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A FIVE-YEAR EXTENSION OF THE INTERNET TAX "MORATORIUM" WOULD FURTHER ERODE THE TAX BASE OF STATES AND LOCALITIES

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Summary

The Senate and the House are likely to take up soon proposed legislation that would extend the current "moratorium" on certain Internet-related state and local taxes. The existing three-year moratorium, imposed by the "Internet Tax Freedom Act" (ITFA), is scheduled to expire on October 21, 2001. A number of bills have been introduced in both houses of Congress that would extend the moratorium for varying lengths of time — including permanently.

An extension of the moratorium in its current form for a period longer than two years is likely to affect adversely the ability of state and local governments to reach and implement a solution that would allow Internet sellers and Main Street sellers to be treated fairly with respect to sales tax collections. A long extension is also likely to compound the loss of sales tax revenues arising from the inability of states and localities to require most Internet merchants to charge sales tax on all their sales.

The IFTA moratorium primarily limits the ability of state and local governments to tax monthly subscription fees for Internet access services offered by companies like America Online. The moratorium does not directly affect the ability of states and localities to impose sales taxes on purchases of goods made over the Internet, such as a book ordered from Amazon.com. However, a state's power to require most out-of-state Internet merchants to charge and remit sales tax is already severely constrained by a pair of Supreme Court decisions.

These sales tax restrictions, which the Court first imposed in the very different economy of the late 1960s, are becoming increasingly problematic as e-commerce grows dramatically:

- As recently confirmed by the Congressional Budget Office, the growth of effectively tax-free Internet purchases will erode the sales tax base of state and local governments and could hamper their ability to provide education, health, and other vital services.

- Main Street retailers will be increasingly disadvantaged by the ability of Internet merchants and mail-order catalog companies to avoid the obligation to charge sales tax. Such tax avoidance gives these "remote sellers" an unfair price advantage over their brick-and-mortar competitors.

State and local governments and some retailers have been working vigorously for two years to resolve complications in the structure of sales taxes that make it difficult for Internet sellers to collect these taxes. (It is these complications that initially gave rise to the Supreme Court decisions and that currently stand in the way of a resolution of the Internet sales tax problem.) As one component of any legislation renewing the ITFA moratorium, these government and retailer representatives are seeking congressional affirmation of the principle that states should be empowered to require large Internet merchants to charge sales tax on all their sales if states sufficiently simplify their diverse sales tax laws.

Because the ITFA moratorium does not directly affect state and local sales tax authority, its extension may appear on its face to be harmless. Yet enacting a lengthy moratorium extension now without addressing the sales tax issue in any way is likely to be far from harmless. It would have consequences that extend well beyond the explicit prohibitions in the legislation and actually make the Internet sales tax problem worse in two critical respects:

- **A lengthy extension of the moratorium could accelerate the loss of sales tax revenues from so-called "click-and-mortar" retailers that operate both stores and e-commerce Web sites.**

  If Congress extends the moratorium for five additional years now, without addressing the Internet sales tax issue, it will be sending a signal to retailers that Congress is not willing to assist the states in their efforts to devise and implement a workable system that allows even-handed sales taxation of purchases made in stores and purchases made over the Internet. Retailers are likely to conclude that once having enacted a long moratorium, Congress is unlikely to revisit Internet taxation for the foreseeable future.

  Supporters and opponents alike agree that extending the moratorium for five years is likely to forestall intervening action on the sales tax issue. The Senior Vice President for mail-order catalog issues at the Direct Marketing Association applauded a May, 2000 House vote to extend the moratorium for five years, stating that "Extending the moratorium to 2006 ensures that this. . . Supreme Court [decision limiting sales taxes] remains the law of the land." (The Senate took no action on the moratorium in 2000, and so the House's five-year extension died.) In explaining his intention to offer an amendment to limit any extension of the moratorium to two years when legislation reaches the full House Judiciary Committee, Representative Jerrold Nadler explained: "If you do a lengthy moratorium [extension], so that one side gets what it wants [while] the other side doesn't get what it wants, there's less leverage to get a comprehensive settlement. . . ."

  If retailers conclude that congressional facilitation of an even-handed solution of the sales tax issue is not a near-term possibility, many are likely to take matters into their own hands. Substantial numbers of store-based retailers could move to protect themselves from competitive pressures from Internet merchants by taking advantage of the "separate corporation loophole" used by corporations such as Barnes & Noble and Gateway. This tax-avoidance strategy is based on click-and-mortar retailers establishing their Internet sales operations as separate subsidiaries that, they argue, are not obligated to charge sales taxes on Internet sales any more than "pure" Internet retailers are. Following such a legal restructuring, increasing numbers of click-and-mortar retailers would cease their current practice of charging sales taxes on their Internet sales in all states in which they have stores. Instead, the companies would limit their Internet sales tax collection to the handful of states in which the Internet subsidiary itself is physically present. Thus, the likely end-result of the signal sent by a lengthy moratorium extension would be an acceleration of the sales tax erosion currently underway and, over time, a diminution of the ability of states and localities to fund vital services.

- **A lengthy extension of the ITFA moratorium without technical corrections in its definition of prohibited Internet access taxes could erode state and local revenues from music, movies, software, and similar "digitized content" as delivery of these products shifts to the Internet in future years.**

  ITFA prohibits new taxes on Internet access services and defines such services as encompassing an e-mail account and the ability to view World Wide Web sites *plus* "proprietary content, information, and other services." Because of this definition, computer software, music, movies, encyclopedias, games, and many other products and services could become exempt from sales tax as "Internet access" providers like America Online increasingly move to sell such "digitized content" over the Internet during the next few years. For example, now that America Online has merged with Time Warner, the company could offer basic Internet access service for the current $22 per month, an enhanced service package for $50 per month that gives the subscriber the additional right to download a number of Warner Music CDs, or a deluxe package for a higher fee that also allows additional Warner Home Video downloads. If ITFA's current prohibition on the taxation of "Internet access" service is extended with no modifications in the definition, the ability to obtain a tax exemption for "digitized content" — products and services that can be delivered over the Internet — by "bundling" it with Internet access is likely to punch another large hole in the sales tax base of states and localities.

If the sales taxation of Internet purchases and ITFA's "Internet access" definition are not addressed in legislation extending the moratorium, it would be appropriate to limit the length of the extension to match the one-to-two year time frame it will take for state and local governments to complete their plan for simplifying their sales tax systems. In May, 2000, a two-year extension of the moratorium received 208 votes in the House; a switch of just six votes would have resulted in passage.

Repealing ITFA's "Grandfather Clause" Would Impose an "Unfunded Mandate"

The Internet Tax Freedom Act (ITFA) prohibited new state and local taxes on Internet access services, for example, the typical $20-or-so monthly subscription fee charged by companies like America Online. However, ITFA "grandfathered" taxes on Internet access services imposed by approximately ten states and a handful of local governments at the time the legislation was enacted.

In approving H.R. 1552 on August 2, 2001 and permanently prohibiting states and localities from taxing Internet access services, the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee also voted to repeal ITFA's "grandfather clause." In doing so, the subcommittee effectively invalidated all existing state and local taxes on Internet access services. This would result in an immediate revenue loss for these governments.

In 2000, the Congressional Budget Office confirmed that a congressional rollback of existing state and local taxes on Internet access services constitutes an "intergovernmental mandate" on state and local governments under the Unfunded Mandates Reform Act of 1995 (UMRA). UMRA defines the cost of an intergovernmental mandate to include "the aggregate estimated amounts that all state, local and tribal governments. . . would be prohibited from raising in revenues in order to comply with the federal intergovernmental mandate." CBO further concluded that the state and local revenues that would be lost as a result of the voiding of existing taxes on Internet access services would exceed the $55 million annual revenue loss threshold; this allows a member of Congress to raise a point of order against consideration of legislation containing such a provision.

A brief moratorium extension could be coupled with a congressional "finding" that states and localities have a legitimate expectation that Internet sellers generally will be required to collect and remit sales taxes once state sales tax systems are simplified and harmonized. If Congress approved such a finding, it might encourage some retailers to refrain from exploiting the "separate corporation loophole" for another year or two and thereby mitigate some of the damage to the sales tax base that a moratorium extension would otherwise do. Alternatively, the moratorium extension could go farther and include legislation sponsored by Senator Dorgan (S. 512) and Representative Istook (H.R. 1410) that would:

- spell out detailed criteria for simplification and standardization of state and local sales tax systems and

- commit Congress to taking an expeditious up or down vote on a bill authorizing states to require large Internet merchants to charge sales tax on all their sales once a threshold number of states adopt new sales tax laws satisfying the simplification criteria.

The Internet Tax Freedom Act and State/ Local Sales Taxes on Internet Purchases

The Internet Tax Freedom Act was signed into law by President Clinton on October 21, 1998. ITFA imposed a moratorium on the levying of new state and local taxes on "Internet access" services — the typical $20-or-so monthly fee paid to companies like America Online for an electronic mail account and the ability to access the World Wide Web. The moratorium also prohibits certain "discriminatory" and "multiple" state and local taxes as defined in ITFA.

The Internet Tax Freedom Act does not directly affect the ability of states and localities to impose sales taxes on purchases of goods made over the Internet, such as a book ordered from Amazon.com. That power is already severely constrained, however, by a pair of U.S. Supreme Court decisions, *National Bellas Hess* vs. *Illinois* (1967) and *Quill Corp*. vs. *North Dakota* (1992). These decisions held that a state may only require a mail-order catalog company to charge sales tax to its customers and remit the tax to the treasury of the state in which the customers reside if the company has some kind of physical presence — for example, facilities or employees — within the state's borders.

The "physical presence requirement" for state and local sales tax authority over out-of-state catalog companies was stated broadly by the Court. As a result, state and local governments are effectively unable to collect the sales taxes due on most *Internet* purchases as well.[1] Current e-commerce industry projections indicate that Internet purchases will represent a growing share of both business-to-business and business-to-consumer commerce in coming years. Accordingly, state and local sales tax bases will suffer significant erosion if Internet companies do not begin collecting and remitting tax on their sales.[2] As the Congressional Budget Office has recently observed:

> States and localities cannot easily collect sales taxes on out-of-jurisdiction purchases by their residents. The growth of those purchases and the difficulty of enforcing compliance combine to erode their sales tax bases. Current estimates suggest that such erosion could be large enough to compel many states to choose between reducing spending or seeking new revenues through higher tax rates or new taxes.[3]

The Supreme Court established the "physical presence requirement" for sales tax authority over out-of-state businesses because it believed that the disparities in sales tax rules among the states created excessive tax compliance costs for catalog companies and thus burdened interstate commerce. Since the *Quill* decision, state and local government officials have engaged in several rounds of discussions and negotiations with representatives of the catalog and Internet-commerce industries aimed at formulating ways to reduce sales tax compliance burdens for such "remote sellers" and other retailers doing business in multiple states. At present, representatives of almost three-fourths of the states with sales taxes are actively engaged in a "Streamlined Sales Tax Project" aimed at completing a plan within the next two years for radical simplification and interstate standardization of state sales tax systems.[4]

Seventeen states already have enacted legislation that establishes the framework for implementing the sales tax simplification package ultimately developed by the Project.

The chief objection of remote sellers to having to charge sales tax on Internet and mail-order sales has been the effort and costs entailed in doing so under the current hodgepodge of rules and tax rates in effect. State and local government representatives hope that some large companies would voluntarily collect sales taxes should these burdens be relieved. It seems likely, however, that federal legislation would be needed to empower state and local governments to require Internet and mail-order companies to charge sales taxes should they simplify and standardize their sales tax systems and many large Internet and mail-order companies still not begin collecting the taxes.[5]

Proposed Legislation to Extend the Internet Tax Freedom Act

Even as state and local government organizations work as expeditiously as possible to address legitimate concerns about potential sales tax compliance burdens for Internet merchants, Congress is considering legislation that, if enacted, could hamper progress on the Internet sales tax issue. On August 2, 2001, the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee approved H.R. 1552, which would permanently prohibit states and localities from taxing Internet access services and extend the ITFA moratorium on "multiple" and "discriminatory" state and local taxes for five years beyond its October 2001 expiration date.[6] Similar legislation has been introduced in the Senate; S. 246 introduced by Senator Smith (New Hampshire) would extend the moratorium for 5 years, and S. 777 introduced by Senator Allen would make the moratorium permanent.

Even though ITFA does not directly affect state and local sales tax authority, enactment of an extension of the moratorium in its current form for five or more years is likely to accelerate and deepen the serious erosion of the tax base of state and local governments that is anticipated over the next several years as electronic commerce grows. There are two major reasons to anticipate an additional, adverse impact on state and local revenue-raising ability were a lengthy extension of the moratorium to be enacted.

More Corporations Would Exploit the "Separate Corporation" Loophole to Avoid Charging Sales Tax

As discussed above, the Supreme Court has held that a state cannot require an out-of-state company to charge sales tax on purchases by the state's residents unless the company has a physical presence within the state's borders. Some corporations take the position, however, that even *substantial* physical presence in a state does not establish an obligation to collect and remit tax on sales in that state, so long as the facilities and workers in the state are employed by a corporation that is *legally* separate from the corporation doing business with the customer — regardless of whether the two corporations are commonly owned.

The Barnes & Noble bookstore chain and the computer manufacturer Gateway are two companies that have set up their corporate legal structures in a manner that their managers apparently believe relieves them of an obligation to charge tax on Internet sales in most states. Both companies are "click-and-mortar" businesses that own stores in dozens of states and also operate an e-commerce Web site. For each company, the part of the business that makes Internet sales is incorporated separately from the part of the business that operates local stores.[7] Neither company charges sales tax on Internet sales to individual consumers except in a few states where the Internet businesses themselves are physically present.[8] The stores and the Web sites sell many identical products, engage in joint advertising, and do their utmost to establish a common brand identity in the minds of potential customers. Nonetheless, both companies apparently take the position that placing ownership of the Web "store" and the physical stores in two separate but commonly-owned corporations keeps the Web operation from incurring a sales tax collection obligation in a state where a store is located.

Despite the examples of companies like Gateway and Barnes & Noble, it appears that most "click-and-mortar" retailers currently are *not* adopting the "separate corporation" tax-avoidance strategy. Companies like Bloomingdale's, Macy's, Circuit City, Gap, Staples, Home Depot, and Nordstrom collect sales taxes on their Internet sales in every state in which they have stores.

Any "click-and-mortar" retail chain that collects sales tax on its Internet sales places itself at a significant price disadvantage, however, vis-a-vis any of its competitors that do not charge tax. Combined state and local sales tax rates often range from six to eight percent. Thus, merchants that sell exclusively over the Internet and click-and-mortar businesses that have implemented the "separate corporation" strategy may start out with an effective price advantage over businesses that charge sales tax on their Internet sales. Even a five or six percent price advantage is economically significant in a marketplace in which consumers can compare prices for the same items at different Web sites with a few clicks of a mouse.

Despite the potential adverse impact on their competitiveness, many click-and mortar retailers have been holding off from separately incorporating their Web operations and ceasing to collect taxes on their Internet sales. In part, they may be doing so because they have decided for now that it is better to charge applicable sales taxes than to run the considerable risk that the Supreme Court might one day hold that separate incorporation of a business' stores and its Internet operations does not protect the Web site from sales tax collection obligations.[9] (Were the Supreme Court to issue such a ruling, companies like Gateway and Barnes & Noble could owe some states many years worth of sales taxes that they failed to collect on their Internet sales.) In addition, companies may have refrained from establishing separate operations in the hope that Congress would soon take some concrete steps toward a constructive solution to the Internet sales tax issue. At a minimum, these businesses wish to see:

- a clear expression of congressional support for the principle that states should have the power to require Internet and mail-order merchants to charge sales taxes if state sales tax systems are simplified and harmonized; and

- an indication that Congress will revisit the Internet sales tax issue when a plan for such simplification and harmonization is developed.

If a lengthy extension of the ITFA moratorium is not coupled with endorsement of a so-called "level playing field" — the principle that brick-and-mortar, Internet, and mail-order retailers eventually should be equally obligated to charge sales tax on their sales — enactment of the extension will likely be perceived as a rejection of the principle. Moreover, a five-year extension of the moratorium will send a strong message that Congress is unlikely to revisit *any* Internet-tax related issues until 2006. As a result, the floodgates are likely to open to corporate restructuring aimed at sales tax collection avoidance by the large number of click-and-mortar retailers that have yet not implemented it.

Enactment of a five-year extension of the moratorium would lead boards of directors of many click-and-mortar retail chains to conclude they cannot expect Congress to "level the playing field" in the foreseeable future and to decide they can no longer afford to suffer a competitive disadvantage by continuing to charge sales tax on their Internet sales. In sum, the vast majority of click-and-mortar chains are likely to move rapidly to emulate the aggressive tax-avoidance tactics of competitors like Barnes & Noble and Gateway if Congress enacts a five-year extension of ITFA without addressing the issue of sales taxation of Internet purchases.

Because most click-and-mortar retailers are still collecting sales taxes on Internet sales in states in which they have a store, widespread reversals of this policy could substantially accelerate the erosion of the state and local sales tax base arising from the *Quill* decision and the growth in Internet commerce. But the threat to state and local revenues may be even more profound.

One thing that all retail store owners would like to devise is a way to discourage customers who don't find the book they want or the size or color dress they want from seeking the product at their competitor's store down the street. One means of doing so would be to steer customers to a self-service, Internet-linked computer kiosk in the store that could be used to place orders with the retailer's Internet subsidiary. For example, Barnes & Noble could advertise that a customer who discovered that the book she came into the store to buy was out of stock could place an order for it at Barnes & Noble.com using an in-store computer. The possibility of avoiding sales taxes could be used to convince the customer to wait a few days for the book rather than try to look for it at another store.[10]

This scenario is not a hypothetical "horror story" concocted by state officials to support their position that Congress should empower them to require major Internet retailers to collect and remit sales taxes in every state in which the merchant makes sales.[11] Kmart, the third-largest store-based retailer in the United States, has already placed kiosks linked to its Bluelight.com e-commerce affiliate in half of its stores, with plans to place them in all of its stores by 2002.[12] Yet Bluelight.com only collects and remits sales taxes for the states of California and Ohio.

If fierce competition leads click-and-mortar retailers to "push the envelope" of tax avoidance one more step by widely implementing this in-store Internet kiosk strategy as Kmart has, then the very existence of the sales tax as a key revenue source for states and localities would be threatened. Consumers could essentially avoid paying a sales tax on everything they examined or tried-on at a store if they were willing to wait a day or two to have it delivered to them from the out-of-state warehouse of the store's affiliated Internet business. An enormous share of retail purchases could fall into this category and, accordingly, a large share of state and local sales tax receipts could be at risk.[13]

In sum, enactment of a five-year extension of the Internet Tax Freedom Act moratorium that does not address the Internet sales tax issue threatens to initiate a vicious cycle that could greatly accelerate the erosion of state and local sales tax bases that has already begun to take place.

Future Sales Taxation of Most Digital "Content" Delivered Over the Internet Could Be Blocked

The most immediate and certain impact of ITFA is the prohibition of new state and local taxes on monthly customer fees for Internet access services (for example, America Online's $22 per month fee for unlimited dial-up modem access). However, loose drafting of ITFA's "Internet access" definition has created a loophole that, if not closed, is likely to block future sales taxation of a wide range of products and services that can be delivered over the Internet.

ITFA defines "Internet access" as:

> *a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. Such term does not include telecommunications services.*

This is an extremely broad definition that encompasses far more than what the average person thinks of as Internet "access" — the ability to send and receive e-mail and instant messages, to view and interact with World Wide Web pages, and to enter Internet "chat" rooms. The definition also explicitly includes all "proprietary content" that is converted to digital bits and bytes, sold with "Internet access," and *delivered* over the Internet. Such proprietary content includes downloaded computer software, music, movies, games, magazines, encyclopedias, stock quotes, and similar "goods" and services.

At present, relatively few states tax digital "goods" if they are sold in the form of an Internet download. Computer software is the most widely taxed such product, yet 17 of the 45 states with sales taxes do not impose them on downloaded software even though these 17 states do tax software sold on a CD-ROM. Only 19 states tax any type of downloaded "information" other than computer software.[14]

The fact that few states currently impose their sales taxes on downloaded music, movies, games, software, and other "proprietary content" probably has had a relatively minor impact on state and local sales tax revenues so far. However, the revenues foregone could grow significantly within a five- to ten-year time frame. Relatively few Americans yet have big-enough Internet "pipes" into their homes to make downloading a large computer program or the contents of an entire CD-ROM encyclopedia or Digital Video Disk practical. Moreover, few major producers of such content are offering their products for sale as digital downloads, because of both the limited "bandwidth" of their customers' Internet connections and concerns about the potential for illegal copying of such valuable computer files. However, both of these constraints are likely to relax significantly over the next few years. High-bandwidth telephone and cable-TV Internet connections are likely to be widely purchased by affluent American households. Content producers will settle on a few currently competing technologies aimed at reducing the likelihood of content piracy. It seems quite likely that most forms of software, information, and entertainment that are capable of being produced in digital form in fact will be widely sold and delivered over the Internet within five to ten years.[15]

When that happens, many states and localities that tax such digital content when it is sold as a software, audio, or video disk will want to be able to tax the downloaded versions as well. State and local governments will want to preserve both their sales tax bases and the competitiveness of their local book, music, and video stores. However, if ITFA's prohibition on taxation of "Internet access" is still in effect in its current form, state and local governments will be stymied in their efforts to extend their sales taxes to proprietary content delivered over the Internet.[16] Two different interpretations of ITFA's "Internet access" definition could block future sales taxation of downloaded material.

The first interpretation would give "Internet access" providers like America Online (AOL) free reign to sell proprietary content free from sales taxes by "bundling" it with access services as traditionally understood. Recall again that ITFA defines "Internet access" as "includ[ing] access to proprietary content . . . [sold] as part of a package of services offered to users." Now that America Online has merged with Time Warner, the company could supplement AOL's existing $22 monthly service with a service package for $50 per month that also includes the right to download a number of Warner Music audio recordings, another deluxe package for a higher monthly fee that includes additional Warner Home Video movie downloads, and so on.[17] All of Time Warner's valuable and extensive collection of media properties could be bundled with AOL's access service and sold free from sales tax.[18] This prohibition could have a significant adverse revenue impact on states and localities, because Internet access providers like AOL have a physical presence in most states (with modem banks and other equipment constituting their local “points of presence”) and otherwise would be obligated to charge sales tax.[19]

A much wider array of companies than Internet access providers might be able to avoid future sales taxation of their digital wares under a second interpretation of ITFA’s “Internet access” definition. Every company selling and delivering digitized content over the Internet arguably is providing “Internet access” under ITFA’s definition read literally. For example, it would seem that a company that has a Web site at which music may be downloaded is “providing a service that enables users to access content . . . offered over the Internet,” the definition of “Internet access” in ITFA. In short, a company delivering digital “goods” over the Internet would have a strong case that it would not have to charge sales tax, *even if* the company is not an Internet access provider like America Online that controls local access telephone numbers, banks of modems, and similar infrastructure.[20]

In sum, if the ITFA moratorium is extended with no change in its “Internet access” definition, the states are unlikely to be able to apply their sales taxes to a variety of information- and entertainment-oriented products that could be widely sold and delivered over the Internet within five to ten years. This would punch another large hole in the sales tax base of states and localities and compound the already-substantial competitive disadvantage of Main Street retailers vis-a-vis their e-commerce rivals.

Conclusion

A lengthy extension of the Internet Tax Freedom Act in its current form could have major, additional, adverse impacts on state and local sales tax revenues. If companies are not to gain new incentives and opportunities to avoid charging sales tax on Internet sales, ITFA’s definition of tax-exempt “Internet access” needs to be narrowed, and the principle that states and localities should be empowered to require all large Internet merchants to charge sales taxes once state and local sales tax systems are simplified and standardized should be affirmed in any new legislation. If the moratorium is extended this year without addressing the Internet access and sales tax issues, no more than a one- to two-year extension to permit state and local governments to complete their current sales tax simplification project would be warranted. Alternatively, an extension could include legislation sponsored by Senator Dorgan (S. 512) and Representative Istook (H.R. 1410) that would:

- spell out detailed criteria for simplification and standardization of state and local sales tax systems and

- commit Congress to taking an expeditious up or down vote on a bill authorizing states to require large Internet merchants to charge sales tax on all their sales once a threshold number of states adopt new sales tax laws satisfying the simplification criteria.

Notes

1. Even if taxes are not charged by the seller on interstate sales, purchasers are legally obligated to pay "use" taxes directly to their home states. However, most experts agree that it would be unrealistic to expect more than a small fraction of use taxes to be self-remitted by individual consumers unless purchasers were subject to use tax audits or other enforcement actions that would raise significant privacy concerns. Compliance with use tax self-remittance requirements by many businesses — especially small businesses — is also spotty.

2. It is frequently asserted in mass-media stories concerning the Internet sales tax issue that business-to-business sales over the Internet do not result in a loss of state and local sales tax revenues because such sales are not subject to sales taxes. Such statements are erroneous. While it is true that a significant share of business-to-business sales are exempt from sales taxes, the non-exempt share is sufficiently large to generate a major share of state and local sales tax receipts. Indeed, the most widely-cited study of this issue estimates that approximately 40 percent of sales tax revenues are associated with business-to-business sales. (See: Raymond J. Ring, Jr., "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, March 1999.) Accordingly, the rapid growth of business-to-business Internet sales predicted by most Internet industry forecasters is likely to make a major contribution to the loss of sales tax revenue that results from the inability of states and localities to require non-physically-present sellers to charge sales tax to their customers.

3. Statement of G. Thomas Woodward, Assistant Director for Tax Analysis, Congressional Budget Office, before the Senate Finance Committee, August 1, 2001.

4. The Web site of the Streamlined Sales Tax Project is www.geocities.com/streamlined2000/.

5. Richard Prem, the director of tax policy for Amazon.com, has observed: "The problem with a voluntary system is that there is a reward for holding out. . . . By joining, businesses would be giving up sales." Quoted in Christopher Swope, "E-conomics Problem," *Governing*, March 2000. At the time he made the statement, Prem was the head of e-business services at the Deloitte & Touche accounting firm.

6. Sales taxes levied on Internet access services by approximately ten states at the time ITFA was enacted were "grandfathered" by ITFA. However, H.R. 1552 reverses the grandfathering and prohibits all states and localities from taxing Internet access services as defined in ITFA. Several of the pending Senate bills that would extend ITFA also eliminate the grandfathering provision.

7. Barnes & Noble owns approximately a 40 percent share of Barnes & Noble.com, as does media conglomerate Bertelsmann.

8. Gateway.com's Web site indicates that there is at least one Gateway Country Store in every state except Hawaii, New Hampshire, Vermont, and Wyoming; however, Gateway.com itself only "collects applicable sales tax on merchandise in MA, MO, NC, and UT." Barnes and Noble has stores in every state except West Virginia; however, "Barnes & Noble.com currently collects sales tax in the following states: KY, NY, NJ, VA, TN, NV."

9. The weak legal foundation of the "separate corporation" strategy for avoiding a sales tax collection obligation is discussed in Michael J. McIntyre, "Taxing Electronic Commerce Fairly and Efficiently, *Tax Law Review*, Volume 52, Number 4 (1999).

10. Barnes & Noble is, in fact, in the process of placing kiosks in all of its bookstores linked to its Barnes & Noble.com Internet affiliate. See: "Barnes & Noble Announces Plans for Extensive Integration of Stores and Web Site," company press release dated October 26, 2000.

11. State and local government organizations have long been on record supporting a so-called *de minimis* provision in federal Internet sales tax legislation. Such a provision would exempt companies with nationwide sales below a certain dollar threshold from an obligation to collect sales taxes in states in which they lack a physical presence.

12. "Bluelight.com & Kmart Launch Kiosks," company press release dated January 10, 2001. A recent *Washington Post* story included a picture of one of Kmart's in-store kiosks, which was surrounded by advertising asking: "Can't find what you want? Look here! Great specials and savings only online. Products that may be out of stock at Kmart. Thousands of products you won't see in the store." See: Martha McNeil Hamilton, "Online Merchants Muster Forces for Demanding Holiday Season," *Washington Post*, November 4, 2000.

13. States would not be powerless if they attempted to compel "click-and-mortar" retailers installing Internet kiosks in their stores that were linked to their Web sites to charge sales tax on Internet sales. (See the article cited in Note 9.) But achieving sales tax collection in such circumstances would take a great deal of time. Many states would first have to re-write their state sales tax laws to assert that having an in-store kiosk obligates the Web site to charge sales tax. These laws then would have to be upheld by litigation that could take years and almost inevitably would be appealed to the U.S. Supreme Court. Even if the states ultimately prevailed, considerable damage to state and local sales tax collections would have occurred in the interim period. In any case, states would much prefer to resolve the Internet sales tax issue comprehensively and constructively rather than through litigation.

14. Vertex, Inc. Tax Cybrary, "Internet Tax Table, State Level." Available at www.vertexinc.com/cybrary/internet/tax_table.asp.

15. "Only about 2 million customers had signed up for high-speed [Internet access] services by the end of 1999, but this number will swell to more than 15 million by 2003, according to industry research firm Jupiter Communications. The speedy network connections are just one side of the coin. Movie studios, music and software companies, and Net entertainment companies are salivating at the idea of being able to present consumers with video, downloadable songs and software, or Web programming that rivals broadcast television. The recent combination of America Online with cable network giant Time-Warner is only the most obvious example of this trend." John Borland, "Media Industry Lays Groundwork for New High-Speed Networks," Cnet News.com, April 12, 2000 (news.cnet.com/news/0-1004-200-1686864.html). Forrester Research, Inc. projects that by 2004, 40 percent of Internet sales of software and 25 percent of Internet sales of music will be in the form of downloads (as contrasted with orders from Web sites delivering the goods on hard media). See: David Lake, "E-Commerce Spotlight: The Lowdown on Downloads," *The Industry Standard*, February 7, 2000, www.thestandard.com/metrics/display/0,2149,1136,00.html.

16. Proponents of maintaining the sales tax free status of most digital content delivered over the Internet often argue that it would be technologically impossible for states to tax such material because the seller cannot know the identity or delivery location of the purchaser and therefore which state's tax to charge. A comprehensive response to this assertion is beyond the scope of this paper. Nonetheless, because the assertion has become almost common wisdom in discussions of e-commerce taxation, a brief response is in order.

It certainly is technologically possible for a seller of digitized content that will be delivered over the Internet to accept anonymous "electronic cash" for the purchase and to permit a download to occur without knowing the identity or location of the purchaser. Technologies also exist (e.g., the "Secure Electronic Transactions" protocol) that permit merchants to validate the legitimacy of a credit card payment without knowing the identity or billing address of the purchaser. Nonetheless, there are good reasons to doubt that anonymous purchasing of digitized goods will become widespread (with the obvious exception of pornography).

Fundamentally, anonymous purchasing does not appear to be in the interest of either the seller or the purchaser. Sellers want to know as much about their customers as possible so that they can sell them more products. This information is a key competitive advantage that "direct marketers" like Internet merchants have over brick-and-mortar retailers whose customers walk into the store and pay cash or use a general-purpose credit card. The enormous value of this information to retailers explains such schemes aimed at revealing the identity of purchasers as discount cards at bookstore chains and store-specific charge accounts. Internet merchants are likely to resist strenuously foregoing the opportunity to obtain information about the identity of their customers. Similarly, purchasers of relatively expensive digital content like a software program or an audio CD are likely to want to reveal their identities to the seller so that they can obtain new copies if the download is unsuccessful or the copy is subsequently damaged. For both reasons (and others beyond the scope of this discussion), it seems unlikely that anonymous purchasing of relatively valuable digital content will become widespread in the near future. Sellers are likely to know at least the credit card account billing address of their customers, which can be used for sales tax purposes.

17. "Some of AOL's most ambitious initiatives draw upon Time Warner properties. There's the much touted AOL Anywhere strategy, which extends the service — and now, content like CNN headlines — to cell phones, Palm Pilots, and wireless e-mail devices like AOL Messenger, an AOL-branded version of Blackberry. There's MusicNet, a fledgling joint venture with Warner Music, BMG, EMI, and Real Networks that will sell online subscriptions to a music library. There's AOL TV, which, while off to a clunky start, is viewed inside the company as a step toward the convergence of the Internet and television, which would make possible, for example, HBO's The Sopranos on demand." Marc Gunther, "What Does AOL Want? Growth, Growth, and More Growth," *Fortune*, July 23, 2001.

18. If ITFA's provision to "grandfather" existing taxes on Internet access services were retained, the ten-or-so states whose taxes were grandfathered would likely to be able to tax proprietary content like music, software, and magazines even if it were bundled with Internet access service. Virtually all Internet service providers furnish at least some proprietary content with their access services, such as news headlines and guides to using the Internet. Accordingly, grandfathered states would have a strong case that they were already taxing bundled "proprietary content" at the time ITFA went into effect and, accordingly, that the grandfather clause encompasses new forms of digitized content that ISPs might begin bundling with access services in the future.

19. It might be argued that even if the scenario described in this paragraph is plausible, future sales taxation of only a small proportion of software, music, and other digitized content might be blocked if ITFA were extended because the vast majority of Internet service providers (ISPs) are not in the same position as an AOL Time Warner and do not own significant amounts of media "content." This argument ignores the fact that the barriers to becoming an ISP are quite low; thousands of ISPs are small "mom-and-pop" businesses. Any company owning valuable content that can be digitized and delivered over the Internet would find it in its interest to become an ISP if that ensured that the content could be sold free from sales tax. Indeed, a number of companies, such as Kmart, have already formed ISPs for a variety of other non-tax reasons. If companies like Walt Disney, Corel (publisher of Wordperfect software), and Sony Music could obtain the ability to sell all of their movies, software, and music free from sales tax by leasing a few modems and Internet routers from AT&T or MCI in a couple of cities to qualify as Internet access providers themselves, it seems likely that they would do so.

20. If a court upheld this second interpretation of ITFA's "Internet access" definition and ITFA's "grandfather" clause were preserved, the grandfather clause would probably leave a somewhat larger group of states free to tax various categories of "digital content" than would the first interpretation.

As noted above, 28 states presently tax downloaded computer software; this number does not appear to be significantly different from the number of states that taxed downloaded software at the time ITFA was enacted. A vendor of downloaded computer software not bundling it with Internet access as conventionally understood might take the position that he nonetheless qualified as a seller of "Internet access" under the second interpretation of that definition. Even so, he would still have to charge tax in the 28 states that taxed downloaded software when ITFA went into effect. In contrast, an ISP bundling content with Internet access services would only have to charge sales tax in roughly ten states whose taxation of such services was grandfathered (again, assuming the grandfather clause were preserved in an ITFA extension; see note 18).

Nineteen-or-so states were taxing forms of digital content other than computer software on ITFA's effective date; their ability to take advantage of the grandfather clause could be more tightly constrained. Most of the state laws subjecting downloaded information to state sales taxes were written before it was technically feasible to download things like music and movies; the laws were drafted with online, text-based information services like Lexis-Nexis in mind. A state issuing an official pronouncement that it considered music, movies, and other digital goods and services to be encompassed in its existing sales tax on "information" or "information services," likely would find itself in a Catch-22 situation. Sellers of these kinds of digitized goods would argue that the pronouncement proved that the state was not taxing the items prior to ITFA's effective date and therefore could not begin to tax it now.