

# INTERNET VIRTUAL STORES AND THE FUTURE OF INTERSTATE TAXATION

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## I. INTRODUCTION

Until the modern emergence of e-commerce and online “virtual stores,” many products and services purchased daily by consumers in the United States have been subject to some type of state and local sales tax. Typically, sales tax placed on retail transactions will vary in their rates depending on where the transaction occurred<sup>1</sup> and usually reflect priorities in policy and spending decisions<sup>2</sup> made at state and local levels of government.<sup>3</sup> Consequently, current infrastructures for tax collection and distribution by states<sup>4</sup> are grounded principally on traditional retail operations because of accessibility to the public and their physically static location.<sup>5</sup>

However, e-commerce presents new and more sophisticated challenges to the traditional sales tax paradigm and complicates both collection mechanisms and jurisdictional tax authority held by the states.<sup>6</sup> The immense effects of e-commerce have also caused novel legislative demands to surfaced, even requiring such progressive measures as defining the

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<sup>1</sup> See Sales Tax Institute, Sales and Use Tax Rates, at <http://salestaxinstitute.com/sales-tax-rates.html> (last visited Sept. 28, 2003). State sales tax rates vary between zero percent in Alaska, Delaware, Montana, New Hampshire and Oregon, with only Alaska containing localities that impose a sales tax, to seven percent in Mississippi and Rhode Island, however these two states impose very low local sales tax rates, zero percent for Rhode Island and between zero percent and 0.25% for Mississippi. New York State imposes a four percent sales tax. Local rates within states range between zero and seven percent. In New York State local sales tax rates range between zero and four and one-half percent. *Id.*

<sup>2</sup> *Id.*

<sup>3</sup> Joseph R. Feehan, *Comment: Surfing Around the Sales Tax Byte: The Internet Tax Freedom Act, Sales Tax Jurisdiction and the Role of Congress*, 12 ALB. L.J. SCI. & TECH. 619, 620 (2002).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

Internet's "location" and identifying who has jurisdictional rights<sup>7</sup> to tax certain internet transactions.<sup>8</sup> Not surprisingly, in 1998, Congress postponed addressing these issues when it passed the Internet Tax Freedom Act (ITFA), which: (1) established a three-year moratorium on state and local taxes on internet access and sales; (2) called for no new federal taxes during that period; and (3) established an Advisory Commission on Electronic Commerce.<sup>9</sup>

Yet after acquiring more understanding over e-commerce, Congress attempted to curb its initial protectionism over the Internet by passing legislation which would eventually allow states to tax internet sales under more defined rules. More specifically, the Internet Tax Moratorium and Equity Act<sup>10</sup> would (1) make permanent the ITFA moratorium only as it applies to internet access,<sup>11</sup>(2) extend the moratorium on other taxes so Congress,<sup>12</sup> the

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<sup>7</sup> Susan Nauss Exon, *A New Shoe is Needed To Walk Through Cyberspace Jurisdiction*, 11 ALB. L.J. SCI. & TECH. 1, 3 (2000).

<sup>8</sup> Jurisdiction becomes an important issue because e-commerce companies and mail order houses are able to operate in many states without maintaining an actual physical presence in any of the states where they sell their goods.

<sup>9</sup> Internet Tax Freedom Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681-719 (1998). The tax moratorium does not apply to federal income tax; and the federal income tax applies to ISPs the same way it applies to other service providers. (See Sen. Rep. No. 105-276, at 3 (1998). The Report clarifies that the moratorium applies to state and local sales and use taxes and does not affect the power of the Internal Revenue Service to tax the income realized through the sale of goods and services on the Internet, thus an ISP would include all fees for providing Internet access in their gross income. *Id.*) Additionally, clients of an ISP would typically receive a deduction if the Internet service qualifies as a business expense. See *Id.* (stating that the cost of an ISP qualifies as a business expense deduction). The tax moratorium also does not affect the 3% federal excise tax on local and long distance telephone service, which means that an Internet user will pay this charge when connecting to the Internet. (See *Id.* In January of 2001, H.R. 236 was introduced to repeal the 3% tax. See H.R. 236, 107[su'th'] Cong. (2001) available at [http://thomas.loc.gov/cgi-bin/query/C?c107:./temp/c107\]pgohm](http://thomas.loc.gov/cgi-bin/query/C?c107:./temp/c107]pgohm) (last visited Sept. 23, 2003)). Thus, Congress makes it clear that the moratorium is directed at the taxing powers of state and local governments and the Federal tax issues will be dealt with in subsequent and separate legislation.

<sup>10</sup> S.1542, 107[su'th'] Cong. (2001).

<sup>11</sup> The concept behind the legislation is the development and adoption of a streamlined sales and use tax system will provide "one-stop multi-state reporting, ... uniform definitions, ... rules [and] procedures, ... along with reasonable compensation for tax collection by sellers."

states, and localities could work together to develop a uniform streamlined sales and use tax system<sup>13</sup> which would more adequately address e-commerce<sup>14</sup> and remote sellers,<sup>15</sup> and (3) would authorize the states to enter an Interstate Sales and Use Tax Compact which would allow states to capture revenue from internet sales.<sup>16</sup>

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S.1542, at 5(a). Further, a *de minimis* exception would eliminate much of the unfairness the current system places on e-commerce and other remote sellers. *Id.* The legislation would also authorize the simplification of state use taxes through averaging.

<sup>12</sup> (H.R. 1675, 107[su'th'] Cong. (2001), available at <http://thomas.loc.gov/cgi-bin/query/C?c107:/temp/c1072op631> (last visited September 26, 2003). The legislation to make the Internet tax moratorium permanent has attracted 23 sponsors, mostly from Representative Cox's home state of California, but also from a variety of other states as well. (See Bill Summary & Status for H.R. 1675, (2001), available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR01675:@@L&summ2=M&> (last visited September 23, 2003).

<sup>13</sup> The large support from California is interesting given the state's reliance on sales tax as a revenue source along with what appears to be an aggressive effort on the part of state legislators to subject out of state retailers to state sales taxes.) The idea of making the Internet Tax Moratorium permanent also found support in the United States Senate. Senate Bill 777 of 2001 is identical to the House proposal (See S. 777, 107[su'th'] Cong. (2001), available at <http://Thomas.loc.gov/cgi-bin/query/C?c107:/temp/c107UjyLA> (last visited September 21, 2003)) and was introduced by Senator George Allen who, like, James Gilmore, the Chairman of the Advisory Commission on Electronic Commerce, is a former Governor of the State of Virginia. (See U.S. Senator George Allen, Biography, at <http://allen.senate.gov/Biography.html>.(naming Senator Allen as the 67[su'th'] Governor of Virginia, serving from 1994-1998) (last visited Sept. 24, 2003); Office of the Governor, Jim Gilmore, at <http://www.state.va.us/governor/govbio.htm>. (naming Governor Gilmore as the 68[su'th'] Governor of Virginia who has served since 1997, and is the chairman of the Advisory Commission on Electronic Commerce) (last visited Sept. 23, 2003); see also The Library of Virginia website at <http://www.lva.lib.va.us> (explaining that "the Library of Virginia is in the process of archiving Governor Gilmore's website.")

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* This system would provide for uniformity and less confusion among Internet sellers, and any state that joined the compact would have to adopt this system. Once twenty states have adopted the compact, the legislation provides that a copy shall be provided to Congress and Congress may approve or reject the Compact. While the consensus among the states Governors and State Legislatures leaned in favor of a system where states would be able tax transactions over the Internet, there is support in Congress to make the tax moratorium permanent. For instance, Representative Christopher Cox, the author of the Internet Tax Nondiscrimination Act, originally called for a five-year extension of the tax moratorium and has introduced legislation that would make the moratorium permanent. Eleven of the bill's cosponsors, like Representative Cox, were from California, however, the bill also found cosponsors from Arizona, Florida, Georgia, Illinois, Indiana, Ohio, Pennsylvania, Utah and Virginia. See *Id.*

Despite Congress' diminishing trepidation surrounding the taxation of internet commerce,<sup>17</sup> the recent creation and development of sophisticated online "virtual stores" has added new layers of difficulty to the ongoing dilemma. Online companies structure and operate virtual stores much the same way<sup>18</sup> as their physical counterparts,<sup>19</sup> yet remain practically impervious to burdensome tax obligations imposed by state and local governments.<sup>20</sup> Although State taxation of nonresident corporations is bound by the nexus requirements<sup>21</sup> of two clauses in the U.S. Constitution (Due Process Clause and the Commerce Clause),<sup>22</sup> the chasm between physical and "virtual" reality is quickly closing and normative jurisprudential models employed to explicate differences which exist in the tax treatment of e-commerce<sup>23</sup> will likely be viewed as antiquated<sup>24</sup> and deficient.<sup>25</sup>

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<sup>17</sup> *Id.*

<sup>18</sup> However, these companies are usually more efficient as they are not confronted with the same managerial and overhead issues typically found in traditional retail operations.

<sup>19</sup> *Id.*

<sup>20</sup> See Magdalena Yesil, *Creating the Virtual Store* 10 (1997) ("The virtual store is a storefront in cyberspace, a place where customers can shop from their home computers and where merchants can offer merchandise and services for a fraction of the overhead required in a physical storefront."); James C. Gonyea & Wayne M. Gonyea, *Selling on the Internet* 39-40 (1996) (defining "electronic storefront" nontechnically as "a location (*i.e.*, an address) on the Internet from which you can electronically advertise and sell your commercial products and/or services to other Internet users all around the world").

<sup>21</sup> Lieberman, Richard L. and Stewart Lipeles, *The Geoffrey Case: A Failed Attempt to Provide Content to the Economic Nexus Principle*, STATE TAX NOTES, March 7, 1994.

<sup>22</sup> Craig J. Langstraat, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 AKRON TAX J. 1 (1999). While the purpose and meaning of these two clauses are not identical, each of them requires that a nonresident have sufficient contacts, or nexus, with the state before it can be subject to tax in that state. This means that, even if a company is earning income from sales to customers within a state, the company is not subject to tax if it does not have nexus with that state. Traditionally, these nexus requirements have been considered to mandate a physical contact between the state and the nonresident corporation. The physical presence of such items as the taxpayer's tangible property, employees, or agents has been considered sufficient to meet the nexus requirements of both clauses. *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> "As technological progress . . . increases the flow of commerce between States, the need for jurisdiction over nonresidents [undergoes] a similar increase . . . . In response to these changes, the requirements for personal jurisdiction over non-residents [evolve]." *Hanson v. Denckla*, 357 U.S. 235, 250-251, 2 L. Ed. 2d 1283, 78 S. Ct. 1228 (1958).

Accordingly, the aim of this article is threefold: (1) to explore the effect virtual stores have on the physical presence requirement for economic nexus, (2) evaluate arguments for and against in forcing the traditional sales tax model into the virtual environment of online commerce, and (3) proffer some possible solutions.

## II. PHYSICAL PRESENCE, VIRTUAL STORES, AND CURRENT SALES TAX POLICY

### A. PHYSICAL PRESENCE DOCTRINE

The immense economic growth with e-commerce has attracted tax authorities to devise formulaic methods to tax online industries<sup>26</sup> and "[m]any states and municipalities are cash strapped, and to them, the Net represents fast money."<sup>27</sup> The current theory underwriting the economic nexus test provides that a nonresident company must have sufficient nexus with the state, including adequate physical presence.<sup>28</sup> The Supreme Court underscored this requirement of physical presence in the nexus test as applied to state use

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<sup>25</sup> Frieden, Karl A. and Michael E. Porter, *The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce*, STATE TAX NOTES, November 11, 1996. The possibility of tax base erosion is closely related to the growth of electronic commerce and other intangible services discussed above. As these services grow, the portion of business conducted by the traditional, tangible methods will diminish. Thus, the tax base allowed states by the physical presence standard of nexus will diminish unless states can find a way to tax these new methods of conducting business. *Id.*

<sup>26</sup> One important motivation for states' pursuit of economic nexus involves the relationship between in-state and out-of-state vendors that is caused by electronic commerce and similar services. If out-of-state vendors service in-state customers through the Internet, and their revenues are not subject to tax, they possess a significant advantage over in-state vendors who are required to pay taxes on their revenues. Thus, aside from increasing revenues and protecting the tax base from erosion, states have a further motivation in the form of the need to resolve such inequities between in-state and out-of-state vendors.

<sup>27</sup> Simons, John, *Shaking Down the Net: Local Governments Seek to Tax Internet Sales and Services*, U.S. NEWS AND WORLD REPORT, June 10, 1996; at 60-61.

<sup>28</sup> John J. Cronin & Maryann B. Gall. *Economic Nexus: A Case Study*, STATE TAX NOTES Feb. 16, 1998. *See* Arkansas Regulation 1996-3, entitled "Apportionment of Business Income Arising From Intragroup Intangible Licensing Transactions."

taxation in *Quill Corp. v. North Dakota*.<sup>29</sup> In this case, the Court held when assessing a state use tax the nexus test is not satisfied<sup>30</sup> unless the nonresident company has sufficient physical contact with the forum state.<sup>31</sup> However, the Court failed to close the proverbial door on other taxes placed by states against foreign corporations who do not have any meaningful physical contact with the state.<sup>32</sup>

The South Carolina Supreme Court exploited this opening provided by *Quill* when it upheld a net-income based tax<sup>33</sup> against a nonresident corporation which had no physical contact with South Carolina.<sup>34</sup> In *Geoffrey, Inc. v. South Carolina Tax Commission*,<sup>35</sup> the Court held a foreign corporation that was receiving royalty payments from sales made in South Carolina by a licensee can be permissibly required, even with no physical contact, to pay both state income tax on the royalties as well as a corporate license fee.<sup>36</sup> Apart from non-

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<sup>29</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). It is important to highlight Justice White's vigorous dissent questioned the logic of this "substantial nexus," or "physical presence" standard, arguing that the standard did not provide the bright-line rule that the majority claimed. *Id.* at 321-33 (White, J., dissenting).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at. 316

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied* 114 S.Ct. 550 (1993).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* Following the incorporation of Geoffrey and the formation of the licensing agreement, Toys 'R' Us began doing business in South Carolina. On its South Carolina returns, Toys 'R' Us deducted the royalty payments made to Geoffrey from its South Carolina taxable income. Originally, the South Carolina Tax Commission disallowed the royalty expense deductions. However, the Commission later reversed its ruling on the issue and allowed the deductions, while, at the same time, holding Geoffrey subject to tax on the royalty income. Geoffrey challenged the imposition of the tax, arguing, among other things, that its indirect contacts with South Carolina were not sufficient to allow the imposition of a net income-based tax. The case was ultimately appealed to the South Carolina Supreme Court, which upheld the lower court's decision against Geoffrey. *Id.* The court held that Geoffrey was "aware of, consented to, and benefited from Toys 'R' Us's use of Geoffrey's intangibles in South Carolina." *Id.* The court also held that Geoffrey's intangible property in South Carolina, consisting of an "account receivable" and a "franchise," was sufficient to create an economic nexus and allow the state to impose the tax. *Id.* Based on these two facts, the court

resident corporations paying income tax, mail order companies<sup>37</sup> seem most analogous to e-commerce where the absence of physical presence does not impede companies from doing business in the forum state.<sup>38</sup>

In *McLeod v. J.E. Dilworth Co.*,<sup>39</sup> the Supreme Court addressed the issue of jurisdiction when sales taxes were imposed entirely in one state although the goods were delivered to another state. Here, a Tennessee corporation received orders for mill and machinery supplies from an Arkansas company via phone and mail, subject to acceptance by the home office.<sup>40</sup> Once the orders were accepted by the home office, title passed upon delivery to a common carrier and the company never made any collections in Arkansas.<sup>41</sup> The Court held "the Tennessee seller was through selling in Tennessee"<sup>42</sup> and the tax on the sale in Arkansas was in fact a tax on interstate commerce.<sup>43</sup>

In *McGoldrick v. Berwind-White Coal Mining Co.*,<sup>44</sup> the Supreme Court came to a different result under very similar circumstances. In *McGoldrick*, a Pennsylvania corporation, which maintained an office in New York, executed sales contracts in New York and made

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concluded that the imposition of the tax violated neither the Due Process Clause nor the Commerce Clause. The Court established a three-part test to determine when jurisdiction over a direct seller would be appropriate for Due Process purposes. First, the corporation must direct its activities at the residents of the state. *Id.* Second, those contacts must be sufficient for due process purposes. *Id.* Third, the tax must be related to the benefits the corporation receives from the forum state. The Court noted that it was looking at the amount of economic activity in the forum state, rather than a corporate presence therein. *Id.*

<sup>37</sup> *Metro. Life Ins. Co. v. Robertson-Ceco Corp.*, 84 F.3d 560, 572 (2d Cir. 1996) (noting that extensive mail order and telephone sales alone could support general jurisdiction if sufficiently "continuous and systematic.")

<sup>38</sup> See supra note 3.

<sup>39</sup> 322 U.S. 327 (1944).

<sup>40</sup> *Id.* at 328.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 330.

<sup>43</sup> *Id.*

<sup>44</sup> 309 U.S. 33 (1940).

actual deliveries within the state.<sup>45</sup> The Court held executing sales contracts and making in-state deliveries provided sufficient contact with the state to impose a sales tax, resulting in the Court upholding the validity of New York's tax.<sup>46</sup> *McLeod* and *McGoldrick* differ as the *McLeod* Tennessee corporation's only contact with the forum state was through the mail, while the *McGoldrick* Pennsylvania corporation had actual physical presence in the forum state.

The Supreme Court again addressed a similar issue in *National Bellas Hess, Inc. v. Dep't of Revenue*,<sup>47</sup> where it considered whether communication with consumers by mail or common carrier was adequate to establish jurisdiction for taxation. Here, the only contact the nonresident corporation had with Illinois stemmed from semi-annual catalogues it mailed to customers and the acceptance/delivery of orders it received through the mail.<sup>48</sup> To determine jurisdiction, the Court applied a test to see whether the tax was "designed to make [the] commerce... [support] the cost of the local government whose protection it enjoys."<sup>49</sup> Furthermore, the court examined "whether the state has given anything for which it can ask return."<sup>50</sup> By applying this test the Court determined when dealing with customers solely through use of the mail and common carrier, *National Bellas Hess* did not avail itself of any of the relevant protections from Illinois.<sup>51</sup> The company did not have sufficient contact and Illinois was unable to show mere use of the mail system established enough of a

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<sup>45</sup> *Id.* at 44.

<sup>46</sup> *Id.* at 58.

<sup>47</sup> 386 U.S. 753 (1967).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 756 (quoting *Freeman v. Hewit*, 329 U.S. 249, 253); see *Greyhound Lines v. Mealey*, 334 U.S. 653, 663 (1948); see also *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 462 (1959).

<sup>50</sup> *Nat'l Bellas Hess*, 386 U.S. at 756 (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444); see also *Standard Oil Co. v. Peck*, 342 U.S. 382, 385 (1952); *Ott v. Mississippi Barge Line Co.*, 336 U.S. 169, 174 (1949).

<sup>51</sup> See *Nat'l Bellas Hess*, 386 U.S. at 758.

connection,<sup>52</sup> resulting in the company enjoying the State's protection. The outcome being the State of Illinois could not assert jurisdiction over the remote seller.

In reaching its decision in *National Bellas Hess*, the Court cited several cases where jurisdiction would be appropriate.<sup>53</sup> For example, a court would declare jurisdiction for sales tax when sales to customers in a forum state were arranged by local agents,<sup>54</sup> the seller maintained local retail stores,<sup>55</sup> or the seller had "wholesalers, jobbers or 'salesmen' conducting continuous local solicitation tantamount to physical presence in the forum state."<sup>56</sup> Again, here lies one of the problems with applying a fair tax<sup>57</sup> to internet transactions, since e-commerce companies would fall into all three of the above categories.

In *National Bellas Hess*, the Court also expressed concern over the effect upholding the Illinois tax would have on interstate commerce. It referred to "the many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements ..." as a complicated system of obligations to jurisdictions, which provide no

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<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> See generally *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939) (explaining that the state made distributors agents for collecting tax); see also *General Trading Co. v. State Tax Comm'n of Iowa*, 322 U.S. 335 (1944) (noting retailers must collect tax from purchasers); *Felt*, overruled in part by *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>55</sup> See *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941) overruled in part by *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); see also *Nelson v. Montgomery Ward*, 312 U.S. 373 (1941) (stating that respondent maintained 29 retail stores within Iowa).

<sup>56</sup> See *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960); overruled in part by *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Whether dealing with specific or general jurisdiction, the touchstone remains 'purposeful availment' . . . [to] ensure[ ] that 'a defendant will not be haled into a jurisdiction solely as a result of "random," "fortuitous," or "attenuated" contacts.'" *Glencore Grain Rotterdam B.V. v. Shivnath Rai Harnarain Co.*, 284 F.3d 1114, 1123 (9th Cir. 2002).

<sup>57</sup> See *supra* notes 45-46 and accompanying text (discussing several U.S. Supreme Court cases where the Court examined circumstances when it would be fair for a state to collect a tax on a company engaged in interstate commerce);

benefits to the corporation.<sup>58</sup> Whereas in 1967, the year of the *National Bellas Hess* decision, only some 2,300 taxing jurisdictions existed.<sup>59</sup> As a result, many state governments and some members of Congress advocate the adoption of a uniform sales tax among the states.<sup>60</sup> The end goal of such a system would be to clarify the existing sales tax system and simplify variations among different taxing jurisdictions.

In *Standard Pressed Steel Co. v. Department of Revenue of Washington*,<sup>61</sup> the Court held mere presence of an employee of a corporation within a state in which the corporation owned no property<sup>62</sup> "made possible the realization and continuance of valuable contractual relations" within the state.<sup>63</sup> While it is not difficult to understand how an employee representing a company could constitute a physical presence for the company, as that person physically resides within the state, the rationale the Court employed seems notably overbroad and inconsistent with the later decision in *National Bellas Hess*. Both mail-order catalogs and interactive websites that allow purchasing facilitate "contractual relations"<sup>64</sup> in the identical manner as the employee liaison in *Standard Pressed Steel*.

The Court remained consistent in its inconsistency with *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*.<sup>65</sup> There, the Court found a nexus existed where the

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<sup>58</sup> *Nat'l Bellas Hess*, 386 U.S. at 759. Parties opposed to the taxation of direct mail companies and companies operating over the Internet often raise this argument. See *Id.*

<sup>59</sup> See H.R. Rep. No. 89-565, pt. 3, at 872 (1965); see Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, vol. 1 (1995), table 27 (recording that by 1994, as many as 6,579 jurisdictions imposed sales and use taxes).

<sup>60</sup> *Id.*

<sup>61</sup> 419 U.S. 560 (1975).

<sup>62</sup> The employee reference by the Court worked out of his home and therefore the employer did not own any office space to house him. *Id.* at 561.

<sup>63</sup> *Id.* at 562

<sup>64</sup> *Id.*

<sup>65</sup> 483 U.S. 232 (1987). In *Tyler Pipe*, the Court vacated and remanded two cases where claimants asserted the invalidity of a tax exemption regarding a remote seller that sold into Washington state. However, the Court did affirm that an out-of-state manufacturer had

out-of-state seller used in-state independent contractors to solicit sales.<sup>66</sup> The company neither owned property in the state nor employed residents of Washington.<sup>67</sup> The Court approved the lower court's determination that "the crucial factor governing nexus is whether the activities performed in the state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in the state."<sup>68</sup> Again, an interactive website or a mail order catalog could be "significantly associated with the taxpayer's ability to establish and maintain a market," inevitably leading to further confusion in applying the *Tyler Pipe* rationale.

In the past, state courts have made similar determinations to facilitate jurisdictional taxation against nonresident corporations. In *Scholastic Book Clubs, Inc. v. State Board of Equalization*,<sup>69</sup> Scholastic appealed a grant of summary judgment denying its claim for a refund of use taxes.<sup>70</sup> Scholastic utilized teachers as liaisons with California students who purchased books from the company.<sup>71</sup> The court reasoned the teachers were agents of the seller because they obtained "sales within California from local customers for a foreign corporation."<sup>72</sup> The California court further stated, as agents, they created the necessary nexus and therefore tax liability for Scholastic. Here again, websites can likewise be considered as "obtaining sales," making the court's reasoning perplexing in an e-commerce setting. These decisions mystified the physical presence standard which originally created a

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sufficient nexus to be amenable to taxation where sales representatives performed certain activities related to the manufacturer's business. See *Id.* at 250-251.

<sup>66</sup> *Id.* at 249.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 250 (citing *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 105 Wash. 2d 318, 323 (1986)).

<sup>69</sup> 207 Cal. App. 3d 734 (1989).

<sup>70</sup> *Id.* Scholastic involved the issue of whether an out-of-state book seller was amenable to taxation when it used teachers to facilitate book sales. The company had neither a physical facility nor a regular employee in the state. *Id.* at 736.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 740.

tax exemption only for those remote sellers "whose only connection with customers in the State is by common carrier or the United States mail."<sup>73</sup>

More recently, in *Gator.com Corp. v. LL.Bean, Inc.*,<sup>74</sup> the Ninth Circuit held that despite a Maine corporation had neither physical presence nor authorization to do business in California, it had systematic and continuous contact<sup>75</sup> with the forum state to support general jurisdiction because it maintained a sophisticated "virtual store" and conducted mail order solicitations.<sup>76</sup> The Court held L.L. Bean's virtual online store<sup>77</sup> was the "functional equivalent"<sup>78</sup> to a physical store<sup>79</sup> and because the level of online commercial activity<sup>80</sup> "approximates physical presence,"<sup>81</sup> actual physical presence was not required to satisfy general jurisdiction principles.<sup>82</sup>

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<sup>73</sup> *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 758 (1967).

<sup>74</sup> 2003 U.S. App. Lexis 18115 (U.S. App. , 2003)

<sup>75</sup> *Panavision Int'l, L.P. v. Toeppen*, 141 F.3d 1316, 1320 (9th Cir. 1998), This test requires both that the party in question "clearly [do] business over the Internet," *Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, 952 F. Supp. 1119, 1124 (W.D. Pa. 1997), and that the Internet business contacts with the forum state be substantial or continuous and systematic.

<sup>76</sup> *Id.* The Fourth Circuit has also adopted the "sliding scale" test without explicitly applying it in the general jurisdiction context, noting that "something more" than systematic transmission of electronic signals would be required in order to assert general jurisdiction. See *ALS Scan, Inc. v. Digital Serv. Consultants, Inc.*, 293 F.3d 707, 713-15 (4th Cir. 2002)

<sup>77</sup> For an analysis of interactive versus passive websites as it pertains to the issue of jurisdiction, see *Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414, 419 (9th Cir. 1997).

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> See *Accord Coastal Video*, 59 F. Supp. 2d at 572 ("As with traditional business contacts, the most reliable indicator of the nature and extent of . . . Internet contact with the forum state will be the amount of sales generated in the state by or through the interactive website."); cf. *Bancroft*, 223 F.3d at 1086 (rejecting general jurisdiction on basis of occasional, unsolicited sales of tournament tickets and merchandise to California residents); *Revell v. Lidov*, 317 F.3d 467, 470-71 (5th Cir. 2002); (finding that, although "the maintenance of a website is, in a sense, a continuous presence everywhere in the world," the contacts of an online journal were not "substantial" because it received only 17 and then 18 subscriptions from forum state residents).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* Also see *Gates Learjet Corp. v. Jensen*, 743 F.2d 1325, 1331 (9th Cir. 1984)), *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316, 90 L. Ed. 95, 66 S. Ct. 154 (1945), *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297, 62 L. Ed. 2d 490, 100 S. Ct. 559 (1980), *Helicopteros Nacionales*

On multiple occasions, the *L.L. Bean* Court conspicuously refers to merely the existence of elaborate retail capabilities provided by LL Bean's online store when enumerating the considerations for "approximate physical presence"<sup>83</sup> and not whether customers had actually utilized those capabilities.<sup>84</sup> This strongly suggests the Nine Circuit considers mere accessibility by forum state residents to a sophisticated virtual store<sup>85</sup> as sufficient impetus to place its commercial source in a condition tantamount to being physically present in the forum state.<sup>86</sup>

#### B. LIKELY EFFECTS OF EQUATING VIRTUAL STORES TO THE ECONOMIC NEXUS

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*de Colombia, S.A. v. Hall*, 466 U.S. 408, 415, 80 L. Ed. 2d 404, 104 S. Ct. 1868 (1984)), *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475, 85 L. Ed. 2d 528, 105 S. Ct. 2174 (1985)).

<sup>83</sup> See the "approximate physical presence" language in *Brand v. Menlove Dodge*, 796 F.2d 1070, 1073 (9th Cir. 1986)).

<sup>84</sup> "Like other Internet customers, California residents *may* view and purchase products on-line as well as interact with L.L. Bean customer service representatives "live" over the Internet if they have questions or concerns with an L.L. Bean product." 2003 U.S. App. Lexis 18115 (U.S. App. , 2003)at 4 (emphasis added).

<sup>85</sup> Collections of such virtual storefronts are known, perhaps inevitably, as "cybermalls" or "virtual malls." See Tricia Curry, *Megashopping*, Internet Shopper, Summer 1997, at 57 (reviewing such on-line malls); LeBlanc, *supra* note 1, at 129-30 (discussing cybermalls offered by Internet service providers America Online, Prodigy, CompuServe, and Microsoft Network); Gonyea & Gonyea, *supra*, at 167-73 (distinguishing types of cybermalls and providing lists of cybermalls); Yesil, *supra*, at 66 (discussing linking of virtual stores to form virtual malls); David Cook & Deborah Sellers, *Launching a Business on the Web* 273 (2d ed. 1996) ("These malls, similar to real-life malls, house many businesses under one roof."). See generally Michael Wolff, *Your Personal NetShopping* 34-41 (1996) (describing and listing Web addresses for different virtual malls).

<sup>86</sup> Justice White correctly predicted in *Quill* that "the question of Quill's actual physical presence is sufficiently close to cast doubt on the majority's confidence that it is propounding a truly "bright-line" rule ... it is a sure bet that the vagaries of "physical presence" will be tested to their fullest in our courts." *Quill Corp. v. North Dakota*, 504 U.S. at 330-331. Even before *Quill*, the physical presence standard was difficult to apply, with courts reaching dissimilar results through the application of this supposed bright-line standard and arguably *Quill* only exacerbated the difficulty. See, e.g., *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel Co. v. Dep't of Revenue of Wash.*, 419 U.S. 560 (1975); *Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 207 Cal. App. 3d 734 (1989).

A seller with a site on the Web may use it as a virtual storefront.<sup>87</sup> By setting up a Web site, the seller can publish information about itself and its products or services by using text and eye-catching graphics, as well as sound and video clips.<sup>88</sup> Potential customers can point and click their way through the electronic equivalent of four-color magazine ads and thousands of on-line shopping malls.<sup>89</sup> Consumers can use the Web to compare prices and specifications of products, view multimedia clips of products, and place orders.<sup>90</sup> Merchants are selling goods—such as music, books, flowers, electronic equipment, and practically anything else via the Internet and commercial on-line services.<sup>91</sup> Some commentators predict that “[c]ybermalls will someday make physical shopping malls as outdated as rotary phones.”<sup>92</sup>

Consider vendors can take orders for their products twenty-four hours a day, every day of the year, without tying up any extra staff.<sup>93</sup> Also consider they can open international markets for their products, selling anywhere they can deliver.<sup>94</sup> Finally, consider vendors can turn customers into their own twenty-four-hour customer support staff.<sup>95</sup> It is easy to see the Internet, presents a tremendous opportunity for sellers due to its low cost and easy accessibility.<sup>96</sup> It offers fertile markets and tantalizing rewards for savvy marketers.<sup>97</sup>

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<sup>87</sup> See, e.g., Pete Loshin, *Internet Commerce: The Gold Rush of the New Millennium*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 86.

<sup>88</sup> See Reid Goldsborough, *Reaching the Masses*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 92, 92.

<sup>89</sup> See Rosalind Resnick, *Tooling Through the Internet*, PC NOVICE GUIDE TO GOING ONLINE, Dec. 1995, at 116, 116.

<sup>90</sup> See Loshin, *supra* note 87, at 87-88

<sup>91</sup> *Id.*

<sup>92</sup> Mitch Betts & Ellis Booker, *Internet Renews Tax Battles; Murky On-Line Tax Jurisdictions Cause Trouble*, COMPUTERWORLD, June 19, 1995 (quoting technology consultant Samuel E. Blecker), available in LEXIS, Market Library, Prompt File.

<sup>93</sup> See Loshin, *supra* note 87, at 86.

<sup>94</sup> See *Id.*

<sup>95</sup> See *Id.*

<sup>96</sup> See *Id.*

Consequently, as commerce grows over the Internet, so does concern over revenue lost by states because of uncollected sales or use taxes on products sold over the Internet or on-line.<sup>98</sup> In fact, state and local authorities fear their "finances are being undone by rapid changes in global commerce and information technologies, particularly the rise of the Internet."<sup>99</sup> In particular, states are extremely concerned about an erosion of their key revenue base: sales taxes.<sup>100</sup> "The rise of untaxed commerce on the information superhighway will be a body blow to local government finances."<sup>101</sup> At the touch of a button, consumers can obtain access to the lowest-priced goods throughout the nation, and at the same time avoid sales taxes.<sup>102</sup> Thus, it is feared that "interstate sales may explode over the Internet, leaving state and local government finances in tatters."<sup>103</sup> As commerce moves from the regular world to the virtual world, states struggle to find a way to tax internet sales.<sup>104</sup> Some assert internet sales are "too significant a part of the economy" to suggest they should be exempt in the long-term from taxation.<sup>105</sup>

Companies already engaged in commerce over the Internet are confused about their tax collection obligations.<sup>106</sup> As early as a July 1996 study by KPMG Peat Marwick illustrates the

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<sup>97</sup> See *Id.*

<sup>98</sup> Nathan Newman, *Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway*, 95 STATE TAX NOTES 186-49, Sept. 26, 1995

<sup>99</sup> See Elizabeth Weise, *What a Tangled Web We Weave*, Associated Press, Dec. 29, 1995, available in LEXIS, News Library, AP File. Even more astounding, by other estimates, the volume of sales generated by the Web in 1995 was \$436 million, and is predicted to rise to \$46 billion in 1998. See *World Wide Web User Statistics*, *supra* note 5.

<sup>100</sup> See *Id.*

<sup>101</sup> See *Id.*

<sup>102</sup> See *Id.*

<sup>103</sup> See *Id.*

<sup>104</sup> See Catherine Yang, *New Tolls on the Info Highway?*, BUS. WEEK., Feb. 12, 1996 at 96, 96 (quoting Multistate Tax Commission General Counsel Paul Mines).

<sup>105</sup> See *Id.*

<sup>106</sup> See KPMG Peat Marwick, *Electronic Commerce: Taxation Without Clarification* (visited October 9, 2003) <<http://usservice.us.kpmg.com/salt/archive/july96/story1.html>>

uncertainty felt by companies.<sup>107</sup> Nine out of ten executives of American companies engaged in buying and selling over the Internet called for clarification in the governing regulations.<sup>108</sup> An overwhelming fifty-one percent of the 291 executives surveyed (of companies with gross revenues in excess of \$50 million) stated the lack of clarity in state and local tax laws governing electronic commerce was inhibiting their involvement with internet business applications.<sup>109</sup> An alarming twenty percent admitted they did not know whether their companies were even subject to sales and transaction taxes on the sale of products and services over the Internet.<sup>110</sup>

It appears many states are also struggling with issues surrounding the taxation of sales over the Internet.<sup>111</sup> A few have even created study groups to deal with the issues involved.<sup>112</sup> Clear guidelines are needed for states and for companies already transacting business over the Internet or on-line, or those desiring to do so.<sup>113</sup> At least one scholar had argued "states can apply the express rule of these agency/representative . . . cases to persuade courts and administrative tribunals to find substantial nexus"<sup>114</sup> for out-of-state sellers. An examination reveals this theory cannot serve as the basis for jurisdiction over out-of-state merchants selling over the Internet or on-line.

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<sup>107</sup> See *Id.*

<sup>108</sup> See *Id.*

<sup>109</sup> See *Id.*

<sup>110</sup> See *Id.*

<sup>111</sup> See Stacey Singer, *Tax Collectors View Sales on Internet with Distress*, CHI. TRIB., May 15, 1996, at 1.

<sup>112</sup> For example, the California Legislature, worried that business transactions on the Web escape taxation by states as well as local jurisdictions, has created the California Internet Review Commission to look into applying sales taxes to the Internet. See David Hipschman, *Get Ready, They're Trying to Tax Commerce on the Internet*, THE LEDGER, Mar. 17, 1996, at D11. Similarly, The Illinois Department of Revenue has established a new study group to tackle the problems. See Singer, *supra* note 50.

<sup>113</sup> See *Id.*

<sup>114</sup> See R. Scot Grierson, *Constitutional Limitations on State Taxation: States and Use Tax Nexus on the Information Highway*, 96 STATE TAX NOTES 35-38, Feb. 21, 1996

Some argue states have jurisdiction to tax out-of-state vendors, who lease space on a commercial on-line service's network and register with them as sellers, by virtue of the commercial on-line service's physical presence<sup>115</sup> in-state.<sup>116</sup> June Summers, director of the Multistate Tax Commission's National Nexus Program, asserts a commercial on-line service such as CompuServe has hardware, and thus physical presence, in every state.<sup>117</sup> Accordingly, supporters of the agency theory in the context of on-line sales reach the conclusion that the commercial on-line service's in-state physical presence provides a nexus for taxation of out-of-state vendors registered as sellers with the commercial on-line service.<sup>118</sup>

The problem with viewing commercial on-line service providers as representatives of the kind in the *Tyler Pipe* line of cases is they do not perform the types of activities on behalf of the vendor the *Tyler Pipe* representatives performed.<sup>119</sup> The commercial on-line services merely carry the vendor's "advertisement" or information into every state, much like the U.S. Postal Service delivers an advertising pamphlet, or a magazine carries an advertisement into every state.<sup>120</sup> Accordingly, basing nexus jurisdiction on the physical presence of a commercial on-line service would be very similar to basing nexus jurisdiction on the physical presence of the U.S. Postal Service or other mail carrier in every state, or on a magazine, distributed in every state, in which the out-of-state seller advertises.

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<sup>115</sup> Commercial on-line services have a "physical presence" in almost every state because they have a mainframe, in which they store their data, in almost every state.

<sup>116</sup> It is important to note that this argument only attempts to establish jurisdiction over sellers registered with the commercial on-line service, and not over sellers selling over the Internet.

<sup>117</sup> See Harriet Hanlon, *MTC Examines Making (Tax) Money on the Internet*, 95 STATE TAX NOTES 150-26, Aug. 4, 1995

<sup>118</sup> See *Id.*

<sup>119</sup> Robert Levering, senior vice president of the Direct Marketing Association in Washington, notes that the retailer only has an arm's-length contract to use the on-line service as a communications carrier. See Betts & Booker, *supra* note 23, at 64.

<sup>120</sup> 483 U.S. at 250.

*Tyler Pipe* provides that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."<sup>121</sup> The Court noted that the sales representatives acted daily on behalf of Tyler Pipe by calling on its customers and soliciting orders.<sup>122</sup> They maintained and improved the name recognition, market share, goodwill, and individual customer relations of the seller.<sup>123</sup> They provided Tyler Pipe with virtually all its information regarding the Washington market, including product performance, competing products, pricing market conditions and trends, and customer financial liability.<sup>124</sup> Similarly, in *Scripto Inc. v. Carson*, the salesmen were actively engaged in Florida as representatives of the seller for the purpose of attracting, soliciting, and obtaining Florida customers.<sup>125</sup> In *Standard Pressed Steel*, the representative consulted with a major purchaser of the taxpayer's product regarding its anticipated needs and requirements for the product, and followed up with consultation as to any difficulties in the use of the product.<sup>126</sup>

Commercial on-line services do not perform the same types of activities the in-state representatives performed in the agency line of cases.<sup>127</sup> Although commercial on-line

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<sup>121</sup> See *Id.*

<sup>122</sup> See *id.* at 251.

<sup>123</sup> See *id.* at 249.

<sup>124</sup> See *id.* at 250.

<sup>125</sup> See 362 U.S. at 209.

<sup>126</sup> See 419 U.S. at 561.

<sup>127</sup> It is noteworthy that *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), also has been cited as a case supporting the agency/representative theory of nexus. Specifically, it is cited to suggest that the agency/representative theory of nexus establishes jurisdiction over an out-of-state seller regardless of the nature of the activities the agent performs on behalf of the seller. See *id.* This is somewhat misleading. In the case, National Geographic, a nonprofit corporation with headquarters in the District of Columbia, maintained two offices in California that solicited advertising copy for National Geographic's monthly magazine. See 430 U.S. at 552. The two offices performed no activities related to National Geographic's operation of a separate line of business-its mail-order business for the

services put vendors in touch with customers all over the world, and in some cases provide services such as payment collection, they do not engage in active solicitation on behalf of the seller, or provide the type of customer support services as the *Tyler Pipe* representatives.<sup>128</sup> Accordingly, the agency/representative theory does not establish nexus over out-of-state vendors selling through commercial on-line services.

A related argument for establishing jurisdiction over vendors who lease space on a commercial on-line service's network is the in-state telecommunications infrastructure which allows for delivery of the seller's storefront serves as the physical presence in-state.<sup>129</sup> Commercial on-line services typically supplement the reach of their own networks through agreements with other telecommunications providers to ensure delivery of their product in

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sale of maps, atlases, globes, and books. *See id.* Orders for these items were mailed from California directly to National Geographic's Washington, D.C., members and magazine subscribers, or on order forms contained in the magazine. *See id.* Deliveries were made by mail from National Geographic's Washington, D.C., or Maryland offices. *See id.* National Geographic challenged the constitutionality of California's use tax, as applied to its mail-order activities in California. It is important to note that the requisite nexus was based on National Geographic's actual physical presence in the state, not the presence of National Geographic's agents or representatives in-state. *See id.* at 556. The two offices located in California were not acting as agents of National Geographic, or owned or run by entities separate from National Geographic; they were owned and run by National Geographic. Thus, the language of *National Geographic* to the effect that nexus may be found without regard to the nature of the activity carried on within the state is not relevant for determining whether nexus based on an agency/representative theory exists. *See id.* at 560.

<sup>128</sup> Where the vendor is selling digitized versions of traditionally tangible personal property (such as books or music), and the commercial on-line service actually helps deliver the digitized information, the assertion is made that the commercial on-line service, which is delivering the product being sold, is acting as an in-state representative of the seller because it is directly "associated with the taxpayer's ability to establish and maintain a market in the state for the sales." (quoting *Tyler Pipe*, 483 U.S. at 250). However, the commercial on-line service is acting no differently from the U.S. Postal Service when it delivers shopping catalogs, as well as ordered merchandise, to an in-state customer. Thus, it is difficult to see why the agency/representative argument has any more force when the product being sold by the out-of-state seller is digitized information delivered by the commercial on-line service rather than a tangible good.

<sup>129</sup> *See Id.*

the various states.<sup>130</sup> Some commentators suggest the telecommunications provider effectively acts as the conduit through which the seller's information must travel to take advantage of the benefits provided by the market state.<sup>131</sup> Thus, it is urged by some that the telecommunications provider essentially acts as the seller's in-state distributor or representative.<sup>132</sup>

This reasoning can be extended to argue the telecommunications provider serves as the basis for jurisdiction over out-of-state vendors selling to in-state customers over the Internet. Internet service providers (ISPs) use the telecommunications infrastructure for delivery of information, so the telecommunications provider, who controls the telecommunications infrastructure, acts as an in-state representative of the vendor whose message it allows to be delivered.<sup>133</sup> This argument is flawed. Again, the telecommunications providers merely carry the vendor's information into the taxing state. They do not engage in active solicitation or perform other services similar to those provided by the *Tyler Pipe* representatives.

Additionally, the argument assumes the physical presence of a representative of the vendor's representative is sufficient to provide jurisdiction over the vendor: the vendor contracts with the ISP or commercial on-line service, who contracts with the telecommunications provider, who in turn has the in-state physical presence. This certainly goes beyond the holding of *Tyler Pipe* and similar cases. *Tyler Pipe* held the in-state physical

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<sup>130</sup> See *Id.*

<sup>131</sup> See *id.* It is noteworthy that R. Scot Grierson makes the agency/nexus argument in the context of obtaining jurisdiction over sellers of digitized information. See *id.* His theory is that the relationship between the telecommunications and the digitized information seller is singularly important because delivery of the information is impossible without the telecommunications vehicle. See *id.* He reasons that the "unequivocal physical presence of the in-state telecommunications equipment inures to the [benefit of the] information seller, thereby creating the requisite substantial nexus." *Id.*

<sup>132</sup> See *id.*

<sup>133</sup> To connect to the Internet, users must obtain access to the Internet. They can obtain a direct connection by paying a fee to an ISP, such as SprintLink or AT&T EasyLink. Alternatively, they can obtain a connection by paying a commercial on-line monthly fee.

presence of a representative of the seller may serve as the basis of jurisdiction over the seller.<sup>134</sup> If the physical presence of a representative of a vendor's representative can serve as the basis of jurisdiction, then conceivably a state could establish jurisdiction over practically anyone.

Furthermore, the argument appears to assume there is one person or centralized figure who owns or acts on behalf of the telecommunications infrastructure over which the message travels to reach its destination. In fact, there is no such centralized figure. The telecommunications infrastructure is controlled by many different parties.<sup>135</sup> Thus, it is unclear who exactly is serving as the out-of-state vendor's representative. Additionally, it is important to note emerging technology, such as microwaves, satellites, and radio-waves, will be used to transmit information over the Internet more prevalently in the future.<sup>136</sup> Thus, there may not be any "physically present" telecommunications equipment in-state upon which jurisdiction may be based.

It has also been urged that a state has jurisdiction over an out-of-state seller because the ISPs have a physical presence in the state and are representatives of the vendor.<sup>137</sup> Others suggest states may obtain jurisdiction over out-of-state vendors selling over the Internet or

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<sup>134</sup> See 483 U.S. at 249-50. "[I]t often is said that 'no one' owns the Internet. In fact, the 'Net is owned by many someones who all control their own pieces of it. When a network is connected to the Internet, it is generally understood that some of the resulting traffic will have nothing to do with local computers. System operators let this data flow by on its way to other destinations. . . . The present Internet is a loose collection of huge networks run largely by giant phone companies such as MCI and Sprint, connected at several major points with many smaller regional net[w]orks." Alan Phelps, *Ready, Set, Click: The Internet Races into the Mainstream*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 6, 7-8.

<sup>135</sup> See JILL H. ELLSWORTH & MATTHEW V. ELLSWORTH, *MARKETING ON THE INTERNET: MULTIMEDIA STRATEGIES FOR THE WORLDWIDE WEB* 4 (1995).

<sup>136</sup> See David Brunori, *ABA Tax Section Meeting: State Panel Debates Future of Internet Taxation*, UDITPA, 96 STATE TAX NOTES 94-24, May 14, 1996.

<sup>137</sup> See *Id.*

on-line because of the in-state presence of credit card payment systems they use.<sup>138</sup> These representational nexus theories fail to take account of the relationship between the in-state representative and the seller. To serve as the basis of jurisdiction for tax purposes, the representative must perform solicitation or customer service activities of the same magnitude and nature as those of the *Tyler Pipe* representatives, thus allowing the establishment and maintenance of a market by the seller in the taxing state.<sup>139</sup> The representatives in the above-cited theories do not perform activities similar to those of the *Tyler Pipe* representatives. Accordingly, the theories of representational nexus do not establish jurisdiction over out-of-state vendors selling over the Internet or on-line. It is interesting to note, however, that the Multistate Tax Commission's current draft of nexus guidelines adopts a representational nexus approach in the area of internet sales.<sup>140</sup>

Some might suggest in light of changing technology, the present physical presence definition may be outmoded and in need of dramatic revision.<sup>141</sup> As technology advances and becomes more widespread, it becomes exceedingly easy for persons to engage in activities in various jurisdictions, without physical presence within the jurisdiction.<sup>142</sup> The virtual presence of a seller in a state allows her to advertise her product, provide

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<sup>138</sup> See *Id.*

<sup>139</sup> See 483 U.S. at 249-50.

<sup>140</sup> The current MTC Guidelines state: Physical Presence: An out-of-state business is, or is deemed to be, physically present in the taxing state for possible application of that state's sales or use tax when the business engages in one or more of the following activities beyond a de minimis level: maintains in the taxing State by private contract, and not by purchase from a common carrier in the common carrier's status as common carrier, telecommunications linkage that permits, the out-of-state business to establish and maintain a market in the taxing State . . . . MULTISTATE TAX COMM 'N, NEXUS GUIDELINE FOR APPLICATION OF A TAXING STATE'S SALES AND USE TAX TO A REMOTE SELLER § II.C.7 (draft of Oct. 25, 1994).

<sup>141</sup> Mitch Betts & Ellis Booker, *Internet Renews Tax Battles; Murky On-Line Tax Jurisdictions Cause Trouble*, COMPUTERWORLD, June 19, 1995 (quoting technology consultant Samuel E. Blecker),

<sup>142</sup> See *Id.*

demonstrations, obtain and accept orders, provide customer support, and obtain customer feedback-nearly all the activities in which physical presence would have allowed her to engage.<sup>143</sup> Further, as Virtual Reality Transfer Protocol (VRTP) becomes available, virtual showrooms and product demonstrations can become part of the Web.<sup>144</sup> Consumers will be able to virtually walk through a showroom or mall, drive a car, use a computer, or talk to technical support personnel using the Web.<sup>145</sup>

It is likely when the Supreme Court wrote the opinions in *Bellas Hess* and *Quill*, it did not foresee sales over the Internet could occur, or they would become so prevalent. It might be argued a simple solution allowing states to tax internet and on-line sales would be for state legislatures to enact statutes expanding the definition of physical presence to encompass "virtual presence." As in *L.L.Bean*, the seller would be viewed as having physical presence in any jurisdiction where its Web site is accessed by a consumer.

While changing the definition of physical presence to include virtual presence seems an appealing and simple solution, it presents problems. By changing and expanding the definition of physical presence, and in effect equating nonphysical presence in a state with physical presence, the state legislative bodies would be effectively writing the constitutional requirement of physical presence out of existence.<sup>146</sup>

No one would dispute it would be unconstitutional for a state legislature, in response to *Bellas Hess* and *Quill*, to enact a statute providing the presence of mail-order catalogs in-state

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<sup>143</sup> See *Id.*

<sup>144</sup> See *Id.*

<sup>145</sup> See *Id.*

<sup>146</sup> See *Id.* See *Quill*, 504 U.S. at 314-18 (finding that the Commerce Clause requires an out-of-state seller to have physical presence in a state before the state may impose a use tax on the seller).

of an out-of-state seller constituted physical presence of the seller in the state.<sup>147</sup> It is important to note there is no real difference between a seller making sales to in-state customers over the Internet and a seller making sales to in-state customers via mail-order catalogs. There is no meaningful difference between a customer receiving a catalog in the mail and then dialing up a phone number to place an order, and a customer accessing a seller's Web site and placing an order via the Web site itself. Certainly the customer can place the order more immediately on the Web site, without having the intermediate step involved of picking up a telephone to place her order, and have questions about the product answered, so she can obtain instant gratification. Nevertheless, one type of presence is no closer to falling within the definition of "physical presence" than the other.

The representational nexus theory does not provide a jurisdictional nexus. Changing the definition of physical presence is also an unworkable solution. While the idea of millions or billions of dollars of internet and on-line sales taking place untaxed may seem outrageous to some, it appears that presently the only way states can constitutionally impose use tax collection obligations on out-of-state vendors selling to in-state customers over the Internet and on-line is if Congress passes a definitive statute allowing such taxation.

Until states persuade Congress to allow them to tax out-of-state vendors based upon their presence on the Internet or on-line, companies are free to sell goods without collecting use tax, as long as they do not otherwise have physical presence in-state.

### III. TAXING E-COMMERCE: ARGUMENTS FOR AND AGAINST

#### A. ARGUMENTS FOR TAXING E-COMMERCE

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<sup>147</sup> *See id.*; *see also* 386 U.S. at 756-60 (finding it unconstitutional for states to impose a use tax on an out-of-state seller with no physical presence in the state).

Proponents of e-commerce taxation are quick to underscore the vast amount of estimated revenue lost by failing to consistently tax online sales transactions. Though it is safe to assert that states are losing revenue which would otherwise be generated by e-commerce tax, the exact amount remains difficult to measure and questionable in estimation.<sup>148</sup> Furthermore, it remains unclear whether the amount collected under a sales tax would outweigh the likely discouragement of using the Internet as a shopping medium and the corresponding depressant effect on the U.S. economy.<sup>149</sup>

The U.S. General Accounting Office ("GAO") reported in March 2000 that estimated nation-wide tax revenue losses for internet sales ranged from \$ 300 million to \$ 3.8 billion in 2000.<sup>150</sup> The report prudently noted, however, that "little empirical data exist on the key factors needed to calculate the amount of sales and use tax revenues that state and local governments lose on Internet ... sales."<sup>151</sup> This partly explains the wide variation in the tax loss estimates,<sup>152</sup> but also highlights the fact that, in shaping internet taxation policy, there are few, if any, absolute statistical figures which merit objective reliance.

Moratorium critics and taxation proponents point to figures similar to those from the GAO to support their call for an internet sales tax. Often, these proponents come from smaller and more indigent states which perceive uncollected sales tax for e-commerce to be vastly undermining their state's revenue and has the dire effect of endangering their essential

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<sup>148</sup> U.S. Gen. Accounting Office, Pub. No. GAO/GGD/OCE-00-165, Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain (2000) [referred to hereinafter as GAO Report].

<sup>149</sup> Cal Code Regs. tit. 18, 1684 (2001); see Rich Prem et al., Establishing a Framework to Evaluate E-Commerce Tax Policy Options 8 (2000) at 3.

<sup>150</sup> GAO Report, *supra* note 85, at 19. Of course, it should be noted that with the dramatic increase in domestic Internet use and quantity of online shopping venues, this number is likely significantly higher at this writing than the report reflects.

<sup>151</sup> *Id.* at 3.

<sup>152</sup> *Id.*

services due to lack of funding.<sup>153</sup> It seems clear, however, that uncollected e-commerce sales taxes do not yet significantly impact state economies. Though there is a definite revenue loss, the amounts lost may be quite nominal compared to the states' revenue as a whole.<sup>154</sup> Notably, there is even less agreement on whether or not a permanent moratorium on the collection of an Internet sales tax would eventually cause critical revenue consequences.<sup>155</sup>

It is important to understand uncollected sales tax revenue does not uniformly affect each individual state. Along with the lack of uniformity in taxation rules comes a lack of uniformity in reliance on revenue generated by sales taxes.<sup>156</sup> For example, analysts believe states of the Southwest - Arizona, New Mexico, Oklahoma and Texas - average a greater reliance on sales tax than do many other states.<sup>157</sup> Thus, it stands to reason the uncollected sales taxes could have a larger effect on these states than others.

The second major pro-taxation argument is it is simply an issue of basic fairness to tax internet sales at the same rate as conventional "brick and mortar" sales. Proponents argue no palatable reason exists to give a subsidy to the Internet industry, especially one that comes at the expense of conventional retailers.<sup>158</sup> Moratorium critics argue this type of subsidy

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<sup>153</sup> See, e.g., *Taxing Internet Sales Levels the Playing Field*, BUS. WEEK, Mar. 27, 2000, at 234 describing an interview with Kentucky Governor Paul E. Patton).

<sup>154</sup> See Robert J. Cline & Thomas S. Neubig, Ernst & Young Economics Consulting and Quantitative Analysis, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998* 11 (1999) (finding that the losses due to uncollected Internet sales tax in 1998 represented less than one-tenth of one percent of state and local sales and use tax revenues); see also Prem et al. *supra* note 85, at 20-21 (citing Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, NAT'L TAX J. 413-28 (1999)).

<sup>155</sup> Prem et al., *supra* note 85, at 21

<sup>156</sup> See generally Karl Frieden, *Cybertaxation: The Taxation of E-Commerce* 151-155 (2000).

<sup>157</sup> *Id.* at 84.

<sup>158</sup> See, e.g., *Taxing Internet Sales Levels the Playing Field*, BUS. WEEK, Mar. 27, 2000, at 234.

"violates traditional notions of tax neutrality, which strive to tax similarly situated taxpayers equally."<sup>159</sup>

The last major pro-taxation argument provides that the digital age requires a simplification of existing tax structures. Currently, more than 7,500 jurisdictions in the United States impose a sales tax.<sup>160</sup> Arguably, federal management of an internet sales tax could be a viable way to simplify the sales tax structure and avoid the problems that come with remote vendors<sup>161</sup> trying to comply with such a large number of sales tax rates.<sup>162</sup>

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<sup>159</sup> James John Jurinski, *Federalism and State Taxation of E-Commerce: Is the End in Sight for State Sales Taxes?*, 18 J. ST. TAX'N 30, 37 (1999).

<sup>160</sup> Frieden, *supra* note 93, at 184.

<sup>161</sup> The odds of an ill-equipped remote seller to find himself in a very complex tax problem is great as it is so easy to set up a web-based business. See Jeff Bertolucci, *Make the Net Your Business*, PC Computing, Dec. 1997, at 420, 420 (reviewing five different services that not only help one build a Web site, but that also provide hard disk space for one's site on an Internet service provider's computer, an Internet domain name, one or more e-mail addresses, on-line and phone tech support, and in most cases Web design software, all for monthly fees ranging between \$39.95 and \$500); *ACLU v. Reno*, 929 F. Supp. 824, 843 (E.D. Pa. 1996) (noting the government's expert's estimate that "creation of a Web site would cost between \$1,000 and \$15,000, with monthly operating costs depending on one's goals and the Web site's traffic"); Joseph R. Garber, *Cybermall Rats*, Forbes, June 16, 1997, at 122, 122 (discussing a company that will give you all the software you need to create a Web store, lease you virtual mall space and handle all of the housekeeping, including order-taking and report generation, for a fee of \$100 a month for a small shop and \$300 a month for a large one); Richard Castagna, *An Amiable Host*, Windows Mag., Apr. 1997, at 206, 208 (discussing an Internet service provider that allows those paying a subscription fee of \$100 per month to "set up [a] business Web site without shelling out another buck for hardware, software, and technical support [and] guarantees that you'll have a prototype of your site done within one hour"); David Seachrist, *Hanging Out an Internet Shingle*, BYTE, Apr. 1997, at 136, 136 (reviewing three "all-in-one, entry-level Internet-storefront packages," each including a Web server, database, and tools for creating the actual Web content, at prices ranging from \$1,495 to \$4,995); Hogan, *supra* note 6, at 106 (reviewing Peach Tree Internet Suite, a \$199 product described as "one of the easiest and cheapest ways" to create a commercial Web site); Bruce Judson, *NetMarketing: How Your Business Can Profit from the Online Revolution* 44-45 (1996) (estimating the cost of "a very basic Website" of approximately 10 pages of content, along with a simple online form for ordering or customer response, at about \$2,500, and estimating the cost of "a more complicated site," perhaps including an online catalog with graphics, audio, or multimedia, at between \$5,000 and \$50,000).

<sup>162</sup> Note that in the e-commerce context (as with sales taxes in general) the buyer actually pays the tax, rather than the seller. See Merrill Matthews Jr., *Should We Tax the Internet?* 5 (Institute for Policy Innovation, Policy Report No. 152, 2000). Since buyers will not

Software currently available can keep track of the various tax rates of each jurisdiction in which a vendor sells and can assess the tax burden accordingly.<sup>163</sup> However, this software is often very expensive because it necessarily requires updates as a consequence of constantly changing laws in the various taxing jurisdictions, as well as being costly to implement and install.<sup>164</sup> Some suggest the federal government could feasibly subsidize both the purchase and dissemination of this software.<sup>165</sup> Alternatively, it could exempt vendors who have revenue below a certain predetermined level from having to comply with the tax rates.<sup>166</sup>

#### B. ARGUMENTS AGAINST TAXING E-COMMERCE

Opponents of e-commerce taxation primarily argue a ban on such taxation is necessary to encourage proper dispersal of this beneficial technology.<sup>167</sup> They claim the Internet is so important a technology in a new world economy, the United States ought not to discourage its development through burdensome taxation.<sup>168</sup> Indeed, one study has suggested that enforcing currently existing sales taxes on internet sales could reduce the number of online

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ordinarily volunteer to pay such a tax and since it is not feasible to collect directly from the buyer, the issue is when the state has the power to impose a duty on the seller to collect the tax.

<sup>163</sup> Prem et al., *supra* note 86, at 3.

<sup>164</sup> *Id.* at 3, 11. In addition to the cost issue, the software is not capable of determining tax exempt sellers, products or services. *Id.* at 11.

<sup>165</sup> See, e.g., *Id.* at 33 (summarizing David Polatseck's Sales Tax Simplification Proposal).

<sup>166</sup> See *Id.* at 17; H.R. 4462, 106th Cong. 4(a)(12) (2000).

<sup>167</sup> Prem et al., *supra* note 86, at 16. The Internet system of computer networks was introduced by the federal government in 1969 to link "computers and computer networks owned by the military, defense contractors, and university laboratories conducting defense-related research." *ACLU v. Reno*, 929 F. Supp. 824, 831 (E.D. Pa. 1996). It has been characterized variously as a "unique and wholly new medium of worldwide human communication," *id.* at 844, and "the most participatory form of mass speech yet developed." *Id.* at 883.

<sup>168</sup> See *Id.*; *Taxing Internet Sales Hurts Consumers*, *BUS. WEEK*, Mar. 27, 2000, at 236 (interview with Massachusetts Governor Paul Cellucci).

purchasers by twenty-four percent.<sup>169</sup> Since e-commerce may spur wholesale economic growth, not just the growth of online sales, discouraging internet commerce through taxation could have a deleterious effect on the entire economy.<sup>170</sup>

Taxation opponents also argue non-taxation of internet commerce does not significantly diminish state and local revenues. A 1999 study found the estimated revenue loss in 1998 due to uncollected e-commerce transactions was only approximately one-tenth of one percent of total sales and use tax collections.<sup>171</sup> If so, the potential revenue gained from placing a sales tax on e-commerce transactions may not counterbalance the negative effects such a tax would have on the economy through a substantive decrease in the number of e-commerce transactions.<sup>172</sup>

A natural and logical extension of this argument is that before taxing e-commerce transactions, it would be much more beneficial to place a tax on non-internet remote transactions such as mail-order sales. The amount of revenue lost due to these types of

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<sup>169</sup> Matthews, *supra* note 98, at 15 (citing Austan Goolsbee, *In a World Without Borders: The Impact of Taxes on Internet Commerce* (1999)). The World Wide Web (the "Web") has been characterized as "a collection of protocols and standards for accessing information on the Internet, [which is] the physical medium used to transport the data." Net.Genesis & Devra Hall, *Build A Web Site* 5 (1995). The Web was created in 1990 by Tim Berners-Lee of CERN, the European Particle Physics Laboratory, and achieved enormous popularity in 1993 with the introduction of Mosaic, the first graphical "Web browser." See Robert H. Reid, *Architects of the Web: 1,000 Days That Built the Future of Business* at xxiii-xv (1997); Robert Wright, *The Man Who Invented the Web*, *Time*, May 19, 1997, at 64, 66 (discussing Mr. Berners-Lee's invention of the "three technical keystones of the Web"); Adam Blum, *Building Business Web Sites* 5-6 (1996); David Angell & Brent Heslop, *Mosaic For Dummies* 13-14 (Windows ed. 1995). It consists of "a series of documents stored in different computers all over the Internet" whose interlinking has made it "currently the most advanced information system developed on the Internet." *ACLU*, 929 F. Supp. at 836. One author sees the thousand days beginning in late 1993/early 1994 and ending in early 1997 as a critical period during which "the Internet has been captivating the awareness if not direct participation of literally everyone in the United States . . . ." Reid, *supra*, at xxxv.

<sup>170</sup> See *Id.* at 11-13.

<sup>171</sup> See Cline & Neubig, *supra* note 91, at 9.

<sup>172</sup> See, Prem et al., *supra* note 86, at 3.

remote sales is arguably much greater than that lost through current internet transactions.<sup>173</sup> Such taxation would create a large source of revenue for the states and at the same time, leave the Internet tax-free and encourage its growth.

Finally, opponents of taxation often argue that the existence of more than 7,500 sales tax imposing jurisdictions in the country<sup>174</sup> makes it difficult if not impossible to comply with all applicable taxes to which a company will be subject in the course of doing business. Use of the software referenced to above is perhaps one way to deal with this problem.<sup>175</sup> Nevertheless, such software places a potentially expensive burden on internet business and therefore undermining its appeal. Due to more burdensome cost structures of a small business,<sup>176</sup> not only would requiring such software place smaller vendors at a competitive disadvantage, but it also may discourage entry into the market because of the high cost of purchasing and updating the software.<sup>177</sup>

The basic policy positions explained above create very different ramifications. It is indisputable the pro-tax position certainly would allow states to earn more revenue. What is disputable is how much they would gain<sup>178</sup> and whether that amount would significantly aid state economies such that it outweighs the depressant effect on e-commerce. Since e-

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<sup>173</sup> GAO Report, *supra* note 85, at 19 (reporting non-Internet remote sales revenue loss of \$1.3 billion to \$ 5.3 billion).

<sup>174</sup> Frieden, *supra* note 93, at 184.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.*

<sup>177</sup> Interagency Working Group on Electronic Commerce, A Framework for Global Electronic Commerce 2 (1997) (available on-line at *About a Framework for Global Electronic Commerce* (visited July 2, 1997) <<http://www.whitehouse.gov/WH/New/Commerce/about.html>>; *cf.* Kim Komando, *CyberBuck\$: Making Money Online* 16 (1996) ("Being online doesn't let you do new things as much as it lets you do things in a new way."); Ann Davis, *Tangled Web: How the Net Became Land of Opportunity for Legal Profession*, Wall St. J., Oct. 13, 1997, at A1 ("Even sophisticated businesspeople," claims one attorney, "mistake the Internet for a world apart from the real world,' where existing laws don't apply.").

<sup>178</sup> See GAO Report, *supra* note 85, at 19, 59-61.

commerce will likely become a much larger part of the national economy,<sup>179</sup> it is probable that the amount of money lost through untaxed e-commerce will greatly increase in the future. Yet, at the present time the amount of money lost is probably not significant.<sup>180</sup>

If taxation causes a decline in the number of people who buy over the Internet, this may affect growth in the e-commerce sector,<sup>181</sup> but it remains unclear whether taxation will have any effect on this growth over the long term.<sup>182</sup> As a public policy matter, then, the issue becomes how the United States as a social order prefers to balance the twin goals of maintaining states' revenues at acceptable levels and encouraging growth of a perceived beneficial industry. Commentators have argued too extreme a position will have deleterious effects.<sup>183</sup>

As illustrated above, many have commented on the wisdom of taxing or not taxing e-commerce. Despite the quantity written, few have considered the dire effects such policies would have on our federal system of government. While there has been a recent spate of Supreme Court cases that reassert the sovereignty of the states,<sup>184</sup> it is indisputable Congress

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<sup>179</sup> *Id.*

<sup>180</sup> *Id.*

<sup>181</sup> See Matthews, *supra* note 98, at 15 (citing Austan Goolsbee, In a World Without Borders: The Impact of Taxes on Internet Commerce (1999)). There are indications that the proliferation of companies' own web pages may lessen the need for virtual malls. See William M. Bulkeley, *Nets Inc. Files for Protection From Creditors*, Wall St. J., May 12, 1997, at B4 (chronicling the failure of a company operating an electronic catalog where many industrial companies showed their wares to corporate buyers and engineers); Vince Emery, How to Grow Your Business on the Internet 430 (1995) (noting that several leading cybermalls failed "because they offered nothing to their tenants that their tenants couldn't get on their own for a far lower cost").

<sup>182</sup> Tracy LeBlanc, *Online Shopping Brings the Mall to You*, in PC Novice Guide to Going Online 128, 128 (1997).

<sup>183</sup> *Id.*

<sup>184</sup> See, e.g., *United States v. Morrison*, 529 U.S. 598 (2000) (striking down a provision of the Violence Against Women Act as outside of Congress's commerce power); *United States v. Lopez*, 514 U.S. 549 (1995) (striking down a law prohibiting gun possession near schools as outside of Congress's commerce power).

has power to control interstate taxation through the Commerce Clause.<sup>185</sup> It is another issue, however, whether exercise of that power is a sensible choice as a matter of public policy.

State and local control of taxation is a significant component of federalism.<sup>186</sup> Sales tax revenues often fund areas traditionally within state control, such as education.<sup>187</sup> The federal government, in turn, has traditionally respected taxation of in-state commerce as a function of the states.<sup>188</sup> This is good policy, not only as a matter of federal tradition, but because states and their localities are better able to foresee their financial needs and deal with them in an effective manner. This is partly why a multitude of sales tax regimes exists in the United States,<sup>189</sup> and why there is no federally mandated general sales tax comparable to those established in other nations, such as the European value-added-tax.<sup>190</sup> In fact, several governors charged that the suppression of the states' ability to tax through the ITFA was "the greatest affront to state sovereignty in ten years."<sup>191</sup>

If the federal government is to respect the ability of sovereign states to levy sales and use taxes as they see fit, then simultaneously providing a feasible framework for taxation appears by the use of the software described above seems to be the most feasible approach.<sup>192</sup> Yet, this "software solution" may very easily infringe on the rights of the states. As commonly envisioned, the use-tax-tracking software unavoidably involves a third party,

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<sup>185</sup> U.S. Const. art. I, 8, cl. 3 ( "The Congress shall have Power To ... regulate Commerce ... among the several States.").

<sup>186</sup> James John Jurinski, *Federalism and State Taxation of E-Commerce: Is the End in Sight for State Sales Taxes?*, 18 J. St. Tax'n 30, 37 (1999).

<sup>187</sup> See *Taxing Internet Sales Levels the Playing Field*, BUS. WEEK, Mar. 27, 2000, at 234; (arguing that remote e-commerce firms shouldn't have to help cover the costs of local services).

<sup>188</sup> *Id.* at 235.

<sup>189</sup> *Id.*

<sup>190</sup> *Id.* at 236.

<sup>191</sup> McLure at 423 (citing Letter from the Nat'l Governors' Ass'n to Sen. John McCain, chairman, Comm. on Commerce, Science and Transportation & Sen. Ernest F. Hollings, ranking member, Comm. on Commerce, Science, and Transportation (Oct. 6, 1997)), <http://www.nga.org/Releases/Letters/971010letter.htm>. (last visited October 13, 2003.)

<sup>192</sup> *Id.*

such as a federal administrator, to mediate and authenticate results from the use of the software. It is not obvious states would prefer to assign such a valuable and important function to a third party, federal or otherwise.<sup>193</sup> Relinquishing this sort of important state function to another entity is perhaps as great a relinquishment of sovereignty as federal preemption of taxation.

Another option for allowing states to collect revenue while preserving their sovereignty is an interstate compact, as proposed in the 106th Congress.<sup>194</sup> The provisions which sought to extend the moratorium posed an obvious challenge to state sovereignty by preventing states from collecting new revenue from e-commerce.<sup>195</sup> The proposals to create an interstate compact to simplify the current tax system and allow only states that participate to collect sales taxes on e-commerce, while less intrusive, still infringe on state sovereignty.<sup>196</sup>

This point was not obvious from the face of the relevant bills. Senate Bill 2775 provided for "State administration of all State and local sales and use taxes."<sup>197</sup> This language cloaked the fact the federal government would continue to impede the states' ability to collect revenue by putting conditions on such collection. Additionally, supplementary provisions impeded the states' capability to react to their own needs and change their tax policies. For instance, the bills provided for uniform definitions of goods and services which may be taxed.<sup>198</sup> Nevertheless, certain localities may have valid reasons for exempting specific goods or services from taxation, such as giving certain industries an incentive to settle in or do business within the jurisdiction. If the actual terms of the compact deny these

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<sup>193</sup> See Matthews at 4-5.

<sup>194</sup> H.R. 3709, 106th Cong. (2000); S. 2255, 106th Cong. (2000); H.R. 4460, 106th Cong. (2000); S. 2775, 106th Cong. (2000). Though these bills died in the 106th Congress, they may be introduced in the 109th Congress.

<sup>195</sup> H.R. 4460 2(a); S. 2775 3; H.R. 4462, 106th Cong. 3 (2000).

<sup>196</sup> H.R. 4460, 2(b)(2); S. 2775 5(a); H.R. 4462 5(a).

<sup>197</sup> S. 2775 4(a)(9). H.R. 4460 provides for substantially the same thing in 2(b)(2).

<sup>198</sup> H.R. 4460 2(a)(2); H.R. 4462 2(3), 4(a)(2); S. 2775 4(a)(2), 4(a)(4).

exemptions, certain localities would certainly become disadvantaged. Thus, the compact would rob the state of a valuable tool - local administration and leadership of economic development - necessary power for building its economy.

Furthermore, the bills may have eliminated the incentive for a company to relocate to states with no sales tax.<sup>199</sup> The bills may have removed this incentive to relocate because, if the compact provided for the taxation of the transaction in the state of purchase,<sup>200</sup> then the vendor would lose that tax advantage whenever it would sell out of state. If it anticipated that it would do most or all of its business outside of a state with no sales tax,<sup>201</sup> the vendor simply would have no incentive to locate there. This would rob the state of a valuable leverage in its competition to attract businesses to the state.

Another problem was the bills also mandated the states to choose a uniform statewide sales tax rate for remote sales.<sup>202</sup> Though this could be a "blended" rate which only reflected the average of the sales tax rate within a state,<sup>203</sup> this uniform rate would still inhibit the states' and localities' ability to adapt to their own particular circumstances. The federal government would effectively forbid the states from letting their localities determine their own needs and tax rates.

However, the compact would at least have permitted the states to collect revenue from e-commerce and would have defined the *Quill* standard for e-commerce. The compact would have prevented excessive burdens on interstate commerce. It would also have

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<sup>199</sup> Nevada being an example.

<sup>200</sup> The authorization to enter into a compact did not provide for the exact terms of such a compact, so it is possible that the transactions would not have been taxed at the point of purchase.

<sup>201</sup> Indeed, the states that currently do not have sales taxes are among the less populous in the Union. *See* Frieden, *supra* note 13, at 82. This leads to the conclusion that there would be less reason to locate in these states as they offer fewer customers.

<sup>202</sup> H.R. 4460 (2)(b)(2); S. 2775 6(a); H.R. 4462 6.

<sup>203</sup> H.R. 4460 (2)(b)(2); S. 2775 6(a); H.R. 4462 6.

addressed the problem of the exemption from taxation for remote commerce.<sup>204</sup> As a matter of public policy, we should ask whether the resulting infringement on state sovereignty and local control is worth the additional revenue gain.

From the point of view of states' rights, the optimal solution to this dilemma would be to lift the ITFA and prohibit federal control over e-commerce taxation. The obvious problems with this suggestion lie in the tremendous administrative problems and the lack of fairness. It is easy to imagine a remote seller<sup>205</sup> being taxed by several jurisdictions for the same transaction.<sup>206</sup> If a buyer purchased in one state from a vendor located in a second state, and the order traveled through a server in a third state, then the seller could conceivably be liable for three separate taxes on that individual sale.

To combat this problem, the physical presence standard should be strengthened, perhaps through a federal statute, to allow only taxation of companies or sales with a compelling and significant physical presence. Perhaps servers and buyers would not trigger

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<sup>204</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992).

<sup>205</sup> See Lynn Ginsburg, *Put Your Business on the Web*, *Windows Mag.*, Apr. 1997, at 206, 218 ("With new tools that make Web site creation easier, it's now possible for anyone--at any skill level--to create a Web site."); Mike Hogan, *Set Up Shop in Cyberspace*, *PC Computing*, Jan. 1997, at 106, 106. Hogan reviewed two software packages, each available for an estimated street price of under \$200, that each "provide an easy way to set up an entire site, complete with an electronic catalog, a secure commerce system, and a tight connection to your inventory." *Id.* The best part of these packages, according to Hogan, is that "[y]ou don't have to know [programming languages], you don't have to hire any expensive consultants, and with [one of the products] the entire site-building process takes only a few minutes." *Id.* One commentator has prepared a table comparing 11 web-page editing programs at prices ranging from free to \$395. Susann Philbrook, *Putting a Site Together: What You Need to Publish Online*, *Smart Computing*, Dec. 1997, at 52, 54-55.

<sup>206</sup> A virtual storefront in one such cybermall, located at <<http://www.Internetmall.com>>, is now available to anyone with as few as ten products to sell who is willing to pay a start-up fee as low as \$100. "All you have to do is add a 'Buy Now' button to your Web page and the link goes back to The Internet Mall, where all the database and credit-card authorization takes place." Sebastian Rupley & Don Willmott, *Find It, Then Buy It on the Web*, *PC Mag.*, May 27, 1997, at 29, 29 (describing the latest advances in cybershopping); see also Tim Haight, *Electronic Storefronts Made Simple*, *NetGuide*, July 1997, at 104-06 (discussing Viaweb, <<http://www.viaweb.com>>, a cybermall that provides, for a fee of \$100 or \$300 per month, a Web-based storefront selling up to 20 items or 1,000 items, respectively.)

such a requirement, and sales could be taxed at the point of origin. This more territorial approach to the problem could help eliminate severe administrative problems<sup>207</sup> and still preserve the sovereignty of the states while maintaining local governmental control.<sup>208</sup>

The apparent deficiency of manageable judicial standards for determining remote sellers' tax liability led to Congressional legislation on the issue. The Internet Tax Freedom Act currently prohibits the imposition of any new taxes on the Internet or e-commerce, but has expired as of late 2001. Many bills were introduced in the 106th Congress which would have extended this tax moratorium for several more years while creating an interstate compact to harmonize internet taxation.<sup>209</sup> This compact would have effectively streamlined the complicated tax system currently in place. However, these bills would have infringed upon traditional considerations of federalism and state sovereignty.

In addition, from the standpoint of public policy, it remains poignantly unclear whether taxing e-commerce would be beneficial. We must balance considerations of lost revenue and encouragement of a beneficial technology in order to determine a workable solution. A strong possibility for such a solution is for the federal government to take a

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<sup>207</sup> For example, in recent mixtures of virtual and real shopping, the Virtual Emporium, a store with a branch in the Upper West Side of Manhattan, displays sample products and invites customers to use the store's computers to order goods from any of 180 different Web sites, whose owners pay fees to the Virtual Emporium. See David W. Chen, *New Store Offers Shopping On Line*, N.Y. Times, May 21, 1997, at B6. NetMarket, which opened in June 1997, charges membership fees of \$69.95 a year to consumers eager to obtain "price discounts of 10% to 50% off manufacturer's list prices on some 250,000 brand-name products." Susan Jackson, *Point, Click--and Spend*, Bus. Wk., Sept. 15, 1997, at 74-76 (discussing the prospective fortunes of netMarket). In addition, several major search engine sites are also constructing their own shopping mall services. See Heidi Brumbaugh, *Search Engines Plan Massive Shopping Malls*, Internet World, Dec. 1997, at 28 (observing that the Web sites of these search engines "will have shopper's directories and may also link to consumer information and resources"); see *infra notes* 49, 50 and accompanying text (discussing search engines).

<sup>208</sup> Note that because the tax on e-commerce sales is actually a tax on the buyer, questions could arise as to the state's jurisdiction to impose a tax on a person outside its borders.

<sup>209</sup> Though the bills all died in the 106th Congress, they set forth the context regarding the debate around taxing e-commerce, and they may be reintroduced in the current congressional session.

"hands-off" approach to e-commerce taxation, coupled with the strengthening of the existing physical presence standard for determining amenability to such taxation.