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State Sales Taxation of Internet Transactions

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Summary

This report examines state taxation of Internet transactions as well as efforts to achieve uniform state sales and use tax treatment. There are at least two common misconceptions in the area of state taxation of Internet transactions. Contrary to popular belief, (1) states do have the power to impose a sales tax on in-state 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 of their own residents 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. The Internet Tax Nondiscrimination Act of 2001 extended this moratorium through November 1, 2003. In the 108th Congress, the moratorium was allowed to expire. But in its closing days, the moratorium was extended, retroactively from November 1, 2003, until November 1, 2007.

In addition to Congress, other stakeholders are involved in Internet taxation issues. The Streamlined Sales Tax Project, which claims the involvement of 39 states and the District of Columbia, aims to achieve a more uniform sales and use tax scheme. While the Project's aim does not specifically pertain to Internet access taxes, it is inextricably related and has been widely discussed. Congressional action would be required to implement the Project's plan to require sellers to collect sales and use taxes based upon the buyer's home state rates.

This report examines state taxation of Internet transactions, including certain misconceptions surrounding such taxation, as well as efforts to achieve uniform state sales and use tax treatment. It is important to recognize the distinction between Internet access (Internet service) taxes as opposed to sales taxes imposed on Internet purchases. With regard to state sales tax, two commonly held 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. In reality, states still have the power to impose a sales tax on in-state sales that are accomplished via the Internet. Similarly, states have the power to tax transactions of their own residents where the seller is located outside of the state and has no real connection with the state.

State governments depend on sales and use taxes for nearly one-third (32.3%) of their total tax revenue.[2] The traditional method of collecting sales tax has been by the "brick and mortar" retailer, who collects the tax from the purchaser and then remits the money to a state tax agency on a periodic basis. This method has broken down in the out-of-state seller context because the seller, whether mail order or Internet sales, having no substantial nexus to the state is under no enforceable obligation to collect sales tax.[3]

Moratorium

The Internet Tax Freedom Act placed a three-year moratorium on the imposition of new taxes on "Internet access services" or any "multiple or discriminatory taxes on electronic commerce" by state or local governments.[4] In pertinent part, the act defined "discriminatory tax" as imposing "an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means."[5] Accordingly, during the moratorium period states were not permitted to impose a tax on charges to access the Internet nor tax Internet purchases to different persons or entities or at a rate different than purchases made through other mediums (such as traditional "brick and mortar" stores). states that had such an access tax already in place and enforced it as of October 1, 1998, maintained their ability to impose such a tax through a grandfather clause.[6] It remained permissible to apply a sales tax which is administered equally without regard to the medium (face-to-face, mail order, or Internet). The act specifically stated 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

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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 of 1999, P.L. 105-277, §§ 1100 et seq. (1998).

[2] CRS Report RL31252, *Internet Commerce and State Sales and Use Taxes Transactions*, by Steve Maguire, citing U.S. Bureau of the Census, "Summary of State and Local Government Tax Revenue." Currently, 45 states and the District of Columbia impose a sales tax. Only Delaware, New Hampshire, Oregon, Montana, and Alaska do not collect sales tax.

[3] *Quill v. North Dakota*, 504 U.S. 298 (1992).

[4] P.L. 105-277, § 1101(a). The moratorium was originally set to expire on October 21, 2001.

[5] P.L. 105-277, § 1104(2)(a)(iii).

[6] P.L. 105-277, § 1101(a)(1). Ten states and the District of Columbia qualified for this exemption. Currently, only 7 of these impose a sales and use tax on Internet access. See CRS Report RL31929, *Internet Tax Bills in the 108th Congress*, by Nonna A. Noto.

> 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.[7]

The Internet Tax Freedom Act also created the Advisory Commission on Electronic Commerce.[8] The Advisory Commission was tasked with studying "federal, state and local, and international taxation and tariff treatment of transactions using the Internet and Internet access" and reporting its findings to Congress within 18 months.[9] In April of 2000, the Commission's Report to Congress included formal findings and recommendations as well as major policy proposals.[10] Formal findings and recommendations consisted of encouraging initiatives to bring Internet access to lower-income individuals, exploring the privacy implications of Internet taxation, and making permanent the standstill on international Internet taxes and tariffs.[11] The policy proposals included rendering permanent the moratorium on transaction taxes on the sale of Internet access and clarifying which factors establish a seller's physical presence in a state for purposes of determining nexus.[12]

The Internet Nondiscrimination Act of 2001 extended the moratorium imposed by the Internet Tax Freedom Act an additional two years, until November 1, 2003.[13] The 108th Congress originally allowed the moratorium to expire and then, more than a year later, reimposed it retroactively in the Internet Nondiscrimination Act.[14] This act extended the moratorium for four years (November 1, 2003 to November 1, 2007); expanded the definition of "Internet access" to include both providers and buyers of Internet access; grandfathered until November 1, 2007 state Internet access taxes which had been enforced before October 1, 1998;[15] grandfathered until November 1, 2005 state Internet access taxes which had been enforced before November 1, 2003;[16] and excluded from the moratorium state taxes on voice or simalar service utilizing Internet Protocol and all Texas access taxes.

Out-of-State Sellers

When discussing Internet access taxes, a discussion of state sales tax on Internet purchases inevitably ensues. A state may tax a transaction if there is some connection (a nexus) of the transaction to the state. Thus if the seller or the buyer is located in the

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[7] *Id.* at § 1101(b).

[8] P.L. 105-277, § 1102(a).

[9] *Id*. at § 1102(g)(1).

[10] Advisory Commission "proposals" are positions that received a simple majority vote of the Commissioners, while a "finding and recommendation" of the Commission required approval from two-thirds of the commissioners.

[11] Advisory Commission on Electronic Commerce, *Report to Congress*, April 2000. p.4.

[12] *Id*. at p.5.

[13] P.L. 107-75.

[14] P.L. 108-435.

[15] Wisconsin was only grandfathered through November 2006.

[16] Primarily taxes on DSL Internet access.

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 whether the state can require the out-of-state seller to collect the tax from the purchaser.[17]

The Due Process[18] and Commerce[19] 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 of mail order sales. The two major Supreme Court decisions in this area are *National Bellas Hess, Inc. v. Illinois Department of Revenue*,[20] and *Quill Corp. v. North Dakota*.[21]

In the 1967 *National Bellas Hess* decision, 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.[22]

Ten years after *Bellas Hess*, the Supreme Court set out a four part test in *Complete Auto Transit, Inc. v. Brady*[23] for determining whether a state tax is compatible with the Commerce Clause. 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.[24]

This clarification became more significant in the mail-order sales area after the 1992 *Quill* decision. In *Quill*, a case factually similar to *Bellas Hess*, the Court 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."[25]

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[17] Several states impose a duty on the in-state buyer to report the purchase from an out-of-state seller and remit the use tax.

[18] U.S. Const. amend. XIV § 1.

[19] U.S. Const. art. I § 8, cl.3.

[20] 386 U.S. 753 (1967).

[21] 504 U.S. 298 (1992).

[22] 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).

[23] 430 U.S. 274 (1977).

[24] *Id.* at 279.

[25] *Quill* at 312.

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.[26] Therefore the practical outcome 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 not enacted legislation in this area.

Streamlined Sales Tax Project

One of the objections to requiring out-of-state sellers to collect state sales tax is that there are many different sales tax rates (from state-to-state) as well as multiple sales tax rates within an individual state based on the type of good being sold or the locality where the tax is collected. The Streamlined Sales Tax Project (SSTP) is an effort now underway to address, at least in part, these concerns.

SSTP is comprised of thirty-nine states and the District of Columbia. According to the SSTP's website,[27] its goals are to establish uniform tax base definitions; simplify tax rates by allowing only one state rate (with limited exceptions); impose uniform sales and use tax exemptions; create uniform and limited audit procedures for sellers; and have states fund some of the required technology improvements. Many states currently employ a variety of sales tax rates, depending on what the type of purchase is (i.e. goods, food, prescription drugs, etc.). Local governments within states are also able to impose sales taxes, and often do so with a similar variety of rates. The SSTP would limit states to one sales tax rate per state, with the possibility of an exception (different rate) for food and drugs. Local jurisdictions would be allowed one local rate. Additionally, the SSTP would mandate that states and their local governments use a common tax base, and eliminate the widely imposed requirement that businesses file tax returns with local governments.

The coalition states working together are known as the Streamlined Sales Tax Implementing States (SSTIS). This group approved model legislation, the Streamlined Sales and Use Tax Agreement, on November 12, 2002. Ten states representing 20% of the population of sales tax states must conform for the agreement to come into effect (not clear whether states must actually be conforming in operation or just approve conforming).[28] SSTP claims thirty-four states, and the District of Columbia, have approved the agreement and twenty have enacted some form of conforming legislation.[29] The next step is for the participating states would be to ask Congress for the permission to compel out-of-state vendors to collect sales and use taxes once the states have implemented the simplified system by approving the agreement and enacting conforming

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[26] *Id.* at 317.

[27] [http://www.streamlinedsalestax.org].

[28] *Id.*

[29] *Id.*

legislation. In the 108th Congress bills were introduced which would have authorized participating states to require sellers to collect sales and use taxes based upon the buyer's home state rates.[30]

Successful implementation of the SSTP will rely largely on technology to simplify the administration of sales and use taxes. It envisions providing sellers (retailers) the opportunity to employ one of three technology models to ease and modernize administration. Model 1 consists of a Certified Service Provider, paid for by the states, which performs all of the seller's sales tax functions. Model 2 is a Certified Automated System which provides only the tax calculation function. The third option would be for the seller (typically large nationwide retailers) to develop their own system and have it certified by the SSTP.

CRS Products

CRS Report RL31929, *Internet Tax Bills in the 108th Congress*, by Nonna A. Noto.

CRS Report RL31177, *Extending the Internet Tax Moratorium and Related Issues*, by Nonna A. Noto.

CRS Report RL31252, *Internet Commerce and State Sales and Use Taxes*, by Steven Maguire.

[30] *See*, H.R. 8184 and S. 1736 of the 108th Congress.