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State Sales Taxation of Internet Transactions

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Summary

There are at least two common misconceptions in the area of State taxation of Internet transactions. Contrary to popular opinion, (1) States do have the power to impose a sales tax on sales that are accomplished via the Internet even after the enactment of the Internet Tax Freedom Act in 1998 and (2) States do have the power to tax transactions where the seller is located outside of the State and has no real connection with the State. The Internet Tax Freedom Act placed a three year moratorium only on imposition of **new** taxes on "Internet access services" (existing taxes on access services were grandfathered) or any "**multiple** or **discriminatory** taxes on electronic commerce" by State or local governments, not on application of a general sales tax to such transactions. In the 106th Congress, the House passed H.R. 3709 which would have extended the moratorium for five years and repealed the grandfather provision for existing taxes on Internet access services. The Senate took no action on this bill.,

Under current law a State may tax a transaction if there is some connection of the transaction to the State. Thus if the seller or the buyer is located in the State, the transaction may be subject to the State's sales tax. The important question in the out-of-State seller context is not the State's power to tax the transaction, but rather does the out-of-State seller have sufficient nexus to the State so that the State can require the out-of-State seller to collect the sales tax from the purchaser. H.R. 3709 did not address the nexus issue.

This report briefly examines two common misconceptions in the area of State taxation of Internet transactions. These misconceptions are: (1) the Internet Tax Freedom Act of 1998[1] placed a moratorium on a State's power to impose a sales tax on sales that are accomplished via the Internet; and (2) States may not tax transactions where the seller is located outside of the State and has no real connection to the State.

[1] The Internet Tax Freedom Act comprises Titles XI and XII of Division C of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, P.L. 105-277, 112 Stat. 2681 (1998).

Moratorium

The Internet Tax Freedom Act placed a three year moratorium on imposition of new taxes on "Internet access services" or any "multiple or discriminatory taxes on electronic commerce" by State or local governments.[2] In other words, States may not (during the moratorium period) enact a sales tax which applies only to Internet transactions or taxes Internet transactions at a different rate than other transactions. It may apply a sales tax which is imposed on sales equally without regard to the medium (face to face, mail order, or internet). The Act specifically states that:

> .....nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.[3]

In the 106th Congress, The House passed H.R. 3709, which would have extended the moratorium for five years and repealed the exemption for existing taxes on Internet access services.[4]

Out-of-State Sellers

A State may tax a transaction if there is some connection of the transaction to the state. Thus if the seller or the buyer is located in the State, the transaction may be subject to the sales tax. The important question in the out of State seller context is not the State's power to tax the transaction, but rather can the State require the out of State seller to collect the sales tax from the purchaser.[5]

The Due Process[6] and Commerce[7] Clauses of the United States Constitution limit a State from imposing tax liability or collection responsibilities on a business concern unless there is a substantial nexus or in-state contact established with the State. There is currently no statutory authority and scant case law on the subject of nexus and the internet, but the Supreme Court has given considerable guidance in the analogous area of taxation

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[2] *Id.* at § 1101(a). The moratorium expires on October 21, 2001.

[3] *Id.* at § 1101(b).

[4] H.R. 3709 was reported to the House on May 4, 2000 (H.Rept. 106-609) and passed the House on May 10, 2000 (146 CONG. REC. H2821 (daily ed. May 10, 2000)(record vote no. 159)).

[5] Several States impose a duty on the in-State buyer to report the purchase from an out-of-State seller and remit the sales tax. Needless to say, compliance with these requirements is very low.

[6] U.S. Const. amend. XIV § 1.

[7] U.S. Const. art. I § 8, cl.3.

of mail order sales. The two major Supreme Court decisions in this area are *National Bellas Hess, Inc. v. Illinois Department of Revenue*,[8] and *Quill Corp. v. North Dakota*.[9]

In *National Bellas Hess* the Supreme Court held that the State of Illinois could not require an 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 Due Process or Commerce Clause. The Court utilized a physical presence standard for nexus for both of these clauses.[10]

In the twenty-five years between *Bellas Hess* and *Quill* the Supreme Court had clarified the Commerce Clause's four part test in *Complete Auto Transit, Inc. v. Brady*.[11] 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.[12]

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."[13] 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 requirement of the Commerce Clause was reaffirmed.[14] Therefore the practical out come of the case was the same as *Bellas Hess*. The State could not force the seller to collect the tax absent a substantial nexus.

The removal of the Due Process Clause as a road block did open a door for Congress, under its commerce powers, to legislatively empower the States to require the collection of these taxes. The Supreme Court, in *Quill*, specifically invited Congress to act in this area. To date, Congress has chosen not to enact legislation in this area.

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[8] 386 U.S. 753 (1967).

[9] 504 U.S. 298 (1992).

[10] 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. Walter Hellerstein, *Supreme Court Says No State Use Tax Imposed on Mail-order Sellers...for Now*, 77 J. Tax'n 120, 120 (Aug. 1992).

[11] 430 U.S. 274 (1977).

[12] *Id.* at 279.

[13] *Quill* at 312.

[14] *Id.* at 317.

Other CRS Products

CRS Report RL30667, *Internet Tax Legislation: Distinguishing Issues*, by Nonna A. Noto
CRS Report RL30431, *Internet Transactions and the Sales Tax*, by Steve Maguire.
CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress*, by Nonna A. Noto.
CRS Report 95-655 C, *Taxation of Mail Order Sales: A Fact Sheet*, by Arnold Solomon. (May 26, 1995).
CRS Report 92-487A, *Quill v. North Dakota: The Mail Order Tax Case*, by Thomas B. Ripy. (June 8, 1992).