Internet Sales Taxes: Collect *Us* At The Nexus

MGT 511
January 30, 2006
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Abstract: Sales taxes can be a purchase barrier to consumers and they impose an accounting and business-stifling burden on businesses. Because of the Internet Tax Freedom Act (and no driving desire to change), this burden is unfairly distributed to brick-and-mortar concerns. Most examinations of the problem suggest requiring ecommerce businesses to become a form of taxing authority for all other states, thereby shifting not only a taxation burden to these businesses but adding a significant regulatory chore. This paper suggests that taxes be paid at the home location of the ecommerce company or suitable nexus, not the point where the purchaser resides. Further, it recommends enabling individual states to promote their own ecommerce companies by enabling a lower on-line tax rate (for out of state purchases).

Problem: The Internet has essentially resulted in two, unequal business classes in the area of sales tax burden. Those operating as online concerns not only gain from the natural, market-expanding efficiencies of the Internet they were given an important "pass" during the infancy of ecommerce. By relieving them of the burden collecting out-of-state taxes, these businesses find more fertile ground for sales outside their own states. This impacts not only their own states that may be deprived of a company's resources and continued development as a mortar business, but other states as well. This "inequality" may have been advantageous to the development of a fledgling ecommerce industry in the mid to late 90s, but it is time to level the playing field once again.

Solution: Set uniform standards for where Nexus lies in any sales transaction and tax the sales according to the rules of that state. This would have the same basic effect as viewing Internet purchasers as "on-line travelers" to the state of purchase. And while this would reduce the sales tax avoidance aspect of Internet sales, states could choose to offer lower on-line sales tax rates (for out of state purchases) in an effort to make their B2C ecommerce companies more competitive. This approach would increase revenues to states that are otherwise "friendly" to the establishment of ecommerce organizations while depriving far away states of sales tax revenue due to the tax avoidance considerations of purchasers.

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Develop Uniform Standards For Identifying Nexus And Leave It To States To Tax Internet Sales There

> *“There are no necessary evils in Government. Its evils exist only in its abuses. If it would confine itself to equal protection, and, as heaven does its rains, shower its favours alike on the high and the low, the rich and the poor, it would be an unqualified blessing.” – Andrew Jackson (http://www.econlib.org/library/Leggett/lgtDE.html)*

When Andrew Jackson said this in 1834, he and his Democratic Party were decidedly on the anti-tax side of the American political spectrum. And while the concept of the Internet had nothing to do with the statement above it nevertheless has some relationship to the principle of government using taxation to “abuse” one class while “favouring” another.

And while I personally believe that taxation has a stifling effect on economic activity, I nonetheless believe that the fairest way to address the Internet taxation issue is to treat an Internet sale (or any sale via 800-number, mail order in exactly the same way). My view is that although appealing from the standpoint of a businessperson or consumer engaged in a sales tax-free transaction, exempting interstate transactions from sales tax has created “free” zone for which other economic sectors pay.

Giving up sales tax revenue means that, inevitably, states are going to seek other revenue or they are going to cut expenses. Sales taxes will continue to rise in an effort to recapture what states believe they are losing to other states. That’s because these state governments tend to see a “zero sum” game when it comes to states and their annual budgets. Increasing taxes on brick and mortar retail sales further punishes those of limited economic means (Mazerov and Lav 1998).

The Time For Preferential Internet Tax Treatment Has Come. And Gone.

First of all, the uniform tax amnesty act was signed into law at a time when B2C ecommerce was in its infancy. Back then, the Federal government was doing what government has always done when it wanted to "protect" new or fledgling or essential industries. It was tinkering with tax law. The idea of using tax policy to foster the growth of an industry is as old as the republic itself. Tariffs protected America's farming and start up manufacturing during the time of Andrew Jackson just as they protect our logging industry from Canadian imports. Municipalities frequently "abate" property taxes for a period of time in order to encourage companies to move to their areas. Lack of taxation can also help businesses or industries when they are in their infancy. So the lack of interstate sales tax has no doubt been beneficial to start up Internet businesses.

In 1998, Bill Clinton urged that "There should be no special breaks for the Internet, but we can't allow unfair taxation to weigh it down and stunt the development of the most promising new economic opportunity in decades," (CNN All Politics Website 1998).

But today, nearly eight years after President Clinton's remarks, the B2C ecommerce industry is well beyond its childhood. It is now a behemoth that no doubt benefits from numerous other natural advantages offered by the Internet—not the least of which is dramatically expanded markets for etailers and other's selling consumer products.

Brick and mortar businesses, or even many click and mortar businesses (with limited Internet sales) are treated unfairly. Moreover, individual consumers without access to the Internet are shouldering a disproportionate share of the sales tax burden. States see the total loss of revenue as being as high as $45-billion in 2006 alone (Newrules.org 2005). But the most popular question in public seems to be how best to

assure that states collect tax on purchases which consumers make from out of state ebusinesses (and catalog retailers).

> If it turned out that removing its unfair tax advantage killed Internet commerce, then the conclusion would be inescapable that e-commerce grew only because of taxes and could not prevail in a fair fight. But Internet commerce is flourishing not just because it enjoys tax advantages but also because it has other, more important, strengths: the convenience of permitting people to shop at home, the ease of comparison shopping and the real economies e-retailers can achieve through smaller inventories and smaller places of business.
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> Whatever its strengths, however, e-commerce has not eliminated the need for schools, fire departments, police forces, parks, libraries, health care and other government services, and for the revenue to pay for them. To maintain those revenues and to restore a genuinely level playing field for U.S. retailers, Congress and the states should cooperate to make sure that all retailers are treated fairly, whether they sell in shops or in cyberspace," (Aaron 1999).

A couple of developments have occurred since the Internet Tax Freedom Act of 1998, including the extension of the acts provisions, ultimately to November 2007. For one, the Streamlined Sales Tax Project seeks to reduce and simplify the multiplicity of taxing regulations within states. What's more, the availability of TaxWare and other software programs has made it technologically possible for a company to immediately apply a tax rate for any of 7,500 jurisdictions in an interstate sale. And whether it is fair to mandate that ecommerce organizations act as tax collection agencies for these 7,500 state/county/city taxing jurisdictions seems to be a the core of the arguments. Many in ecommerce maintain that it is an undue burden.

Opinion seems to revolve around whether or not a business should be required to collect taxes for a state, even if that state is so far away that the business will never receive any benefits that occur from residing within a state. A writer for the Cato Institute discussing the ills of a labyrinth streamlined sales tax articulates a position, which seems to see the business as the only party that is imposed upon by sales tax.

> If (Utah Governor Mike) Leavitt's pro-tax forces have it their way…Virginia would be able to collect taxes from the Washington-based book retailer. Never mind, of course, that the company that is being taxed has no voice in the tax-and-

> spending decision made by Virginia and that the company never benefits the public services Virginia provides with those tax dollars." (de Rugy 2002)

The Cato writer—like others looking at the argument—seems to completely ignore the fact that, technically, the purchaser is the one being taxed. And another point that seems to go largely ignored is the taxing authority of the state that houses the business (or a nexus). To me, this is where taxing should occur and where the tax should go.

One might argue that both *National Bellas Hess vs. Illinois* and *Quill vs. North Dakota* affirm the state of the buyer's location as the taxing state. However, I would argue that this results in part from the fact that the court was answering legal questions brought about by A) such states attempts to collect tax on their residents purchases and B) that both refer consistently to the Interstate Commerce Clause of the Constitution and its purpose as a means of eliminating what the Bella Hess justices refer to as "unjustifiable local entanglements," (National Bellas Hess 1967). Further both decisions affirm the authority of Congress in such matters (National Bellas Hess 1967, Quill 1992).

It is also important to remember that, coming in 1967 and 1992 respectively, neither Bellas Hess nor Quill mention the Internet, nor do they come close to imagining such a commercial entity. Bellas Hess decision said, "Indeed, it is difficult to conceive of commercial transactions more exclusively interstate in character than the mail order transactions here involved." And Quill's view of the commercial world had really not evolved much beyond:

> … we have held that, if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's in personam jurisdiction even if it has no physical presence in the State. Comparable reasoning justifies the imposition of the collection duty on a mail-order house that is engaged in continuous and widespread solicitation of business within a State. Such a corporation clearly has "fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign." In "modern commercial life," it matters little that such solicitation is accomplished by a deluge of catalogs, rather than a phalanx of drummers… (Quill 1992).

Yet the simple fact is that B2C ecommerce has created a world completely unimagined by these justices. Today, businesses engaged in ecommerce don't deluge consumers with catalogs and they certainly don't engage in drumming. Many simply look to establish a unique selling proposition and leave it to consumers to come looking for them.

Turning The Sales Tax Idea On Its Head (Sort Of)

While the location of the "sale" is generally considered to be location of the buyer (Gercken 2001) it is worth considering turning this assumption upside down as a way to add simplicity and fairness to the question of Internet sales taxation. Taxing according to the tax rate in effect inside the state of the businesses location obviously relieves all B2C businesses of collecting for a mind-boggling array of remote municipalities. And it doesn't place any undue burden on the consumer, who would pay taxes to the far-away state (collected at the time of purchase) just as he would if he were visiting the state and making purchases in person.

While it may be true that a New Yorker buying from a California company is not using California government services, the California business certainly does. And in any tax equation one has to see the tax as something that stifles both buying and selling activity to some extent. Completely ignoring the business location side (or nexus side) of the equation is illogical because in most situations the economic relationship between a business and its native state are likely to be far more substantial than any consumer and his or her native state. To solve this issue, we have to get beyond judicial and legislative thinking that was designed for a mail order world.

Moreover, online sales rely almost entirely on activity by the consumer. In most online transactions, the business online is far more passive than the consumer. The consumer does the searching, the selecting and all the decision-making. And through

the selection process, the consumer has made a conscious decision to do business with an out-of-state etailer.

But the argument is frequently made that it is unfair for a state to be able to tax an out of state business, when that business derives no benefit from the state's services. However, looked at another way, the consumer in Virginia certainly benefits from the selection, service and other attributes of the Washington State business. In the case of many small ecommerce businesses, it can reasonably be assumed that buying from the out-of-state business puts the out of state purchaser—say the Virginian buying from the Washington state business—in position to enjoy the ingenuity of entrepreneurs largely raised and educated in Washington Public schools or state supported universities, who in part use state services to be able to make their product available to Virginians, Ohioans, Missourians and everyone else outside of Washington.

In Bellas Hess, the key issue was the fact that the retailer benefited from the state although it could claim that it had no nexus within. "Bellas Hess enjoys the benefits of, and profits from the facilities nurtured by, the State of Illinois as fully as if it were a retail store or maintained salesmen therein." In Quill vs. North Dakota, the court overturned the ruling in part requiring more substantial nexus. However, the ruling left the door open for congress to get more involved. "No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions."

Reading the first part of the above portion of the Bellas Hess opinion, it is clear that the states most diversified ecommerce companies "enjoy" are the states of their location. But with the door open for congress to make its imprint, the body has conveniently punted away the issue—at least until November of '07. It is time for Congress to look at new solutions to the problem.

Let Individual States Determine If They Want To Enable A Special Rate For Out Of State/Online Sales

Taxing at the home location of the business or other suitable definition of nexus would simplify interstate sales tax matters and, at last, level the playing field between traditional and online businesses. It is a solution that is both fair and practical, once uniform standards for determining difficult nexus issues are in place. Internet sales should be taxed at the rate in effect according to one or more of these location criteria

1. State of incorporation
2. Where the sales point is located (for example, where are the people who operate the site located and paid?)
3. Warehouse location prior to shipment
4. Presence of retail location in purchaser’s state (currently a determinant of nexus in most cases)
5. Server location
6. Prioritized combinations of the above.

Further, I would suggest however that individual states could make a strategic attempt to encourage the growth of their own ecommerce businesses by enabling a lower tax rate for out-of-state sales. This is something that would enable certain states wishing to foster ecommerce growth within their own borders to gain a competitive edge on other states. They might, if they so choose, argue within their own states that a portion of the transaction equation (the consumer) does not benefit from state services.

Conclusion: Level The Playing Field And Let States Benefit From *Their Own* B2C Companies

Imagine if a huge percentage of the California surfer population suddenly became captivated by surfboard and apparel designs developed by a boutique along the Maryland shore. They purchase the products form the boutique's online location and receive them within a day or two. Remembering that the compelling designs were created in Maryland, by largely Maryland-raised business people who have benefited through their lives from Maryland public education, who could reasonably argue that California deserves the sales tax? Especially since the ingenuity, initiative was provided by Marylanders using Maryland infrastructure and other resources.

To me, there is also a high degree illogic to the notion that purchasers from out of state should be exempt from the tax of the state where they are purchasing. There are countless other state taxes which are imposed on out of state buyers no matter whether they purchase them in person or remotely. These include transportation, accommodations, game tickets, and more. States do not (like Canadian Provinces) have provisions for out-of-state travelers to be refunded any sales tax paid while in that state.

Clearly, both Bellas Hess and Quill identify the state of the consumer as the state of the purchase. However both acknowledge the power that Congress has in regulating interstate taxation. The present situation seems irreconcilable with the "sale" considered as being made within the state of the purchaser at the same time states are limited from imposing taxes outside their borders.

The Internet Tax Freedom Act is only a temporary Band-Aid. And the Streamlined Sales Tax Project and TaxWare look as though they make an extremely complicated situation only slightly less complicated. Changing the view of where the sales take place from the location of the consumer to the location of the business (or nexus) is an approach more in-step with the reality of the modern world.

I believe that justices who considered the Bellas Hess case might certainly have seen it this way in 1967 had B2C ecommerce existed. Statements like "The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control, " (National Bellas Hess 1967). This statement, to me, leaves the door open for Congress to adopt a wholesale change in thinking can solve the tax fairness issues.

It is true that formulations would have to be agreed upon to determine what constitutes the taxing location or nexus. But this could then be universally applied. And the multiple municipalities could keep their individual rates rather than being forced into an only slightly less complicated "simplification." Doing all of this will level the playing field for states, businesses and consumers alike. The need for self-reporting of sales taxes on income tax forms would be eliminated. And states would not feel as much continuing pressure to raise their own sales tax rates to make up for the revenue they believe they are losing to out of state transactions.

If congress would step up and enable such true simplification it would end what Andrew Jackson would certainly call an "abusive" system while enabling the Internet economy to continue to "shower its "favours" on us all. So, let's finally put the ecommerce taxation burdens and rewards where they belong—at the location of the ecommerce business.

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