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CRS Report for Congress

Internet Tax Legislation: Distinguishing Issues

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Internet Tax Legislation: Distinguishing Issues

Summary

The *Internet Tax Freedom Act* (ITFA), enacted in 1998, placed a three-year moratorium on the ability of state and local governments to impose new taxes on Internet access, or to impose any multiple or discriminatory taxes on electronic commerce. The moratorium is scheduled to expire on October 21, 2001.

On May 10, 2000, the House approved H.R. 3709, the *Internet Nondiscrimination Act of 2000.* That bill would have extended the current moratorium on state and local taxes for five years. It would have removed the grandfathering protection the ITFA now provides for state and local taxes on Internet access that were already in place in ten states in 1998. H.R. 3709 also expressed a sense of Congress listing attributes that a state tax relating to electronic commerce should contain to avoid being considered multiple or discriminatory and consequently subject to the moratorium. The Senate did not act on an Internet tax bill before the second session ended. The issues remain for the 107th Congress to address.

In addition to H.R. 3709, 12 other bills to regulate state and local taxation of the Internet were introduced in the 106th Congress. This report discusses four major areas of difference among the various bills. The first is whether to extend the current three-year moratorium and, if so, whether on a temporary or permanent basis. A second is whether or not to continue the grandfathering protection provided by the ITFA for state and local taxes on Internet access that were already in place at the time of enactment. A third is whether or not to broaden the scope of the moratorium to explicitly protect electronic commerce in digitized goods and services from sales and use taxation. A fourth is whether or not Congress will take action to facilitate the collection of state and local sales and use taxes on interstate sales of goods and services arranged over the Internet.

This report will be updated as new legislative initiatives emerge on state and local taxation of the Internet.

Contents

Introduction 1

Background 1
Internet Tax Freedom Act 1
Sales and Use Taxes and Internet Sales 2
Role of Congress under the Commerce Power 3
Report of the Advisory Commission on Electronic Commerce 4
H.R. 3709 Passed the House 5

Legislation to Regulate State and Local Internet Taxation in the 106th Congress . . 6

Basic Issues Distinguishing the Bills 7
Extending the Moratorium 7
Grandfathering Protection for Internet Access Taxes 9
Expanding Scope of Moratorium 10
Collecting Sales and Use Taxes on Internet Transactions 10
Simplification of state and local sales and use taxes 11
Voluntary versus required collection by interstate sellers 13
Codify nexus standards 14

For Additional Information 19
CRS Reports 19
Other Resources Available on the World Wide Web 19

List of Tables

Table 1. Comparison of Internet Tax Bills on Four Distinguishing Issues 16

Internet Tax Legislation: Distinguishing Issues

Introduction

The tax moratorium imposed by the Internet Tax Freedom Act is scheduled to expire on October 21, 2001. Thirteen bills to regulate state and local taxation of the Internet were introduced in the 106th Congress. H.R. 3709, the *Internet Nondiscrimination Act of 2000*, passed the House on May 10, 2000. However, the Senate did not act on an Internet tax bill before the second session ended. The issues remain for the 107th Congress to address.

This report begins with a brief background on the *Internet Tax Freedom Act* of 1998, the controversy over collecting sales and use taxes on Internet sales, the message to Congress from the Supreme Court's *Quill* decision on the taxation of mail order sales, the report of the Advisory Commission on Electronic Commerce, and H.R. 3709. The second section lists the bills to regulate state and local taxation of the Internet that were introduced in the 106th Congress. The third section discusses four major issues that differentiate the bills. These include the positions the bills take on extending the moratorium, grandfathering existing Internet access taxes, expanding the scope of the moratorium to the taxation of digitized goods or possibly all electronic commerce, and collecting sales and use taxes on Internet transactions. The comparison of the bills is summarized in Table 1 at the end of the report.

This report will be updated as new legislative initiatives emerge on state and local taxation of the Internet.

Background

Internet Tax Freedom Act

The Internet Tax Freedom Act (ITFA) was enacted on October 21, 1998.[1] The Act imposed a three-year moratorium on the ability of state or local governments to impose new taxes on "Internet access services" or to impose any "multiple or discriminatory taxes on electronic commerce." The Act grandfathered taxes on Internet access that were in place prior to October 1, 1998, thereby permitting them to continue. The moratorium is scheduled to expire on October 21, 2001.

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[1] The Internet Tax Freedom Act comprises Titles XI and XII of Division C of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999 (H.R. 4328, P.L. 105-277, 112 Stat. 2681).

The Act can be viewed as preventive in the sense that most states were not levying the "multiple or discriminatory" taxes prohibited by the moratorium. In 2000 there were ten states with taxes of various types on Internet access that are protected by the grandfathering provision of the ITFA.[2]

Sales and Use Taxes and Internet Sales

Under the Internet Tax Freedom Act's definition of discriminatory taxes, sales transacted through electronic commerce are to be treated the same way as catalog or mail order sales. Under current law, for within-state sales (where both the buyer and seller are in the same state), a state can require the seller to collect the sales tax from the buyer and remit the revenue to the state. For interstate sales, a seller in another state can only be required to collect the "use tax" (the companion tax to the sales tax, applicable to interstate sales)[3] from the buyer and remit the revenue to the buyer's home state government if the seller has a "substantial nexus" in the buyer's state.[4] Substantial nexus is currently defined as physical presence (explained further in the next section of this report on the "Role of Congress under the Commerce Power").

If the seller does not collect a sales or use tax on a transaction, the legal obligation to pay a "use tax" to one's home state nonetheless remains with the buyer. In practice, however, few individual consumers voluntarily remit use taxes to their home state on purchases from out-of-state. Businesses are more likely to pay use taxes, in part because they are subject to audit by state revenue officials.

As Internet commerce continues to develop, state and local governments anticipate a growing, substantial loss of revenue from untaxed Internet sales. Sales taxes are a major source of revenue for states, especially those states without income taxes, and for some local governments.[5] In addition, "Main Street" or "bricks-and-mortar" retailers are complaining about the unfair competition they face from untaxed

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[2] Connecticut, Hawaii, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, and Wisconsin levy their regular retail sales tax on Internet access. (The Connecticut tax is scheduled for repeal effective July 1, 2001.) New Hampshire applies a telecommunications services tax to two-way communications provided by certain types of entities, including Internet access provided by cable TV companies. In addition, Washington state has a business and occupations tax; this is a gross receipts tax levied on all entities doing business in the state, including firms offering Internet access. The Federation of Tax Administrators (FTA) estimated that there would be a combined revenue loss of $75 million for these 10 states for the fiscal year beginning July 1, 2000, if the grandfathering protection was removed. Montana is currently prevented by the moratorium from applying to Internet access charges its retail telecommunications excise tax which is levied on two-way voice, video and data communications, regardless of the medium. Information obtained from the Federation of Tax Administrators, Washington, DC, May 10, 2000.

[3] Every state with a sales tax has a corresponding "use tax," typically defined as a tax upon the storage, use, or consumption of tangible personal property in the state. A transaction taxed under the sales tax is not subject to the use tax.

[4] For further explanation of current law, see CRS Report RS20577, *State Sales Taxation of Internet Transactions*, by John R. Luckey.

[5] See CRS Report RL30431, *Internet Transactions and the Sales Tax*, by Steve Maguire.

Internet sales. Loss of income by Main Street sellers could, in turn, place downward pressure on rents for retail space, the value of retail real estate, and the local property tax base.

On the other side of the issue is concern for the potential compliance burden facing sellers engaged in interstate sales if they were required to be familiar with the unique sales tax laws in each state and local jurisdiction that levies a tax (in order to know what to collect from each customer, on which items) and if they had to file and remit taxes to each of those jurisdictions.. Forty-five states and the District of Columbia levy sales and use taxes.[6] As of May 2000, approximately 7,500 local jurisdictions levied a sales tax.[7] That represents approximately 25 percent of the 30,000 local jurisdictions (counties and cities) that are authorized under their state laws to levy a sales or use tax.

Role of Congress under the Commerce Power[8]

While the issues involved in state taxation of the Internet might not appear to raise federal questions, Congress's power under the Commerce Clause[9] brings these issues into the federal arena. As mentioned in the preceding section, a state may tax a transaction if there is some connection of the transaction to the state. If both the seller and the buyer are located in the same state, the state has the authority to require the seller to collect and remit the sales tax. But if the transaction is purely one of interstate commerce, with the seller not having the requisite nexus to the buyer's state, Congress is the only entity that may regulate the activity, or Congress may authorize the states to do so.

The Supreme Court has held that the Commerce Clause limits a state from imposing tax liability or collection and remittance responsibilities on a business concern unless the business has a "substantial nexus" or in-state contact established with that state. The two major Supreme Court decisions in the sales tax area are *National Bellas Hess, Inc. v. Illinois Department of Revenue*[10] and *Quill Corp. v. North Dakota*.[11]

In *National Bellas Hess* the Supreme Court held that the state of Illinois could not require the out-of-state mail-order sales company to collect a use tax from Illinois customers. Bellas Hess's only contact with the state was via the mails or common carriers. This contact was found to be insufficient to establish nexus under either the

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[6] Delaware, Montana, New Hampshire, and Oregon do not levy state or local sales taxes. The state of Alaska does not levy a sales tax, but its local jurisdictions are permitted to do so.

[7] Estimates by Vertex Inc., Berwyn, Pennsylvania, May 22, 2000.

[8] John R. Luckey, Legislative Attorney, CRS American Law Division, contributed to this section.

[9] U.S. Const. art. I § 8, cl.3.

[10] 386 U.S. 753 (1967).

[11] 504 U.S. 298 (1992).

Due Process or Commerce Clause of the U.S. Constitution. The Court utilized a "physical presence" standard for nexus for both of these clauses.[12]

In the 25 years between *Bellas Hess* and *Quill* the Supreme Court had clarified the Commerce Clause's four-part test for substantial nexus in *Complete Auto Transit, Inc. v. Brady*.[13] For a state tax to be applied to an activity there must be substantial nexus with the taxing state. The tax must be fairly apportioned. It must not discriminate against interstate commerce. The tax must be fairly related to the services provided by the state.[14]

This clarification became even more significant in the mail-order sales area in the *Quill* decision. In *Quill* the Court, in a case factually similar to *Bellas Hess*, dropped the physical presence test for nexus under the Due Process Clause, requiring only that the seller's efforts be "purposefully directed toward the residents of the taxing State."[15] Therefore the Due Process Clause was no longer an impediment to requiring tax collection by the out-of-state seller. However, the physical presence standard or substantial nexus of the Commerce Clause was reaffirmed.[16] The practical outcome of the *Quill* case was therefore the same as *Bellas Hess:* the state could not force the seller to collect the use tax absent a substantial nexus.

However, the removal of the Due Process Clause as a road block did open the door for Congress, under its commerce powers, to legislatively empower the states to require out-of-state sellers to collect use taxes from the customer and remit the revenues to the buyer's home state. In fact, in *Quill* the Supreme Court specifically invited Congress to act in this area. To date, Congress has chosen not to enact legislation granting states the authority to require out-of-state sellers to collect and remit use taxes.

Report of the Advisory Commission on Electronic Commerce

The Internet Tax Freedom Act also created the Advisory Commission on Electronic Commerce (ACEC) to study a variety of issues related to the taxation of electronic commerce and telecommunications. The Commission presented its final report to Congress on April 12, 2000.[17]

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[12] 386 U.S. 753 (1967). Generally, the Due Process Clause relates to the fairness of the tax burden and whether a business has minimum contacts with the taxing jurisdiction. The Commerce Clause is concerned with the effect of the tax on interstate commerce. Hellerstein, Walter. Supreme Court Says No State Use Tax Imposed on Mail-order Sellers...for Now. 77 *Journal of Taxation* 120 (August 1992). p. 120.

[13] 430 U.S. 274 (1977).

[14] *Id.* at 279.

[15] *Quill* at 312.

[16] *Id.* at 317.

[17] The text of the *Report to Congress* is available on the website of the Advisory Commission on Electronic Commerce [http://www.ecommercecommission.org].

Several bills were introduced in Congress in response to the Advisory Commission's report. Some bills reflect the so-called "majority proposals" drafted by the "Business Caucus" of the Commission and included in the Commission's final report.[18] Other bills reflect the so-called "minority proposals" supported by most (but not all) of the state and local government representatives on the Commission. These proposals were not included in the final report of the Advisory Commission, but have been advanced separately as part of the Streamlined Sales Tax Project, represented by Utah Governor Mike Leavitt, also a member of the Advisory Commission (discussed below in the subsection on "Work through NCCUSL or Streamlined Sales Tax Project").[19]

H.R. 3709 Passed the House

On May 10, 2000, the House approved H.R. 3709, the *Internet Nondiscrimination Act of 2000*, which would have extended the current moratorium on state and local taxation of the Internet for five additional years, until October 21, 2006. The legislation would have eliminated the current law's "grandfather" provision that permits states to continue to levy taxes on Internet access that were already in place at the time the Internet Tax Freedom Act was enacted.

H.R. 3709 also expressed the sense of Congress that, to avoid being characterized as multiple or discriminatory (and consequently subject to the moratorium) a state tax relating to electronic commerce should include 14 listed features. These features relate to simplifying state and local sales and use taxes and standardizing their administration nationwide.[20] While this sense of Congress provision would have had no enforcement authority, it acknowledged the issue of state and local sales tax simplification.

The Senate did not act on Internet tax legislation in the 106th Congress.

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[18] Only a few of the proposals before the Commission received the two-thirds vote needed to qualify as a formal recommendation of the Commission. However, Virginia Governor James Gilmore, chairman of the Advisory Commission, ruled that any proposal receiving votes from a simple majority of the 19 Commission members could be included in the final report, but it would be labeled as a "majority proposal" rather than a "recommendation."

[19] The Streamlined Sales Tax Project is discussed further in the sub-section below on "Simplification of state and local sales and use taxes."

[20] The 14 criteria included in H.R. 3709 are listed in footnote 24 to the sub-section below on "Simplification of state and local sales and use taxes."

Legislation to Regulate State and Local Internet Taxation in the 106th Congress

Listed below are the 13 bills to regulate state and local taxation of the Internet that were introduced in the 106th Congress:[21]

H.R. 3252 (Kasich and Boehner). The *Internet Tax Elimination Act.* Introduced November 8, 1999, and referred to the Committee on the Judiciary and the Committee on Ways and Means.

H.R. 3709 (Cox). The *Internet Nondiscrimination Act of 2000.* Introduced February 29, 2000, and referred to the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law. An amended version passed the House by a vote of 352 to 75 on May 10, 2000.

H.R. 4202 (Ehrlich). The *Internet Services Promotion Act of 2000.* Introduced April 6, 2000, and referred to the Committee on Commerce, Subcommittee on Telecommunications, Trade, and Consumer Protection, and to the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law.

H.R. 4267 (Hyde and Conyers, ACEC majority). The *Internet Tax Reform and Reduction Act of 2000.* Introduced April 13, 2000, and referred to the Committee on the Judiciary. (It puts into legislative language many of the "majority proposals" included in the final report of the Advisory Commission on Electronic Commerce.)

H.R. 4460 (Hyde and Conyers, ACEC minority). The *Internet Tax Simplification Act of 2000.* Introduced May 16, 2000, and referred to the Committee on the Judiciary. (It puts into legislative language many of the "minority proposals" *not* included in the final report of the Advisory Commission on Electronic Commerce.)

H.R. 4462 (Bachus). The *Fair and Equitable Interstate Tax Compact Simplification Act of 2000.* Introduced May 16, 2000, and referred to the Committee on the Judiciary and the Committee on Rules.

S. 328 (Smith, B.). Introduced January 28, 1999, and referred to the Committee on Commerce, Science, and Transportation.

S. 1611 (McCain). Introduced September 22, 1999, and referred to the Committee on Commerce, Science, and Transportation.

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[21] For a fuller description of each bill, see CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress*, by Nonna A. Noto. This report draws upon the state and local tax section of that report, which also covers bills addressing federal and foreign taxation of the Internet.

S. 2028 (Wyden). The *Internet Non-discrimination Act*. Introduced on February 3, 2000, and referred to the Committee on Commerce, Science, and Transportation.

S. 2036 (Smith, B.). Introduced February 7, 2000. Read the second time and placed on the calendar on February 8, 2000. It is identical in language to S. 328.

S. 2255 (McCain). Introduced March 21, 2000, and referred to the Committee on Commerce, Science, and Transportation.

S. 2401 (Gregg and Kohl). The *New Economy Tax Simplification Act (NETSA)*. Introduced April 11, 2000, and referred to the Committee on Finance.

S. 2775 (Dorgan). The *Internet Tax Moratorium and Equity Act*. Introduced June 22, 2000, and referred to the Committee on Finance.

Basic Issues Distinguishing the Bills

There are four major areas of difference among the bills introduced in the 106th Congress. These involve the positions the bills take regarding:

- whether the tax moratorium should be extended, and if so, whether permanently or temporarily, and if temporarily, for how many years;
- whether to continue to grandfather existing Internet access taxes;
- whether to expand the scope of the moratorium to prohibit taxation of digitized goods and services, or possibly all electronic commerce; and
- whether, and under what conditions, to authorize the states to collect sales and use taxes on interstate sales of goods and services arranged over the Internet.

Under each of the subheadings that follows, there is a brief discussion of the issue, followed by mention of the specific bills that take a position on that issue. Some of the bills contain multiple provisions and may therefore be mentioned under more than one subheading.[22] This comparison of the Internet tax bills is summarized in Table 1 at the end of this report.

Extending the Moratorium

The first issue differentiating the Internet tax bills is the position taken on the extension of the current three-year moratorium. The moratorium has two components. One addresses the ability of state or local governments to impose new taxes on "Internet access services." The second addresses their ability to impose any "multiple or discriminatory taxes on electronic commerce." Most bills do not

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[22] Some of the bills contain elements in addition to the ones discussed in this report. See CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress*, by Nonna A. Noto.

distinguish between the two components and would apply the same moratorium extension to both. Some of those bills would extend the moratorium temporarily, by two to five years. Others would make it permanent. A few bills propose a longer moratorium extension for taxes on Internet access than for multiple and discriminatory taxes on electronic commerce.

Opponents of any extension of the moratorium by the 106th Congress argued that there was no need for Congress to take action in 2000 because the moratorium does not expire until October 21, 2001. The initial moratorium gave the states impetus to simplify their sales tax systems. Some are concerned that extending the moratorium will remove the urgency that the current moratorium is imposing on the Streamlined Sales Tax Project (discussed below in the subsection on "Work through NCCUSL or Streamlined Sales Tax Project") to draft model sales tax legislation in time for states' legislative sessions in calendar 2001. Others fundamentally oppose federal involvement in regulating state and local taxation of the Internet.

Some supporters have agreed to a five-year extension of the moratorium. Others want to make the moratorium permanent. The latter includes people concerned about providing businesses with greater tax law certainty and stability within which to plan, as well as people fundamentally opposed to taxation of the Internet. These supporters of extending the moratorium are typically not interested in addressing sales taxation of the Internet.

Still a third group would support an extension of the moratorium, but only if it is combined with a commitment by Congress to address the issue of sales taxation of interstate commerce. Many representatives of states' interests view sales tax simplification as a precursor to having sellers collect taxes on interstate sales. They are concerned that any extension of the moratorium be long enough for the states to accomplish meaningful sales tax simplification, but not so long as to allow the Internet to grow large enough to stop any attempt to tax it. From this vantage point, a five-year extension of the moratorium appears too long.

Temporary extension. Like H.R. 3709 which passed the House, H.R. 4202 (Ehrlich), H.R. 4462 (Bachus), and S. 2255 (McCain) would extend the current moratorium by five years. S. 2775 (Dorgan) would extend the current moratorium by four years. H.R. 4267 (Hyde and Conyers, ACEC majority) would provide a five-year extension to the current moratorium on multiple and discriminatory taxes on electronic commerce, but would make the ban on Internet access taxes permanent. H.R. 4267 also would impose a new five-year moratorium on taxation of digitized goods and products and their nondigitized counterparts. H.R. 4460 (Hyde and Conyers, ACEC minority) would extend the moratorium on taxes on Internet access by five years, but the moratorium on multiple and discriminatory taxes by two years.

Make the moratorium permanent. Three bills would solely make permanent the current three-year federal moratorium on state and local taxes on the Internet enacted in 1998: S. 328 (Smith, B.), S. 2028 (Wyden), and S. 2036 (Smith, B.). Two bills would both make the moratorium permanent and expand the scope of the moratorium to ban any sales and use taxes on electronic commerce: S. 1611 (McCain) and H.R. 3252 (Kasich and Boehner). As mentioned, H.R. 4267 (Hyde and Conyers, ACEC majority) would make the ban on Internet access taxes permanent, but would extend

the moratorium on multiple or discriminatory taxes for five years; it would also impose a new five-year moratorium on taxation of digitized goods and products and their nondigitized counterparts.

Grandfathering Protection for Internet Access Taxes

A second area of difference among the bills is whether or not to continue the grandfathering protection provided by the Internet Tax Freedom Act for state and local taxes on Internet access that were already in place prior to October 1, 1998, at the time of the law's enactment. Removing the grandfathering protection would effectively ban all state and local taxes on Internet access.

Like H.R. 3709 which passed the House, H.R. 3252 (Kasich and Boehner) and H.R. 4267 (Hyde) would remove the grandfathering protection. In contrast, both H.R. 4460 (Hyde and Conyers, ACEC minority) and S. 1611 (McCain) would explicitly continue to grandfather existing taxes on Internet access. Any bill that simply extends the current moratorium or makes it permanent would implicitly extend the grandfathering protection for existing Internet access taxes.

The taxation of Internet access refers to applying state and local taxes (on sales, telecommunications, or gross receipts) to the monthly charge (of approximately $15 to $22) that subscribers pay for access to the Internet through Internet service providers (ISPs) such as America Online (AOL) or MindSpring. Supporters of the moratorium on access taxes and of removing the grandfathering protection view access taxes as a form of double taxation. They point out that the underlying "backbone transmission" telecommunications service that the Internet service provider purchases is already taxed. They also argue that access taxes will raise the price of Internet access, discourage usage, and thereby widen the "digital divide" between those with access to the Internet and those without.

Opponents of the moratorium on access taxes, and therefore of removing the grandfathering protection, believe strongly in each state's autonomy to set its own tax policy. They point out that Internet service providers should be able to claim a sale-for-resale exemption for the taxes they pay on telecommunications services. They argue that as long as other modes of communication such as telephone (which is also used to fax) and cable are subject to tax, the Internet should be taxed similarly, so as not to grant the Internet a competitive pricing advantage. Furthermore, they are concerned that when communications services are bundled and sold as a package, there is a problem of how to distinguish the taxed portion from the untaxed Internet access portion of the communications services package.[23]

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[23] For arguments on both sides of this and other Internet tax issues, see Advisory Commission on Electronic Commerce. *Issues and Policy Options Paper*. Final draft submitted to the Advisory Commission from the Report Drafting Subcommittee. Arlington, Virginia, December 3, 1999. Section II, Tax treatment of Internet Access, p. 6-7. The text of the *Issues and Policy Options Paper* is available on the website of the Advisory Commission on Electronic Commerce [http://www.ecommercecommission.org].

Expanding Scope of Moratorium

A third area of difference among the bills is whether the scope of the moratorium on multiple and discriminatory taxes on electronic commerce would be broadened to explicitly protect electronic commerce from sales and use taxation. A distinction is sometimes made between the tax treatment of digitized goods that are both sold and delivered over the Internet, and more traditional goods and services whose sales are arranged over the Internet but which are delivered by other means, in tangible physical form.

H.R. 4267 (Hyde and Conyers, ACEC majority) would expand the scope of the moratorium to include taxes on sales of digitized goods and products – and their non-digitized counterparts. This would approach the goal of a "level playing field," or nondiscriminatory tax treatment between electronic and tangible goods and services, *not* by extending the sales tax to digitized products, but instead by removing from the sales tax base non-digitized counterparts that currently are subject to tax, such as books, videos, and music CDs.

S. 1611 (McCain) and H.R. 3252 (Kasich and Boehner) would expand the moratorium to ban any sales and use taxes "...for domestic or foreign goods or services acquired through electronic commerce." This would apply to any products or services purchased over the Internet, whether they are delivered over the Internet in digital form, or delivered otherwise in tangible physical form.

The bans in all three of these bills would, to a lesser or greater extent, pre-empt existing state authority to tax tangible goods. The bans on taxation would apply to within-state as well as interstate sales. They would pre-empt existing state authority:

- to have sales taxes collected by e-commerce vendors on within-state sales to individuals and businesses;
- to have businesses pay use taxes on their e-commerce purchases from out-of-state; and
- for states to make efforts to collect use taxes from resident individuals on their out-of-state purchases over the Internet.

Collecting Sales and Use Taxes on Internet Transactions

A fourth area of difference among the bills is whether Congress would use its power under the Commerce Clause to help states collect use taxes on interstate sales of goods and services arranged over the Internet. This is probably the most complex and controversial of the Internet tax issues discussed in this report.

Several bills propose guidelines for simplifying state and local sales taxes. However, some pursue tax simplification as a means to encourage a system of voluntary compliance by remote sellers. Other bills provide a formal mechanism in the form of an interstate compact under which Congress would grant states the authority to require out-of-state sellers to collect and remit use taxes if the states complied with certain criteria for sales tax simplification.

Simplification of state and local sales and use taxes. There appears to be widespread agreement that states need to simplify and standardize their systems of state and local sales and use taxes if they hope to improve collection of use taxes on interstate sales made to their residents. In addition to Internet sales, this concern applies to interstate sales arranged by mail order, telephone, face-to-face, or other means. The perceived need for administrative simplification applies regardless of whether collection is to occur on a voluntary basis by remote sellers or through Congress authorizing the states to require sellers to collect.

Reflecting the general consensus on the need for simplification, four other bills include, with some small variations, the same list of 14 criteria for simplification and uniformity included in H.R. 3709 which passed the House.[24] These are H.R. 4267 (Hyde and Conyers, ACEC majority), H.R. 4460 (Hyde and Conyers, ACEC minority), H.R. 4462 (Bachus), and S. 2775 (Dorgan).

Uniform state-wide rate or local-option rate. One of the commonly mentioned goals for a simplified sales tax system is that each state have a single, uniform, statewide use tax rate applicable to all remote sales (purchases made from out-of-state).[25] An average local sales tax rate could be added to the state rate. But out-of-state sellers could only be expected to apply one combined tax rate to a purchase by a customer from any locality in a given state. That is, remote sellers would not be

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[24] The 14 sales and use tax simplification criteria listed in H.R. 3709 are:
(1) a centralized, one-stop, multi-state registration system for sellers;
(2) uniform definitions for goods or services that might be included in the tax base;
(3) uniform and simple rules for attributing transactions to particular taxing jurisdictions;
(4) uniform rules for the designation and identification of purchasers exempt from the non-multiple and non-discriminatory tax system, including a database of all exempt entities and a rule ensuring that reliance on such database shall immunize sellers from liability;
(5) uniform procedures for the certification of software that sellers rely on to determine non-multiple and non-discriminatory taxes and taxability;
(6) uniform bad debt rules;
(7) uniform tax returns and remittance forms;
(8) consistent electronic filing and remittance methods;
(9) state administration of all non-multiple and non-discriminatory taxes;
(10) uniform audit procedures;
(11) reasonable compensation for tax collection that reflects the complexity of an individual state's tax structure, including the structure of its local taxes;
(12) exemption from use tax collection requirements for remote sellers falling below a specified de minimis threshold;
(13) appropriate protections for consumer privacy; and
(14) such other features that the member states deem warranted to remote [sic, instead of promote] simplicity, uniformity, neutrality, efficiency, and fairness.

These features reflect considerations raised in the Advisory Commission on Electronic Commerce's *Report to Congress* as well as efforts currently underway under the Streamlined Sales Tax Project sponsored by the National Governors' Association and other state and local umbrella groups.

[25] One rate per state is not, however, one of the 14 simplification criteria listed in the preceding footnote.

expected to administer the varying local-option taxes particular to different cities or counties in a state.

The findings section of H.R. 4460 (Hyde and Conyers, ACEC minority) would have the state administer all taxes and distribute revenues to subdivisions of the state "according to precedent and applicable State law." None of the other bills addresses how states would distribute the local portion of the use tax collections among their local governments.

Some local government representatives want to leave open the possibility of having remote sellers collect the actual local tax levy. They argue that computer software is, or will soon be, available to make that feasible at a reasonable administrative cost. S. 2775 (Dorgan) provides that a remote seller has the annual option of collecting the actual applicable state and local use tax rate, as an alternative to collecting a single, uniform, statewide rate.

Work through NCCUSL or Streamlined Sales Tax Project. The bills supporting sales tax simplification may differ in terms of which of two organizations they endorse to oversee the simplification effort – the National Conference of Commissioners on Uniform State Laws (NCCUSL) or the Streamlined Sales Tax Project (SSTP).

NCCUSL is a long-standing non-profit association, founded in 1892. Through NCCUSL, the commissioners of uniform state laws from each state join together to promote uniformity in laws among the states. They study existing laws and then draft and propose specific model statutes or uniform legal codes in areas of the law where uniformity seems desirable. NCCUSL is perhaps best known for developing the Uniform Commercial Code (UCC). For a uniform code proposed by NCCUSL to take effect, it must be approved by individual state legislatures. It may be adopted either exactly as written or adapted to the particular preferences of a state. Drafting and enacting a uniform act is typically a lengthy process. For example, it took 10 years for the NCCUSL to draft the Uniform Commercial Code and another 14 years before it was enacted by states across the country.[26] H.R. 4267 (Hyde and Conyers, ACEC majority), H.R. 4460 (Hyde and Conyers, ACEC minority), and S. 2775 (Dorgan) call upon the involvement of NCCUSL in the simplification of the sales tax system.

The Streamlined Sales Tax Project (SSTP) is an ad hoc effort that began in September 1999 as an outgrowth of the proposals of the "minority" on the Advisory Commission on Electronic Commerce, which included most of the commission members representing state and local governments. The SSTP is a voluntary, cooperative effort among state governments. The project has two main components. One is to simplify state and local sales and use taxes and standardize their administration among the states. The other is to identify both the computer software and a financial transmission system that could be used to implement the collection of

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[26] More information about The National Conference of Commissioners on Uniform State Laws is available on their Web site [http://www.nccusl.org].

use taxes on out-of-state sales at a reasonable cost, for which vendors could be compensated by the states.

The original motivating purpose of the Streamlined Sales Tax Project was to get the states to reduce the complexity of their sales tax systems sufficiently that remote sellers would be willing to voluntarily collect and remit use taxes on out-of-state sales. Perhaps longer term, then, Congress might be willing to authorize states to require use tax collection by remote sellers, once it was convinced that administrative compliance costs for sellers had been reduced to a reasonable level.

As of August, 2000, 26 states had formally joined the SSTP, and 11 other states were participating as observers.[27] The SSTP has been holding meetings with the aim of formulating model legislation by December 2000, in time to present to state legislatures for enactment during 2001. The SSTP was also planning to conduct a pilot project, beginning in October 2000, to test the capabilities of existing tax collection software under current sales tax law.[28] H.R. 4462 (Bachus) encourages the states to work voluntarily through the Streamlined Sales Tax Project.

Voluntary versus required collection by interstate sellers. Some of the Internet tax bills would simply endorse sales tax simplification as a means of encouraging voluntary cooperation by sellers. Other bills would have Congress grant a state the authority to require out-of-state sellers to collect and remit use taxes to the buyer's home state if that state meets certain criteria for simplifying its sales and use tax system. H.R. 3709 which passed and H.R. 4267 (Hyde and Conyers, ACEC majority) endorse simplification of state and local sales and use taxes, but do not offer the states authority to require collection.

In contrast, H.R. 4460 (Hyde and Conyers, ACEC minority), H.R. 4462 (Bachus), and S. 2775 (Dorgan) provide a mechanism in the form of a multi-state compact through which Congress would grant a participating state the authority to require collection if the state conformed with certain simplification requirements. Under H.R. 4460 (Hyde and Conyers, ACEC minority) collection authority would be conferred on any state adopting the simplification requirements. Alternatively, under S. 2775 (Dorgan) and H.R. 4462 (Bachus), the compact would take effect automatically once signed by 20 states and sent to Congress, if Congress did not take

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[27] The 26 states formally participating in the Streamlined Sales Tax Project are Arkansas, Florida, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, West Virginia, Wisconsin, and Wyoming. Forty-five states and the District of Columbia levy sales and use taxes. Letter from officials of the National Conference of State Legislatures to the congressional leadership, August 30, 2000. Available online from Bureau of National Affairs (BNA), Tax Core, Primary Source Materials (Congressional Letters), August 31, 2000. Reported in: Bennett, Alison. Electronic Commerce: NCSL Urges Hill Leaders Not to Attach Internet Tax Ban Extension to Larger Bills. Bureau of National Affairs, Daily Tax Report, no. 170, August 31, 2000. p. G-3 to G-4.

[28] More information about the Streamlined Sales Tax Project is available on their Web site [http://www.streamlinedsalestax.org] or [http:www.geocities.com/streamlined2000/].

action to *disapprove* the compact.[29] However, some Members believe that Congress must retain the authority to review and actively *approve* any simplification compact before authorizing the states to require remote sellers to collect taxes.

Codify nexus standards. Some business representatives would like Congress to clarify and codify situations in which use of the Internet (as a means of communication and sales solicitation) would *not* be considered physical presence and therefore would *not* establish a business's substantial nexus in a state for tax purposes.[30] While most discussion of Internet taxation has focused on sales taxation, many businesses engaged in interstate commerce are perhaps more concerned about compliance with business activity taxes (e.g., income, gross receipts, and franchise taxes) in more than one state.[31] In addition to tax liability and reporting requirements, having substantial nexus in a state exposes businesses to the possibility of audits, litigation, and appeals by that state.

Two of the Internet tax bills offer new nexus guidelines for physical presence that would apply to state and local business activity taxes as well as sales and use taxes. They provide taxation "safe harbors" for certain Internet activity, as well as protection for certain traditional, non-Internet sales solicitation arrangements. The two bills list somewhat different business activities that would *not* constitute physical presence. Codifying new nexus guidelines is one component of H.R. 4267 (Hyde and Conyers, ACEC majority), but it is the sole purpose of S. 2401 (Gregg and Kohl).

H.R. 4267 would amend the *Internet Tax Freedom Act*. It would codify nine factors that would not establish sufficient nexus for states to collect a sales or income tax from remote (out-of-state) vendors. Critics consider two of these requests particularly aggressive. One is that customers could receive repair or warranty services in their home state, by or on behalf of an out-of-state seller, on property purchased from that out-of-state seller. The other is that customers could return goods or products purchased over the Internet or through a mail order catalogue to an affiliated party's physical location within their home state.

Critics are also concerned that exempting the affiliation of an out-of-state seller with a person that is physically present and paying taxes in the state would condone the practice of having tax-free Internet kiosks operated by "dot-com subsidiaries"

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[29] Under H.R. 4460 (Hyde and Conyers, ACEC minority) the Secretary of the Treasury would need to certify the simplified system; any state that adopted it could require collection by remote sellers. Under S. 2775 (Dorgan) the compact could take effect automatically once signed by 20 states and sent to Congress, if the Congress did not take action within 120 days to disapprove it. Under H.R. 4462 (Bachus) the compact could take effect automatically once it was signed by 20 states and submitted to the President, its streamlined system was approved by a report from the President to the Congress, and if the Congress did not within 90 days pass a joint resolution (whose language is detailed in the bill) disapproving the system.

[30] This is commonly referred to as establishing "bright-line" nexus standards.

[31] H.R. 2401 defines business activity taxes to include a tax imposed on or measured by net income, a business license tax, a business and occupation tax, a franchise tax, a single business tax, a capital stock tax, or any similar tax or fee imposed by a state. Business activity taxes also include taxes on apportioned corporate net income.

located within traditional retail stores. Critics also point out that exempting the presence of intangible property in a state could protect out-of-state financial institutions from being taxed on their various operations in a state.

S. 2401 would amend a federal statute, 15 U.S.C. 381 et seq., enacted by P.L. 86-272 in 1959. This law prohibits state and local taxes on net income from interstate commerce if the business's only activity in the state was the solicitation of orders, and if those orders were sent outside the state for approval or rejection and filled by shipment from a point outside the state. S. 2401 provides that a state or local government may not impose a business activity tax, or the duty to collect and remit sales or use taxes, on income earned from interstate commerce, unless that person has a "substantial physical presence" (defining a new term) in the taxing state.

S. 2401 lists eight business activities which are *not* sufficient to establish substantial physical presence.[32] These differ somewhat from the factors listed in H.R. 4267. For example, the exempted list includes the ability to receive warranty services but not the ability to return products. It includes the presence of intangible property, but goes further to list numerous specific examples. It specifies the use of the Internet to maintain a World Wide Web site accessible in the state and the use of the Internet to take and process orders via a web page on a computer physically located in the state. Building upon P.L. 86-272, S. 2401 emphasizes the solicitation of orders. It distinguishes between an out-of-state seller having a formal "agency relationship" with an in-state sales solicitor, which would qualify as physical presence, and an independent contractor relationship, which would not.

Supporters say that S. 2401 would merely codify the standard set forth by the U.S. Supreme Court in *Quill v. North Dakota*. But state and local governments generally oppose federal efforts to codify nexus standards, which they view as unduly restricting states' ability to levy business activity (income) taxes as well as sales and

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[32] The business activities listed in S. 2401 that would not constitute substantial physical presence include:
(1) the solicitation of orders or contracts which are approved or rejected outside the state and filled by shipment from outside the state; this includes orders by a person or in the name of a prospective customer of the person, or by an independent contractor working on behalf of such person;
(2) the presence or use of intangible personal property in a state, including patents, copyrights, trademarks, logos, securities, contracts, money, deposits, loans, electronic or digital signals, and web pages;
(3) the use of the Internet to create or maintain a World Wide Web site accessible by persons in the state;
(4) the use of the Internet to take and process orders via a web page or site on a computer physically located in the state;
(5) the use of any service provider for the transmission of communications (whether by cable, satellite, radio, telecommunications, or other similar system);
(6) the affiliation with a person located in the state unless that is the person's agent and the activity of the agent constitutes substantial physical presence; and
(7) the use of an unaffiliated representative or independent contractor in the state to perform warranty or repair services on property sold by a person located outside the state.

(The above list includes 7 rather than 8 entries because item 1 here incorporates the first two items in S. 2401.)

use taxes.[33] One critic describes S. 2401 as depriving states of jurisdiction to tax just about any interstate activity, whether the Internet is involved or not.[34, 35]

Table 1. Comparison of Internet Tax Bills on Four Distinguishing Issues

Bill number (sponsor)	Extension of moratorium	Grandfather Internet access taxes	Expand scope of moratorium	Taxation of interstate sales
H.R. 3252 (Kasich)	Permanent	Eliminate	Ban any sales and use taxes on e-commerce	--
H.R. 3709 (Cox) passed House 5/10/00	5 years, until 10/21/06	Eliminate	--	Endorses simplification of state sales taxes, but does not offer states authority to require collection. Lists simplification criteria.
H.R. 4202 (Ehrlich)	5 years, until 10/21/06	--	--	--
H.R. 4267 (Hyde and Conyers, ACEC majority)	Extend moratorium on multiple or discriminatory taxes for 5 years, until 10/21/06	Eliminate. Permanent ban on Internet access taxes.	Impose new moratorium on taxation of digitized goods and products and their non-digitized counterparts, until 10/21/06	Codify e-commerce nexus guidelines on physical presence. Applicable to business activity or income taxes as well as sales taxes. Endorses simplification of state sales taxes, but does not offer states authority to require collection. Lists simplification criteria. Works with NCCUSL.

[33] Kessler, Martha. FTA Opposes Nexus Change Bill, Favors Expansion of Sales Tax Collection Duty. Bureau of National Affairs, *Daily Tax Report*, no. 113, June 12, 2000. p. G-5. This refers to S. 2401.

[34] Sheppard, Lee A. Business Taxpayers Resist State Tax Nexus in Courts and Congress, *Tax Notes*, vol. 87, no. 6, May 8, 2000. p. 740-47.

[35] For a heated debate on the jurisdictional standards proposal, see Sheppard, Doug, Dean Andal, and Michael Maserov. California's Andal, CBPP's Maserov Go Head-To-Head on E-Commerce. *State Tax Notes*. Tax Analysts Doc. 1999-38291, November 30, 1999. Dean Andal is chairman of the California State Board of Equalization. Andal was a member of the Advisory Commission on Electronic Commerce and the prime supporter of the proposal to codify jurisdictional standards, embodied in S. 2401. Michael Mazerov, a senior policy analyst for the Center on Budget and Policy Priorities, is critical of the proposal.

Table 1. Comparison of Internet Tax Bills on Four Distinguishing Issues

Bill number (sponsor)	Extension of moratorium	Grandfather Internet access taxes	Expand scope of moratorium	Taxation of interstate sales
H.R. 4460 (Hyde and Conyers, ACEC minority)	Extend moratorium on Internet access taxes 5 years, until 12/31/06, and on multiple and discriminatory taxes 2 years, until 12/31/03	Explicitly continues	--	Congress would grant states participating in a multistate compact the authority to require collection if the state conformed with certain simplification requirements. Lists simplification criteria. Works with NCCUSL.
H.R. 4462 (Bachus)	5 years, until 10/21/06	--	--	Congress would grant states joining a multistate compact the authority to require tax collection if the state conformed with certain simplification requirements. Lists simplification criteria. Works through the Streamlined Sales Tax Project.
S. 328 (Smith, B.)	Permanent	--	--	--
S. 1611 (McCain)	Permanent	Explicitly continues	Ban any sales and use taxes on e-commerce	--
S. 2028 (Wyden)	Permanent	--	--	--
S. 2036 (Smith, B.)	Permanent	--	--	--
S. 2255 (McCain)	5 years, until 12/31/06	--	--	--

Table 1. Comparison of Internet Tax Bills on Four Distinguishing Issues

Bill number (sponsor)	Extension of moratorium	Grandfather Internet access taxes	Expand scope of moratorium	Taxation of interstate sales
S. 2401 (Gregg and Kohl)	--	--	--	Codify e-commerce nexus guidelines defining "substantial physical presence." Applicable to business activity taxes as well as sales taxes.
S. 2775 (Dorgan)	4 years, until 12/31/05	--	--	Congress would grant states joining a multistate compact the authority to require collection if the state conformed with certain simplification requirements. Lists simplification criteria. Works with NCCUSL.

For Additional Information

CRS Reports

CRS Report RS20426. *Electronic Commerce: An Introduction*, by Glenn J. McLoughlin.

CRS Report RL30435. *Internet and E-Commerce Statistics: What They Mean and Where to Find Them on the Web*, by Rita Tehan.

CRS Report RL30412. *Internet Taxation: Bills in the 106th Congress*, by Nonna A. Noto.

CRS Report RL30431. *Internet Transactions and the Sales Tax*, by Steve Maguire.

CRS Report RS20577. *State Sales Taxation of Internet Transactions*, by John R. Luckey.

Other Resources Available on the World Wide Web

Advisory Commission on Electronic Commerce. Internet Home Page. [http://www.ecommercecommission.org]

For coverage of arguments generally against applying current sales and use taxes to sales made over the Internet, see:

e-Freedom Coalition. Internet Home Page. [http://www.e-freedom.org]

Representative Christopher Cox's Office. Internet Tax Freedom Act Home Page. [http://www.house.gov/cox/nettax]

For coverage of arguments generally in support of applying current sales and use taxes to sales made over the Internet, see:

National Conference of State Legislatures (NCSL). Internet address. [http://www.ncsl.org/programs/fiscal/tctelcom.htm].

National Governors' Association (NGA). Internet address. [http://www.nga.org/Internet/equality.asp].

Streamlined Sales Tax Project (SSTP). Internet Home Page. [http://www.streamlinedsalestax.org] or [http://www.geocities.com/streamlined2000/]