of the study commission of any of the four versions of the bill. The proposal for a "Commission on Electronic Commerce"in H.R. 3529:

- mandates the broadest representation of interested government and industry groups of any of the four proposals and provides for *membership* of such groups on the Commission (as opposed to only "consultation" in several proposals);
- explicitly charges the Commission with recommending *specific federal legislation* authorizing appropriate state and local taxation of Internet commerce under federally-specified conditions (as opposed to other versions that contemplate either general "policy" recommendations on taxation or a "Uniform Commercial Code" for the Internet that would not necessarily encompass any recommendations on taxation);
- restricts the scope of the recommendations to high-priority state and local *sales tax* issues (unlike other versions that would encompass *federal* international taxation issues, which could greatly retard the Commission's ability to issue a final report);
- provides for mandatory and expedited congressional consideration of the Commission's recommendations (unlike other versions that provide no time frame for congressional consideration or, worse, contemplate a two-stage process, in which the President would have an additional two years to formulate his recommendations to Congress based on the study commission's report); and
- clearly acknowledges the need and right of state and local governments to tax their fair share of electronic commerce.

electronic commerce transactions, and uniform sales tax administration procedures and forms across states.[64] Kendall Houghton, an attorney who has testified in support of the Internet Tax Freedom Act and has also been a key business representative in the National Tax Association Project, has acknowledged that the NGA resolution is a reflection of some consensus between the electronic commerce industry and state and local government on appropriate taxation of electronic commerce. She said recently that industry and government have "a lot more common ground than we've officially acknowledged."[65]

Enactment of the Internet Tax Freedom Act risks damaging the National Tax Association effort. The legislation would eliminate most of the incentives to reach an agreement facing both of the principal types of electronic commerce businesses involved in the project. The first category, the "non-nexus" companies, can be thought of as the businesses that are not currently collecting sales taxes outside of a handful of states in which they have a significant physical presence because they believe the U.S. Supreme Court's *Quill* decision protects them from having to do so. This group would include companies like well-known Internet bookseller Amazon.com and companies that sell software that is downloaded over the Internet.[66] The second category, the "nexus" companies, is comprised of businesses that are currently subject to and complying with taxes on electronic commerce in a relatively large number of jurisdictions because they have a substantial physical presence in most of them. This group would include many of the Internet and on-line service providers (like Compuserve), the major telecommunications companies that provide the Internet infrastructure (like Sprint and MCI), and major on-line information providers (like Lexis-Nexis) whose methods of doing business require them to have a physical presence in many states.[67]

Removing Incentives to Negotiate of Companies with Nexus in Few States

The "non-nexus" companies have representatives at the negotiating table with state and local officials at least in part because they appear to recognize that their reliance on the *Quill* decision to avoid the obligation to collect sales taxes in most states is not without risk. Many experts have noted that there are numerous legal theories that state and local governments could use to require out-of-state electronic commerce businesses to collect sales tax by distinguishing the way they do business from that of the pure mail-order company addressed in *Quill*.[68] Some of the "non-nexus" companies appear willing to consider giving up their perhaps risky reliance on the protection of the *Quill* decision and begin to charge sales taxes *if* state and local governments substantially simplify their sales tax systems and harmonize them with those of other states.

However, agreement along these lines is much less likely to be reached if any of the current versions of the Internet Tax Freedom Act is enacted. Language in all four versions of the act would largely extend a blanket protection from sales tax collection obligations to most Internet merchants and nullify most of the possible legal theories that states might use to extend taxing jurisdiction over out-of-state Internet merchants lacking a substantial physical presence within their borders.[69] Accordingly, enactment of the Internet Tax Freedom Act would remove the greatest incentive the non-nexus companies presently have to negotiate with the states.

The history of state and local government efforts to reach an agreement with the mail-order industry under which catalog companies and other "direct marketers" would begin collecting sales taxes in exchange for sales tax simplification and uniformity should dispel any illusion that many "non-nexus" companies would continue to negotiate actively if *Quill* were bolstered with the protective language in the Internet Tax Freedom Act. The mail-order companies have enjoyed a 30-year "moratorium" on the states' assertion of taxing jurisdiction as a result of the U.S. Supreme Court's 1967 *National Bellas Hess* decision. This decision first established that states could not require mail order companies to collect sales and use taxes if the companies' contacts with the state seeking to impose the tax were limited to communicating with customers by common carrier or U.S. mail.

For a decade after mail-order sales became a serious drain on state and local revenues in the early 1980s, state and local governments tried to obtain federal legislation overturning *Bellas Hess* that would have provided reasonable protections and special benefits for small mail order companies that might have found collection of sales taxes particularly burdensome. For example, the proposed legislation has always exempted small businesses and permitted all mail-order companies, large and small, to avoid having to collect thousands of individual city and county sales taxes. Only after years of failure with federal legislation did state and local governments unsuccessfully seek to reverse *Bellas Hess* with *Quill*. Throughout this entire period and to the present day, the mail-order industry has fought federal legislation with all the weapons at its disposal. These weapons have included flooding customer mailboxes with materials misleading them into believing that the tax on mail-order sales is a new one rather than one that consumers are already legally obligated to pay when sellers do not collect and remit the tax on their behalf.[70]

The mail-order industry has steadfastly defended a physical presence requirement for nexus, notwithstanding that there are now corporations with hundreds of millions of dollars in nationwide sales that are able to avoid collecting sales taxes in every state except their own while corporations many times smaller collect in nearly every state in the country. For example, L.L. Bean, with 1995 sales of $888 million, collects and remits sales taxes only to Maine. In contrast, the Boy Scouts of America

The Direct Marketing Association and the Internet Tax Freedom Act

The Direct Marketing Association is a leading trade association for mail-order companies. In a January 1998 report to its members headlined "New Nexus Threat from the Internet," the Association wrote:

> A new front has opened up in the Nexus Wars, and direct marketers are outnumbered. The issue is: "What will be our national tax policy regarding electronic commerce?" To understand how Internet tax policy will inevitably determine the mail order tax/nexus issue, one needs to recognize two facts:
>
> (1) E-commerce is expected to grow to such a size that most players in the tax policy game concede that e-commerce sales cannot be allowed to escape taxation. Many are already assuming that the rule for e-commerce will have to be: "If you sell over the Net, you must collect the tax."
>
> (2) Whatever rules are adopted for e-commerce will have to apply to the rest of direct marketing. Customers will not be allowed to shop the Internet and then phone or mail in their orders to avoid paying tax.
>
> Thus the key battle to preserve the constitutional nexus protections for direct marketers may be fought over Internet nexus rules. The battleground may well be the Communications and Electronic Commerce Tax Project, a business/government group organized under the auspices of the National Tax Association. . . . Draft report #1 prepared by the drafting committee of the NTA Tax Project . . . could not be worse from the DMA's point of view. The Draft Report assumes for all three of its proposals that all marketers of digital products (music, software, videos, information, etc.) will have nexus wherever they have customers.
>
> The . . . report states "the 'level playing field' concerns may warrant consideration of the question whether these proposals should likewise be applied to competing transactions not involving electronic commerce."

The DMA has been a key supporter of the Internet Tax Freedom Act from its introduction. If the legislation protects Internet sellers from a requirement that they collect sales taxes, mail-order companies are in a better position to argue they should remain similarly protected. However, the DMA may have concluded that both the House and Senate sponsors of the legislation have made concessions to the concerns of state and local governments that could call into question the permanence of the mail-order sales tax loophole. On April 2, 1998, the DMA informed its members of its endorsement of a new version of the Internet Tax Freedom Act, S. 1888:

> [A] bipartisan legislative alternative that the DMA helped craft has emerged. A bill announced yesterday by Senators Judd Gregg (R-NH) and Joseph Lieberman (R-CT) would provide for a tax moratorium on e-commerce, but would leave interstate mail and telephone order tax collection out of the equation. The Supreme Court protections for out-of-state mail order companies provided by the 1992 Quill decision would remain in place.

collect sales and use taxes on their sales of camping equipment, badges, and publications in every state. The Boy Scouts' mail-order sales totaled just $23 million in 1995.[71] The mail-order industry has never agreed in principle that there is a corporation above some size threshold that should have a sales tax collection obligation in exchange for special provisions to reduce tax compliance burdens.[72] Apparently, the competitive advantage that not having to collect sales taxes provides against Main Street competitors that must collect the taxes is too great to relinquish under any conditions. Internet merchants protected from sales tax collection obligations by the Internet Tax Freedom Act will likely fight to preserve this competitive advantage, just as the mail-order companies have for 30 years.

Removing Incentives to Negotiate of Companies with Nexus in Many States

What about the second group of companies, such as multi-state Internet service providers and telecommunications companies, who concede that their physical presence requires them to comply with applicable taxes on their services in a significant number of states? These companies should be the segment of the electronic commerce industry with the greatest interest in a more simple and uniform system, since they are already bearing the costs of the existing level of complexity and non-uniformity. Unfortunately, the Internet Tax Freedom Act allows them to circumvent the complexity by eliminating taxes on many or most of their services during the moratorium period. As discussed above, the legislation would prohibit state and local taxation of Internet access charges and provide telecommunications companies with strong legal grounds for refusing to pay taxes on revenues attributable to carrying Internet traffic. If the Internet Tax Freedom Act is enacted, this category of companies could therefore also lose interest in engaging in what undoubtedly will be a difficult and complex negotiating process. They may choose, instead, to put their resources into achieving renewal of the moratorium when it is set to expire. In sum, enactment of the Internet Tax Freedom Act would appear to eliminate most of the incentives that the businesses with the most to gain from an agreement with state and local governments currently have to reach one.

In addition to removing incentives for the electronic commerce industry to reach a reasonable accommodation with state and local governments, a moratorium on taxation at this time would also have adverse consequences from a practical standpoint. Electronic commerce is in its infancy, but it is poised for rapid growth. Some companies will seek to profit in this new virtual marketplace as providers of the communications and financial infrastructure that will facilitate electronic commerce. Others will be participating as on-line merchants. *Both* types of companies will soon be making billions of dollars worth of investments in the design and purchase of billing systems, secure on-line payment systems, and similar technologies. If massive investments are made in these systems over the next several years with no technical capability for state

and local tax collection built in, the industry is much less likely to turn around at the end of a three to five year moratorium period and agree to retrofit these investments for this purpose. There is great danger that electronic commerce companies will be able to argue convincingly to Congress that the costs of retrofitting these systems will injure an industry that has only recently achieved profitability and that the moratorium should therefore be extended or made permanent. Given present forecasts for the growth in electronic commerce, a permanent moratorium would not only be devastating for the state and local sales tax base, but would also, as discussed above, ensure that sales tax liability would be more and more concentrated in the lowest-income segments of the population.

State and Local Governments Have Incentives to Negotiate With or Without the Internet Tax Freedom Act

Sponsors of the legislation might acknowledge that enactment of the Internet Tax Freedom Act could lessen the incentives that the electronic commerce industry has to negotiate a tax collection agreement and yet argue that without the legislation *state and local governments* have no incentive to negotiate in good faith. This is a fundamental mis-reading of the situation. State and local governments do not need the Internet Tax Freedom Act to encourage them to make reasonable compromises with the industry, because the *Quill* decision by itself is a very heavy "stick" hanging over their heads. State and local governments will not be legally capable of taxing a large share of electronic commerce (at least not without years of costly new court battles they might lose) unless the electronic commerce industry consents to federal legislation reversing *Quill*.[73] The industry can likely block such legislation and will certainly attempt to do so if state and local governments do not commit to substantial uniformity and simplification of their taxation of electronic commerce. *On balance, then, enactment of the Internet Tax Freedom Act appears far more likely to encourage intransigence on the part of the electronic commerce industry than not enacting it would on the part of state and local governments.*

V. Conclusion

The federal government has shifted responsibility to the states for substantial portions of the nation's social safety net and is relying on state initiative and financing to accomplish many social goals. The child health program enacted by Congress in 1997, for example, cannot be successful unless states are willing and able both to invest the state dollars necessary to claim federal matching funds and to exert the effort required to implement a successful program. The same is true for the federal legislation intended to replace welfare benefits with jobs; state funding and state initiatives are both required to reach this national goal. These enhanced responsibilities come on top of more traditional state and local obligations such as education, which, in most states, also requires augmented investments to meet needs and raise educational quality.

If states and localities are to meet their growing responsibilities, they need an adequate revenue base of their own from which to finance programs and services. As indicated in this analysis, all versions of the Internet Tax Freedom Act represent a significant threat to the adequacy of state and local government revenues. Given the anticipated growth in electronic commerce and the merging of the Internet and the telephone system that has begun, state and local governments could be losing billions of dollars in sales taxes and telecommunications taxes annually well before the end of the "moratorium" period if any version of the Internet Tax Freedom Act is enacted. If, as can reasonably be anticipated, taxpayers use the vague wording of the legislation to invalidate through litigation other state and local taxes that the sponsors intend to preserve, state and local revenue losses could be even larger.

The Internet Tax Freedom Act could pose even greater problems for state and local government finances in the long term if it interferes with current industry-government efforts to negotiate appropriate rules for taxing electronic commerce or if it becomes a permanent constraint on state and local taxation. State and local sales taxes

will be collected on an ever-more narrow segment of the consumption of goods and services at ever-higher rates if electronic commerce and traditional mail-order sales remain immune from taxation. If Internet and traditional mail-order sales cannot be taxed, state and local sales tax revenues may not keep pace with the growth of the economy and the population. Moreover, the sales taxes that are collected will likely be paid to an increasing extent by low- and moderate-income households without the wherewithal, training, or inclination to buy their groceries, clothes, and telephone service from Internet merchants and other out-of-state businesses.

Both electronic commerce industry representatives and state and local government officials understand the basic terms of an agreement that would allow state and local governments to tax their fair share of electronic commerce. Companies would have to forfeit their existing legal protections against the obligation to collect sales taxes in states in which they are not physically present. In exchange, state and local governments would have to implement simpler and considerably more uniform sales tax systems. Both sides concur that such an agreement would inherently have to cover traditional mail-order sales as well as electronic commerce; it would make little sense to develop a system for taxing downloaded software if floppy disks containing the same software ordered from a mail-order company could still be sold effectively tax-free. Both sides also recognize that such an agreement would have to be ratified by federal legislation reversing the Supreme Court's *Quill* decision and allowing states to *mandate* collection of sales taxes under a simplified system; Amazon.com cannot be expected to collect sales taxes on its books voluntarily even under the most simple system imaginable if its competitor Barnes & Noble.com is free to choose not to.

As discussed at length above, enactment of the Internet Tax Freedom Act threatens to interfere with the effort of state and local governments and the electronic commerce industry to hammer out an agreement along these lines at a time when the relevant parties are actively negotiating and prospects for success appear to be good. There are, unfortunately, elements of the electronic commerce industry that are satisfied with the status quo.[74] Enactment of the Internet Tax Freedom Act could encourage these elements to abandon the negotiations. Alternatively, if such organizations wanted to avoid the onus of being responsible for the collapse of the negotiations, they could make demands for changes in state and local tax policy that state and local governments could not reasonably be expected to meet. In either case, the failure of the negotiators to reach an agreement would provide those elements of the industry that would like to be able to sell their wares free of sales taxes *permanently* with an argument supporting renewal of the Internet Tax Freedom Act when the initial moratorium period expires.

The risk of scuttling promising negotiations might arguably be worth running if state and local governments were rushing to "tax the Internet" willy-nilly. But they are not. State and local governments are enjoying better fiscal and economic conditions than they have seen in years. States are in a tax-cutting mode, not scrambling for new

sources of revenue; 21 governors have proposed significant tax cuts this year. Less than one-quarter of states are taxing Internet access charges, and the trend has been for legislatures to roll back the taxation of this service. In light of this situation, the risk that enactment of the Internet Tax Freedom Act would prevent the achievement of a long-term solution to electronic commerce taxation issues far outweighs any potential benefits of the "time out" on state and local taxation that the legislation is intended to provide.

Even though state and local governments enjoy strong fiscal conditions and are not rushing to tax Internet services now, these governments do face substantial long-term investment needs that cannot be met if the absence of a permanent agreement results in erosion of the tax base. One sector in need of such investment is public education, a topic of considerable concern to high-technology industries.

Recently, the high-technology business community has focused considerable attention on the inadequacies of public education in the United States and its implications for the industry's future viability. The Information Technology Association of America has published a study indicating that high-technology companies are currently unable to fill 346,000 positions because of an inadequate supply of workers with proper training.[75] Upon release of the study, ITAA President Harris N. Miller stated: "I[nformation] T[echnology] worker shortages continue to be a national crisis today and into the foreseeable future. To solve this dilemma requires the collective wisdom and innovative actions of employers, educators, and the government." More recently, the *Wall Street Journal* has reported that a group of Silicon Valley entrepreneurs has been meeting regularly with Vice President Gore to discuss public policy issues, particularly the possible contributions of the high-technology industry to improving public education.[76] Reportedly, the companies involved are developing a specialized form of World Wide Web browser software tailored to children that will also "enabl[e] parents to have test scores and homework assignments zapped to their home or workplace computers." The *Journal* article indicates that the companies hope to have the software available by this fall and plan to give it to schools at no charge. The *Journal* also reports that the entrepreneurs "plan to offer $2 million of their personal funds as start-up money for California charter schools, semi-independent elementary and secondary schools that embrace the entrepreneurial spirt of small business."

While private or industrial philanthropy can be important, it is unlikely to solve basic educational problems that exist throughout the country. Some 80 percent of college students are enrolled in *public* institutions that are highly dependent upon sales tax revenues for funding.[77] A special Web browser program tailored for schools and parents will be of little use in the 73 percent of public school classrooms that do not yet have Internet access, many of them likely in inner-city schools.[78] And while a $2 million contribution may help public schools in California, it is unclear where the money will

come from for a technology-rich education in North Dakota and Alabama if enactment of the Internet Tax Freedom Act ensures that companies will be able to tap into those states' markets for at least the next three years without incurring any obligation to collect and remit those states' taxes.

If state and local governments are to provide necessary public services in the 21st century and preserve a viable Main Street retail sector, they will have to be able to require electronic commerce businesses to pay their fair share of taxes. In turn, such businesses can reasonably expect a system of taxation of electronic commerce that is substantially more clear, simple, and harmonized among the states than the one that exists at present. Continuing efforts to enact an Internet Tax Freedom Act threaten to divert considerable energy from the work that is needed to achieve these results.

Appendix A:
Sales Taxes, "Use Taxes," and "Nexus" — A Primer

Most people are familiar with sales taxes, the charge that is added to the cost of goods and some services purchased in retail stores. In about two-thirds of the states that levy sales taxes, the tax rate that applies to a given purchase may be the sum of a statewide rate and one or more local government rates. For example, an eight percent sales tax imposed on a retail purchase might consist of six percent imposed by the state, one percent imposed by the county, and one percent imposed by the city.

Sales taxes are charged on sales transactions that occur *within the boundaries of the taxing jurisdiction*. Sales taxes are collected from the purchaser by the seller at the time of sale, and then remitted by the seller to the government(s) imposing them.[79]

Use taxes are less familiar. All states imposing sales taxes also impose "use taxes."[80] Use taxes are charged on the purchase price of goods *purchased out-of-state* but brought into the state for consumption. The purpose of use taxes is to remove the incentive to purchase goods out-of-state where they might be taxed at a lower rate or not at all. If use taxes were not imposed and some consumers did have opportunities to buy out-of-state on a no-tax or lower-tax basis, state and local governments imposing sales taxes would lose revenues. In addition, in-state merchants required to charge sales taxes would lose business to out-of-state businesses because the prices charged by in-state businesses would effectively be higher by the amount of the sales tax. In turn, the harm to local merchants would damage the local economy and local employment.[81]

The order form of mail order catalogs is one place use taxes can be noticed. Many include a sentence like the following: "Residents of California, New York, and Illinois, please add applicable sales taxes." If, as an example, this mail-order company is located in California, the company probably is charging its New York and Illinois

customers their states' *use* tax and its California customers the California *sales* tax. The seller will remit these taxes to the respective governments of the states in which these customers are located. Why is the seller collecting and remitting the New York and Illinois use taxes when it is based in California? Because the mail-order company has established what tax lawyers term "nexus" with those states. "Establishing nexus" means that the California-based seller has made sufficient contact, not only with California but also with New York and Illinois, for those states to have legal power to require the company to collect and remit their respective sales and use taxes.

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 presence of traveling salespeople, the company could be required to collect from customers and remit the applicable use taxes. In the example above, the California-headquartered mail-order company is probably collecting the New York and Illinois use taxes because it has established a physical presence in each of them. For example, the mail-order company might have a warehouse in Illinois and a telemarketing center in New York.

In its 1967 decision in *National Bellas Hess* vs. *Illinois*, however, the U.S. Supreme Court ruled that a mail-order company could *not* be required to collect and remit a state's use tax if the company's only activity in that state consisted of sending in by U.S. mail or common carrier (like UPS or Federal Express) its catalogs and the goods sold to in-state purchasers. While the legal basis for the Court's decision was somewhat ambiguous at the time, the decision clearly stated that requiring the mail-order company to comply with the diverse sales/use tax laws of the state and local governments imposing such taxes throughout the country would create an unconstitutional burden on interstate commerce.

By the early 1980s, mail-order purchasing had skyrocketed.[82] As a result, the inability of state and local governments to require mail-order companies protected by *Bellas Hess* to collect use taxes had become a very serious drain on tax revenues.[83] Faced with this erosion of their sales tax base, states and localities took a number of steps.

First, beginning in the mid-1980s, state and local government organizations sought to obtain federal legislation reversing the *Bellas Hess* decision. However, the mail-order industry (aided by broad segments of private industry generally) succeeded in blocking such legislation. Nonetheless, all major organizations of state and local officials remain on record in support of federal legislation to reverse *Bellas Hess*, most recently introduced as the "Consumer and Main Street Protection Act", S.1586, by Senator Dale Bumpers on January 29, 1998.

Second, state and local governments stepped up their efforts to collect use taxes directly from purchasers. *Even when a seller is not required to collect and remit use taxes,*

purchasers remain legally obligated to pay use taxes themselves directly to their state and local governments. Although this remittance obligation is typically unknown or ignored by individual consumers, many businesses that make out-of-state purchases on which use tax has not been collected are aware of their obligation and do remit the use tax themselves. (They are also aware that they are likely to be audited and assessed for the tax at some point if they fail to do so.) In the late 1980s, state and local governments took concerted action to educate business purchasers about their use tax payment obligations and to enforce the tax against businesses that failed to comply. For example, many states targeted individual professional practitioners such as attorneys, dentists, and doctors who might purchase expensive professional publications, computers, equipment, etc. on which use taxes had not been paid. State and local governments also took steps to collect use taxes from individuals where the purchases were sufficiently large to make enforcement activities cost-effective (as might be the case with jewelry, furs, boats, computers, and similar items). For example, states would agree that if their audits of jewelry stores revealed shipments to each other's residents on which use tax had not been collected, they would share the customers' names and addresses so that use tax bills could be sent directly to the purchasers. An increasing number of states have also recently placed a line on the personal income tax form or a special form in the income tax booklet for remitting use tax, together with an explanation of what the tax is and why it is levied.

Third, once attempts to obtain federal legislation in several sessions of Congress had failed, some states coordinated efforts to bring before the U.S. Supreme Court a new test case that they hoped would lead the Court itself to reverse *Bellas Hess*. These hopes were dashed in June, 1992 when the Supreme Court reaffirmed the *Bellas Hess* decision in *Quill Corporation* vs. *North Dakota*. Attributing much of the mail-order industry's recent rapid growth to the *Bellas Hess* "exemption" and apparently concerned that a reversal of *Bellas Hess* could result in substantial back-tax liabilities for mail-order firms, the Court grudgingly affirmed its earlier decision. In language not often seen in its decisions, the Court acknowledged the "artificiality" of the *Bellas Hess* nexus standard and conceded that it might have decided the matter differently "were the issue to arise for the first time today." The Court invited Congress to intervene and impose rational standards under which state and local governments could require out-of-state companies to collect use taxes: "[0]ur decision [to uphold *Bellas Hess*] is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress is free to disagree with our conclusions."

While in substance the *Quill* decision only reaffirmed *Bellas Hess*, the Court at several points in the decision referred to *Bellas Hess* as having established a "physical presence *requirement*." In fact, *Bellas Hess* had done no such thing. In *Bellas Hess* the Court had only ruled on contacts that were *not sufficient* to create nexus — contact by

common carrier and U.S. mail — not activities that were *required*. Nonetheless, these references in *Quill* to a physical presence "requirement" have led to vociferous disagreement and voluminous post-*Quill* litigation between states and taxpayers regarding the contacts that an out-of-state company must have with a state before it can be required to collect the state's use tax.[84] At one end of the spectrum, many states take the position that *Bellas Hess* and *Quill* only protect companies whose contacts with in-state customers are limited to U.S. mail and common carrier. These states believe that they may therefore require any mail-order company with other regular contacts (for example, hiring a third party to provide in-state warranty service on the mail order company's products) to collect use taxes. At the other end of the spectrum, many taxpayers assert *Quill* stands for the proposition that businesses can only be required to collect a state's use taxes if they have a *substantial physical presence* within its borders. Subsequent to *Quill*, taxpayers have gone so far as to assert that dozens of in-state visits by traveling salesman do not constitute a "substantial physical presence" sufficient to bring with it a duty to collect and remit use taxes.[85]

Which brings the discussion back to electronic commerce and the Internet Tax Freedom Act. The disagreement between state and local governments and taxpayers on the use tax nexus threshold established by *Bellas Hess* and *Quill* is just as strong with respect to interstate sales made over the Internet as it is with respect to interstate mail-order or telephone sales. For example, a major electronic commerce industry trade association, the Interactive Services Association, has asserted that modems and computers comprising Internet service providers' local "points of presence" (which permit customers to gain access to the Internet without incurring the cost of a long-distance call) do not satisfy the "substantial physical presence" required by *Quill* to impose a duty on the Internet service provider to charge any applicable sales or use taxes on the access service.[86] Most state tax administrators would likely vigorously disagree with this position, and indeed a number of states have issued explicitly contrary rulings.[87]

As is discussed in the body of the analysis (see pp. 21-25), one of the major factors that has driven state and local government and electronic commerce industry representatives to the table to negotiate appropriate rules for taxing electronic commerce is the desire of both sides to avoid the costs and risks of losing litigation on nexus issues related to such commerce. Unfortunately, enactment of the Internet Tax Freedom Act would remove most of these risks for a significant element of the electronic commerce industry, and therefore has significant potential to scuttle these negotiations. But the dangers the Internet Tax Freedom Act poses to the future viability of state and local sales and use taxes goes beyond resolving all nexus issues in the industry's favor. As is discussed at pp. 2-4, the proposed legislation might also prevent state and local governments from collecting sales and use taxes on purchases made through the Internet in instances where they can clearly do so now — either from the

purchaser or where the seller clearly has established nexus through an in-state physical presence.

This Appendix is intended to help the reader appreciate the aspects of the analysis related to sales and use tax collection and payment responsibilities. The reader should also be aware that the analysis will often use the term "sales tax" in instances in which, technically, the term "use tax" should be used.

Endnotes

1. This version of the Internet Tax Freedom Act will be referred to as the "Senate Committee" version throughout this analysis. S. 442 was originally introduced by Senator Ron Wyden (D-OR).

2. This version will be referred to as the "House Committee" version. H.R. 1054 was originally introduced by Representative Christopher Cox (R-CA).

3. This draft will be referred to as the "new Senate" version. It was introduced by Senators Judd Gregg (R-NH) and Joseph Leiberman (D-CT).

4. This version will be referred to as the "new House" version. It was introduced by Representative Steve Chabot (R-OH).

5. The "Senate Committee" version of the bill approved by the Commerce Committee on November 4, 1997 prohibits state and local taxes on "(1) communications or transactions using the Internet; and (2) online services or Internet access service."

   The "House Committee" version of the bill approved by relevant subcommittees of the Commerce and Judiciary Committees on October 9, 1997 prohibits state and local taxes on "(1) access to, or use of, the Internet or online services; (2) the transmission or communication of data by or through the Internet or online services; (3) the use or consumption of data acquired through or accessed via the Internet or online services; and (4) transactions that occur through the Internet or online services."

   The new Senate version of the legislation prohibits states and localities from taxing, "directly or indirectly," "the Internet or Internet-related services; or. . . the use of the Internet or Internet-related services."

6. These preservation clauses are contained in a sub-section of the legislation titled "Preservation of State and Local Taxing Authority." The taxes covered by the preservation clauses and the specific wording of the preservation clauses in the House Committee, Senate Committee, and new Senate versions of the legislation are all different. In general, more existing state and local taxes are preserved in the Senate Committee version than in the House Committee version, with the new Senate version preserving the fewest existing taxes.

7. "Bit taxes" and "bandwidth taxes," are imposed, respectively, on the data traffic and data carrying capacity of the Internet. They are not discussed further in this analysis because it is highly unlikely that any state or local government would seriously contemplate enacting such a tax. Such taxes have been discussed in Europe.

8. John C. Dvorak, "The Talk of the Internet," *PC Magazine*, January 20, 1998, p. 87.

9. See: Michael Mazerov, *The "4-R" Act: A Cautionary Tale for the Proposed "Internet Tax Freedom Act*, Center on Budget and Policy Priorities, April 24, 1998.

10. Even when states cannot legally compel out-of-state *sellers* to collect and remit sales taxes, state residents have an obligation to pay taxes on their purchases. (See box on p. 3.) While individuals usually ignore this largely unenforceable obligation, businesses often pay the taxes because, unlike

individuals, they are at significant risk of being audited for them. Forrester Research, Inc. estimates that business purchases will be the fastest-growing segment of Internet commerce. Forrester expects annual "business-to-business" sales over the Internet to reach $327 billion annually by 2002 and sales to individual consumers to reach $17 billion by 2001. *Forrester Report: Business Trade & Technology Strategies*, July 1997; *Forrester Report, People & Technology Strategies*, October 1997. Both available at www.forrester.com.

11. "Over 45% of U.S. Homes Had Computers Last Year," *Wall Street Journal*, March 10, 1998. The source of the data is Computer Intelligence, a research group.

12. "Study Finds Affluent Are Most Likely to Buy Online," *Web Week*, May 12, 1997.

13. *Electronic Retailing*, November/December 1997, p. 54.

14. "Report: Web Site Usage Up 130% in 1997," April 28, 1998, available at www.InternetNews.com/bus-news/1998/04/2802-report.html.

15. Major players in the Internet industry understand that modes of communication are largely interchangeable. In response to the question, "How does AT&T WorldNet [the company's Internet access service] fit into AT&T's broader strategy?" the vice president in charge of the service replied: "We think it's not going to be very long before people buy full communications services, and that includes their Internet access, their telephony, perhaps their entertainment. We want the opportunity to package Internet service with the other services they use. Getting it on the same bill is a good, convenient starting place. Combining services so that when you [want to] reach somebody you can reach them by e-mail or reach them by voice mail or reach them by telephone, or reach them by pager through a single directory, for example, is an enormous opportunity." "The Goal: No Busy Signals," ISP World insert to *Web Week*, April 14, 1997.

16. L.J. Kutten, "1997 Sales/Use Tax Chart of Computer Software and Internet Transactions," *State Tax Notes*, November 17, 1997, pp. 1243-4.

17. This analysis will discuss three major categories of existing state and local taxes that will be affected by the Internet Tax Freedom Act: sales/use taxes, telecommunications taxes, and general business taxes (like the corporate income tax). However, the list of revenue sources potentially affected by the legislation is by no means limited to these three categories. For example, local franchise fees imposed on telecommunications companies will also be adversely affected by several versions of the legislation, where these fees are based in part on gross receipts attributable to carrying Internet traffic.

    A major point of this analysis is that it is impossible to determine with certainty the state and local taxes that would be invalidated by the Internet Tax Freedom Act. This only will be determined as lawyers for Internet-related companies review the language of the act after its enactment and assess the likelihood that courts would sustain a taxpayer's position that it is no longer required to pay a particular tax. Only litigation will determine the ultimate effect of the legislation.

18. For example, the sales taxes in Hawaii and Arizona are formally titled, respectively, the "General Excise Tax" and the "Transaction Privilege Tax." The Internet Tax Freedom Act gives no guidance as to whether all, some, or none of the preservation clauses covering sales, gross receipts, or business license taxes apply to the Hawaii and Arizona taxes. The conditions placed on the application of the preservation clauses for each of these three types of taxes are dramatically different. Significant litigation on the question of which, if any, of the three preservation clauses apply in Hawaii and Arizona would be almost inevitable were any of the three versions of the Internet Tax Freedom Act

containing preservation clauses to be enacted.

19. Not all Internet companies concede that their Internet-related property constitutes sufficient physical presence to establish nexus for sales and use tax purposes. See box, p. 5.

20. The apparent intention of the sponsors of the Internet Tax Freedom Act to prevent states from asserting nexus over Internet businesses based on the physical presence of Internet-related property is most explicit in the House Committee version. This version provides: "No State or political subdivision thereof shall have power to consider any conduct, activity, or *presence* by or on behalf of a retailer on or via the Internet or online services as a factor for purposes of determining whether the retailer is subject to its jurisdiction for purposes of sales or use taxation imposed by that jurisdiction." (Emphasis added).

    Language in the Senate Committee version may have the same effect. For sales and use taxes on Internet transactions to be preserved, the Senate Committee bill requires that "the obligation to collect [sales or use taxes on Internet transactions be]. . . imposed on the same person or entity as in the case of similar sales, use or transactions not using the Internet. . . " In the absence of any definition of "similar sales," Internet merchants are free to argue that the term is intended to mean an interstate mail-order sale by a typical mail-order company having no nexus with the state. Since the U.S. Supreme Court's *Quill* decision prevents states from imposing an "obligation to collect" sales taxes on most interstate mail-order merchants, Internet merchants could argue the legislation gives them similar protection.

    In the new Senate version the *Quill* decision would likely prevent the assertion of nexus on the basis of the in-state presence of Internet-related property. In order for sales taxes to be preserved, the obligation to collect them must be "imposed on the same person or entity as in the case of sales or transactions effected by mail order, telephone, or other remote means." Since an obligation to collect sales taxes cannot usually be imposed on mail-order sales, it most likely cannot be imposed on electronic commerce sales under the new Senate version of the Internet Tax Freedom Act.

    The new House version of the proposed legislation attempted to preserve the ability of states to assert nexus on the basis of ownership of Internet-related property. However, the preservation language is written in such a way that it could be thwarted easily by creating a subsidiary to own the property that is separate from the corporation actually making the interstate electronic commerce sales.

21. A "Frequently Asked Questions" document on the Web site of the original House sponsor, Rep. Chris Cox states: "Highlights of the Internet Tax Freedom Act: Tax-Free Internet Access. Prohibits state and local governments from imposing taxes on Internet access charges--the $19.95 or so that millions of Americans pay to our nation's 4,000 Internet service providers. . ." (Available at www.house.gov/ cox/Nettax /Web-FAQ.html.)

    The new House version of the Internet Tax Freedom Act, H.R. 3529, was apparently intended to implement a compromise agreement between Rep. Cox and seven organizations representing state and local governments. Coverage of the press conference at which the agreement was announced widely reported that the compromise provided for the grandfathering of existing state taxes on Internet access services. Nonetheless, H.R. 3529 effectively fails to grandfather such taxes. The relevant provision reads: "The prohibition in subsection (a) shall not apply to taxes expressly imposed on Internet access or online services by State statute enacted prior to March 1, 1998." All states taxing Internet access do so based on an administrative determination that Internet access satisfies the state's definition of taxable "telecommunications," "information services," etc. None of

these states' statutes expressly identifies "Internet access" as a taxable service, and, accordingly, none of these states' taxes on Internet access would be preserved were H.R. 3529 to be enacted.

22. Such taxes are usually in the form of gross receipts taxes on telecommunications companies that are passed through to the Internet service providers, but sales taxes may also be applied to telecommunications services.

23. The new House version attempts to prevent pyramiding taxation of Internet access by including in the definition of prohibited "multiple" taxes, "any tax that does not ensure that the cost incurred in using telecommunications services to offer, sell, or provide electronic commerce [defined to include Internet access] is not subject to taxation under the same tax at a different stage of the process of offering, selling, or providing such electronic commerce." If the new House version allowed the taxation of access charges, as it had been reported to do, this provision would be sufficient to prevent pyramiding or double-taxation.

24. "One study indicates that transport costs, including incoming phone lines, leased lines and interconnection at a network access point, currently amount to roughly 25% of an Internet service provider's total costs. Lee W. McKnight & Brett A. Leida, 'Internet Telephony: Costs, Pricing and Policy" (1997), at 14." Federal Communications Commission, *Report to Congress In the Matter of Federal-State Joint Board on Universal Service*, April 10, 1998, p. 34, note 131. Available at: www.fcc.gov/Bureaus/Common_Carrier/Reports/fcc98067.pdf.

25. Information Highway State and Local Tax Study Group, "Supporting the Information Highway: A Framework for State and Local Taxation of Telecommunications and Information Services," *State Tax Notes*, July 3, 1995, p. 64.

26. The U.S. Telephone Association has endorsed the Internet Tax Freedom Act, and its members include such signatories to the earlier "white paper" as Ameritech, Bell Atlantic, BellSouth, GTE, Pacific Telesis, SBC, and USWest. (Sources: www.house.gov/cox/Nettax/Web-endorse.html; www.usta.org/fullmem.html.)

27. See: Federal Communications Commission, *Report to Congress in the Matter of Federal-State Joint Board on Universal Service*, April 10, 1998, pp. 1-54. In this report the FCC has reaffirmed that Internet service providers are not "common carriers" but has acknowledged that some companies providing telephone-to-telephone voice service over the Internet might be.

    In the same report, the FCC points out that some large telecommunications companies that provide the high-bandwidth fiber-optic "pipes" that comprise the "backbone" of the Internet are arguably supplying basic telecommunications services to themselves on a non- "common carrier" basis:

    > In those cases where an Internet service provider owns transmission facilities, and engages in data transport over those facilities in order to provide an information service, we do not currently require it to contribute to universal service [subsidy] mechanisms. We believe it is appropriate to reexamine that result. One could argue that in such a case the Internet service provider is furnishing raw transmission capacity to itself. To the extent this means the Internet service provider is providing telecommunications as a non-common carrier, it would not generally be subject to title II [of the Telecommunications Act, which regulates common carriers]. (Source: Pp. 35-6 of the FCC report; footnote omitted.)

    The companies the FCC is referring to could use this FCC analysis to argue that since the FCC has acknowledged they are not "common carriers," the preservation clause covering taxes on a "common

carrier. . . acting in the capacity of a common carrier" does not preserve any state or local taxes on these Internet "backbone" telecommunications services. In sum, substantial litigation concerning whether state and local taxes applicable to Internet-related telecommunications services are preserved under the House and Senate Committee versions of the Internet Tax Freedom Act is readily foreseeable if either is enacted.

28. "AT&T Plans to Cut Up to 18,000 Jobs; Firm to Offer Internet Phone Service, Adjust Focus," *Washington Post*, January 27, 1998.

29. *Washington Post*, November 4, 1997, p. C8.

30. John C. Dvorak, "The Talk of the Internet," *PC Magazine*, January 20, 1998, p. 87.

31. The inability of the FCC Commissioners to reach a consensus on where to draw the line between computer-based Internet access services that can be used to make voice telephone calls over the Internet and "pure" Internet telephone services is further evidence that the Internet Tax Freedom Act's distinction between tax-exempt Internet access and taxable "telecommunications" is likely to be unworkable and litigious. See: Dissenting Statement of Commissioner Harold Furchtgott-Roth on the FCC universal service report to Congress, April 10, 1998. Available at: www.fcc.gov/Speeches/Furchtgott_Roth/Statements/sthfr817.html.

32. Indeed, the 1995 telecommunications industry "white paper" quoted above justified the policy of taxing the final value of "information highway" services rather than input services because of the unworkability of taxing the inputs. It said: "Sales tax laws should recognize that it will be virtually impossible to determine where one service begins . . . and the other telecommunications service ends on the information highway." (Information Highway State and Local Tax Study Group, "Supporting the Information Highway: A Framework for State and Local Taxation of Telecommunications and Information Services," *State Tax Notes*, July 3, 1995, p. 65.)

33. Paul Stapleton, "A New ISP Investment Story-With Data to Boot," *Boardwatch Magazine*, October 1997. Available at www.boardwatch.com/mag/97/oct/bwm58.htm.

34. Furthermore, corporate income taxes are not imposed on all corporations in many states. Many states have special taxes that apply in lieu of corporate income taxes to corporations providing insurance, telecommunications, transportation, electrical, and similar services. The imposition of such taxes in lieu of corporate income taxes would be an additional reason that a state's corporate income tax would fail the stated condition in the House Committee and new Senate versions of the Internet Tax Freedom Act that income taxes must be imposed on "all businesses" in order to be preserved.

35. "California Franchise Tax Board Supports New Legislative Proposals," *State Tax Notes*, November 24, 1997.

36. For example, a publisher that sells a specialized newsletter that it makes available in both hard-copy and on the Internet might terminate the hard copy version. The publisher could then claim that the Internet version cannot be subjected to sales tax because the legislation provides that on-line services can only be taxed if a "similar sale" off the Internet is taxed.

37. Congressional Budget Office Mandates Statement dated January 21, 1998, on S. 442 Internet Tax Freedom Act, As Ordered Reported by the Senate Committee on Commerce, Science, and Transportation on November 4, 1997, p. 3. As CBO noted "states could not provide definitive estimates of their tax revenues [attributable to Internet access services] because many providers of

these services also provide other taxable services and typically remit their tax collections to the states as one sum. In addition, the industry is growing so quickly that revenue figures from previous years are not very useful for estimating present collections."

38. Maloff Group International, Inc., 1996-1997 Internet Access Providers Marketplace Analysis, October 1997, Executive Summary, p. 1 (available at www.maloffgroup.com).

39. Connecticut is phasing out its tax on Internet access services. Removing Connecticut from the calculation lowers the annual revenue loss estimate to $475 million.

40. CBO itself was unwilling to conclude that state and local taxation of Internet access charges is, in fact, prohibited under the Senate Committee version of the legislation, since sales taxes could potentially be defended in court on the basis that Internet access is a "similar sale" to telephone-based voice-mail or information services. It seems unlikely that state and local governments could prevail in such litigation. Regardless of the ultimate outcome of such litigation, Internet service providers could certainly be expected immediately to suspend compliance with sales taxes on Internet access charges and force states to establish in court that the taxes were still valid. The revenue losses would be incurred until such a state position were sustained.

41. See p. 4 or the longer discussion in Appendix A.

42. Of course, in the absence of enactment of the Internet Tax Freedom Act, states could also collect some of the use taxes due on Internet purchases directly from purchasers. The Internet Tax Freedom Act's negative impact on the ability of states to collect use taxes from purchasers is discussed above on pages 2 and 4. Some of the ways in which states attempt to collect use taxes from purchasers are discussed in Appendix A on p. 33.

43. See note 10.

44. "Dell Ups Ante on E-Marketing," *DM News*, January 26, 1998, www.dmnews.com/articles/1998-01-26/22.html.

45. "Report Predicts $1.5 Trillion in Global Web Commerce by 2002," *InternetNews*, July 1997. (Available at www.InternetNews.com/ec-news/1997/07/0901-activ.html.) The source of the estimate is Internet marketing research firm ActivMedia.

46. This estimate is based on a combined state and local sales tax rate of 6.0 percent. This is probably lower than the actual average sales tax rate. Sales tax consultant Vertex, Inc. estimates that the average *state* sales tax rate in 1997 was 5.13 percent. In *counties* that levy sales taxes, Vertex estimates the average 1997 rate to have been 1.5 percent, and in *cities*, 1.6 percent. Of course, not all states, counties, or cities impose sales taxes. (Vertex, Inc., "1997 Sales Tax Trends," available at www.vertexinc.com/news60/97rts.html.)

47. Aggregate state and local general sales tax collections for the four quarters ending with the second quarter of 1997. Source: www.census.gov/ftp/pub/govs/www/qtax.html.

48. It is not possible to estimate even the order of magnitude of the potential revenue impact of the new House version of the Internet Tax Freedom Act. As discussed on pp. 6-7, most sales and use tax revenues on purchases of physical *goods* ordered over the Internet are probably preserved under the new House version. Potential sales tax revenues on services and digitized content *delivered* over the Internet *are* at risk under the new House version (p. 7), but the authors did not have available to them detailed breakdowns of electronic commerce forecasts that disaggregate physical goods versus

services and digitized content.

49. "Users Spent $18.5 Billion to Get On-Line in 1996," *Wall Street Journal*, April 21, 1997.

50. This $5 billion figure assumes that an average 6 percent sales tax is applicable to $92 billion in property and services used to access the Internet. This revenue loss could be in addition to the $10 billion estimated loss attributable to the inability to tax goods and services purchased over the Internet. Of course, there is probably some overlap between the two categories, so that the total sales tax revenue loss under the new Senate version of the legislation would likely be somewhat less than $15 billion.

51. National Conference of State Legislatures, *State Budget Actions, 1997*, December 1997.

52. "Over 45% of U.S. Homes Had Computers Last Year,"*Wall Street Journal*, March 10, 1998. The source of the data is Computer Intelligence, a research group.

53. "Internet Users Spend More Time, Money on PCs." Available at www.InternetNews.com/bus-news/1998/03/3102-mediametrix.html.

54. Cited in "The Newest Phone War," *New York Times*, March 8, 1998.

55. "Study Finds Affluent Are Most Likely to Buy Online," *Web Week*, May 12, 1997.

56. "A big factor in this staggering growth spurt [of advertising on the World Wide Web] is advertisers' realization that Web demographics are very skewed toward educated, high-income people, says Microsoft chief operating officer Bob Herbold. 'About 65 percent of Internet users have incomes of at least $40,000 per year, and over 90 percent of Internet users have some college experience,' he says." (Source: "Web Ads Hit Their Stride," *PC Magazine*, April 21, 1998.)

57. " 'Build It Yourself' is Motto of Sites Selling Everything from Golf Clubs to CDs to Bicycles," *Internet World*, March 2, 1998, at www.internetworld.com/print/current/ecomm/19980302-build.html.

58. See: Garry Boulard, "Wine Wars: to Ship or Not to Ship," *State Legislatures*, October/November 1997, pp. 12-19. The article quotes Rich Cartiere, an editor at Wine Business Publications: "There has always been a market for direct shipping in this country, but it exploded once people gained access to the Internet and found they could order the kind of specialty wines that they could never find in their local wine stores back home."

59. This phenomenon could have a significant racial dimension as well. A recent study reported that white households with incomes below the national median ($40,000) were more than twice as likely to own home computers as black households with comparable incomes. (See: Donna L. Hoffman and Thomas P. Novak, *Bridging the Digital Divide: The Impact of Race on Computer Access and Internet Use*, February 2, 1998. Available at www2000.ogsm.vanderbilt.edu.) Since the availability of a computer is a precondition to Internet shopping, the disparity in computer ownership between white and black households could result in the latter bearing a disproportionate share of sales taxes if electronic commerce is effectively tax-exempt. Hispanic households could be similarly disadvantaged, since only 30 percent of such households currently own a computer. (See: "Hispanic Computer Gap Is Steady," *USA Today*, April 30, 1998, at www.usatoday.com/life/cyber/tech/ctc609.htm.)

60. Statistics from the Direct Marketing Association show that the likelihood of being a mail order shopper rises steadily with income. In 1995, 78 percent of households with income of $100,000 or

more made a mail or telephone order purchase, while only 56 percent of households with income below $10,000 did. (Source: Direct Marketing Association *1997 Statistical Fact Book*, p. 7). Internet purchasing is likely to be even more highly correlated with income, since the financial resources needed to make such a purchase (a computer, modem, Internet access account, and credit card) are so much greater than those required of mail-order purchasers (a free catalog, a 32 cent stamp, and cash that can be remitted through a money order at any post office).

61. For example, downloaded software could be doubly taxed if both the state where the server at which the software is "picked-up" taxes it and the state in which the purchaser is located taxes it, *and* neither state gives a credit for the other state's tax.

62. The National Tax Association is the leading professional association for economists and attorneys interested and active in tax policy issues.

63. A list of the participating organizations and all of the key documents produced thus far are available on the project's World Wide Web site at www.nhdd.com/nta/ntaintro.htm.

64. National Governors' Association Policy EC-16, "Internet Development Act of 1998," Adopted February 1998.

65. "Industry, Government Not Far Apart on Internet Taxation, Attorney Tells NLC," *State Tax Notes*, March 16, 1997.

66. Amazon.com is only used as an example of the kind of company that would logically fall into the "non-nexus" category. The organizations representing business in the National Tax Association-sponsored project are all trade associations, and their specific membership is not known to the authors.

67. A sponsor of the Internet Tax Freedom Act reports: "Lexis-Nexis, for instance, employs numerous sales representatives to recruit new customers and to provide in-person service and advice to its customers. Under current standards of nexus, this amounts to substantial physical presence and the company would have sales and use tax collection responsibility in that state." Source: *Bill Summary; FAQ*, at www.house.gov/chriscox/nettax/Web-FAQ.html.

68. See, for example, R. Scot Grierson, "State Taxation of the Information Superhighway: A Proposal for Taxation of Information Services," *Loyola of Los Angeles Entertainment Law Journal*, Vol. 16, 1996, especially Section VI., "Constitutional Limitations: Applying Traditional "Nexus" Standards to Out-of-State Information Service Providers."

69. See note 20.

70. For example, a mailing to mail-order purchasers from Arizona Mail Order Co., Inc. on behalf of 65 catalog companies included a letter to be signed and sent in to congressional offices. The letter protested: "this legislation is an unpublicized way of raising state taxes. . . "

71. For sales figures, see Arnold Fishman, *1995 Guide to Mail Order Sales*, Marketing Logistics, Inc., Vol. I, pp. II-2, IV-8. For information concerning states for which L.L. Bean and the Boy Scouts collect sales/use taxes, see their recent catalog order forms. Dell Computer Corporation, with annual revenues of $12 *billion*, apparently only collects sales/use taxes for its home state of Texas as well as Nevada and Kentucky. (Sources: Dell's Web site at www.dell.com/dell/media/infokit/index.htm and "Online tax bite," *U.S. News and World Report*, July 21, 1997, p. 62.)

72. "The D[irect] M[arketing] A[ssociation] opposes, and will continue to oppose, any attempts to legislate mandatory collection of use taxes. This position has been the cornerstone of our use tax position over the past four decades." *DMA Washington Report*, November 20, 1997 (www.the-dma.org).

73. The electronic commerce industry appears to be taking ever-more creative and aggressive steps to avoid having to collect sales taxes. A lawsuit last summer (since dropped) by the well-known on-line bookseller Amazon.com against its rival Barnes & Noble asserted that Barnes & Noble incorporated its Internet operation as a separate subsidiary in part to avoid collecting sales taxes in all 47 of the states in which its bookstores are located. (Amended Answer and Counterclaim of Amazon.com in *Amazon.Com Inc.* Against *Barnes & Noble, Inc. And Barnes and Noble Online, Inc.*, U.S. District Court, Southern District of New York, No. 97 Civ. 3466). In defending itself against a tax assessment issued by Connecticut, America Online appears to have taken the position that it can avoid nexus by leasing modems from the telephone company rather than owning them directly. (See box, p. 5.) Time will tell whether these actions by the taxpayers achieve the tax immunity they seek, but the actions signal to state and local governments that at least some major players in the electronic commerce industry are prepared to risk expensive litigation to defend what they perceive as their constitutional right not to collect sales taxes. Collectively, state and local governments would undoubtedly prefer a comprehensive federal legislative solution to the issue rather than many more years of costly litigation against determined opponents.

74. The business organizations participating in the National Tax Association-sponsored negotiations have acknowledged that there are segments of the electronic commerce industry that do not support changing nexus law in exchange for sales tax simplification: "Some, *but by no means all*, of the Business Group Members have reason to believe their constituencies would endorse a plan that subjects them to a duty to collect tax in exchange for tax simplification, compensation, and equality of treatment." (Emphasis added.) Source: Memorandum from Jeffrey Friedman and Ken Silverberg to NTA Communications and Electronic Commerce Tax Project Operating Committee, re: Business Groups' Discussion Outline for the Feb. 4th Meeting, January 23, 1998. Available at www.nhdd.com/nta/docs/ntam3.htm. One of the NTA Project participants apparently in the "by no means all" category is the Direct Marketing Association; see the box on p. 23.

75. "Major Study Finds IT Worker Shortages Continue to Threaten U.S. Companies," January 12, 1998. Available at www.itaa.org.

76. "How a Vice President Fills a Cyber-Cabinet: With Gore-Techs," *Wall Street Journal*, March 13, 1998.

77. Source: www.census.gov/population/socdemo/school/report95/taba-7.txt.

78. "Report: Majority of Schools Now Online," *USA Today*, February 26, 1998, available at www.InternetNews.com/isp-news-1998-02/261-usa-report.html. The new federal report cited in the article says that 78 percent of public schools now have at least one Internet connection, but that only 27 percent of classrooms can currently link directly to the Internet. A 1997 report by the Educational Testing Service found that nationally, there is an average of one computer available for every 10 public school children, but that in schools with 90 percent or greater minority enrollment, the ratio of computers to students is 17 to one. See: "Poor, Minority Students Lack Access to Computers," *Washington Post*, May 15, 1997.

79. In nearly all states that permit local governments to levy sales taxes, the local sales taxes are also remitted by the seller to the state; the state then distributes the local taxes back to the local governments that imposed them.

80. Many — but not all — local governments that impose sales taxes also impose use taxes.

81. It should be emphasized that use taxes are only intended to "level the playing field" between in-state and out-of-state purchases; use tax rates cannot legally be higher than the sales tax rates that would apply if the same product were purchased in an in-state retail store, and states cannot impose use taxes on goods that would not be subject to sales taxes if purchased locally.

82. A number of factors undoubtedly contributed to this rapid growth. To cite just a few, the falling cost of telecommunications had enabled even very small companies to provide free long-distance telephone access for order-taking through 1-800 numbers, UPS and Federal Express had emerged as efficient, low-cost competitors to the Postal Service, the widespread penetration of credit cards into the middle class had eliminated most of the worry for mail-order merchants about the credit-worthiness of distant customers, and the growth in time-pressed, two-earner families made the possibility of shopping from home 24-hours-a-day increasingly attractive. The ability to avoid paying sales taxes on mail-order purchases has also been a significant contributor to the growth of such purchases, particularly of big-ticket items, like furniture and jewelry, and of items that can be uniquely identified, like a particular model of an expensive camera.

83. That revenue loss is currently estimated at more than $3 billion annually, hence the reference above to the "$3 billion question". (U.S. Advisory Commission on Intergovernmental Relations, *Taxation of Mail Order Sales, 1994 Revenue Estimates*, 1995, p. 6).

84. Much of the litigation and controversy also arises from a number of Supreme Court cases decided both before and after *Bellas Hess* (but before *Quill*) that involve the issue of when nexus may be established by the temporary in-state presence of representatives of the out-of-state company (including both employees and independent contractors).

85. In a recent case in New York, the Orvis Company claimed it was immune from responsibility to collect sales and use taxes despite evidence that salespeople made an average of 76 in-state customer visits per year. (Source: *In the Matter of Orvis Company Respondent-Appellant* v. *Tax Appeals Tribunal of the State of New York*, New York State Court of Appeals, No. 138, 1994).

86. Interactive Services Association, *Logging on to Cyberspace Tax Policy*, White Paper, November 1996, Section IV.A. Available at www.isa.net.

87. Connecticut's tax assessment on America Online is based on the position that an Internet service provider's local "points-of-presence" do establish sales tax nexus. (See box, p. 5). See also Virginia's private ruling P.D. 97-306, July 18, 1997.