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## NOTES

### Collecting Sales and Use Tax on Electronic Commerce: E-confusion or E-collection

#### INTRODUCTION

In November 1999, Utah Governor Michael Leavitt, chairman of the National Governors' Association (NGA), ignited a powder keg in the hotly contested national electronic commerce ("E-commerce")<sup>1</sup> tax debate when he introduced a radical proposal designed to streamline the administration and collection of sales and use tax<sup>2</sup> on a national basis.<sup>3</sup> On behalf of the "Big Seven" public policy

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1. The Internet Tax Freedom Act (ITFA) defines E-commerce as "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access." 47 U.S.C. § 151 (1994 & Supp. IV 1998).

2. Much of the anti-tax sentiment regarding E-commerce stems from a misunderstanding of the natures of the sales and use taxes, when the taxes are applied, and who is ultimately responsible for paying the taxes. Cf. *Hoover Institution Testimony at Senate Budget Committee Hearing on Internet Taxation*, 2000 ST. TAX TODAY 24-24, Feb. 4, 2000, ¶ 4, at LEXIS, LEXSTAT, 2000 STT 24-24 [hereinafter *McLure Testimony*] (providing a transcript of Charles E. McLure, Jr.'s testimony before the Senate Budget Committee Hearing on Internet Taxation). Two fundamental points help to clarify the confusion regarding sales and use taxes. First, sales and use taxes are excise taxes levied upon the buyer of tangible and intangible goods and certain specified services. See Edward A. Morse, *State Taxation of Internet Commerce: Something New Under the Sun*, 30 CREIGHTON L. REV. 1113, 1129 (1997). Although imposed upon the buyer, the seller usually collects sales taxes from the buyer at the time of sale. See *id.* Second, sales taxes are imposed on intrastate sales, while use taxes are imposed on interstate sales. See *McLure Testimony, supra*, ¶ 1.

A merchant physically present in a state is responsible for the collection and remittance of sales tax on taxable transactions completed within that state. See Morse, *supra*, at 1129. A state, however, cannot require an out-of-state merchant, such as a mail-order company, to collect the use tax on sales to consumers in a state where the remote merchant lacks nexus. *Quill Corp. v. North Dakota*, 504 U.S. 298, 317-18 (1992) (holding that under the Commerce Clause, North Dakota could not compel an out-of-state retailer without a physical presence in North Dakota to collect use tax on sales to North Dakota residents). For a more detailed discussion of *Quill*, see *infra* notes 35-50 and accompanying text.

3. See *NGA News Release Announces Utah Governor's Proposal for Sales Tax Simplification*, 1999 ST. TAX TODAY 225-36, Nov. 23, 1999, ¶ 1, at LEXIS, LEXSTAT, 1999 STT 225-36 [hereinafter *NGA News Release*].

organizations,<sup>4</sup> Governor Leavitt presented the Streamlined Sales Tax System (SSTS) to the Advisory Commission on Electronic Commerce (ACEC)<sup>5</sup> for consideration at its December 1999 meeting.<sup>6</sup> The SSTS provides a framework for state governments that simplifies and modernizes sales and use tax administration without either congressional or judicial intervention. It “incorporates uniform definitions within tax bases, simplified audit and administrative procedures, and emerging technologies to substantially reduce the

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4. The “Big Seven” are the NGA, the National Conference of State Legislatures, the National Association of Counties, the National League of Cities, the U.S. Conference of Mayors, the Council of State Governments, and the International City/County Management Association.

5. The ITFA created the Advisory Commission on Electronic Commerce (ACEC), a nineteen member blue ribbon commission, to study domestic and international Internet taxation issues over an eighteen-month period and report its recommendations to Congress in April 2000. Subsection (b) of the ITFA specified that sixteen of the representatives were to be allocated equally between state and local governments and the E-commerce industry. The remaining three members were the Commerce Secretary, the Treasury Secretary, and the United States Trade Representative (or their respective delegates).

Following the initial round of appointments to the ACEC, industry appointees outnumbered their state and local government counterparts ten to six. Realizing that this imbalance violated the statutorily prescribed composition of the commission and, perhaps more importantly, fearing that this imbalance would not adequately represent state and local interests in the E-commerce debate, the National Association of Counties and the U.S. Conference of Mayors filed suit in federal district court in March 1999 to prevent the ACEC from meeting. See Doug Sheppard, *Federal E-Commerce Panel Shaped Multistate Tax Discussions in 1999*, 1999 ST. TAX TODAY 248-21, Dec. 28, 1999, at LEXIS, LEXSTAT, 1999 STT 248-21. Following the subsequent replacement of two private industry representatives with state and local government appointees, the public-private equilibrium was restored. *Id.* Consequently, the suit was dropped, and the ACEC held its first meeting in June 1999. *Id.*

This initial confrontation over the composition of the ACEC symbolized the overall ineffectiveness of this panel to formulate an Internet sales tax policy. From June 1999 to March 2000, the ACEC met formally four times. With each meeting the deep divisions among the commission’s members became more apparent. Thus, the likelihood of presenting a unified recommendation to Congress diminished significantly. Glenn R. Simpson & Jerry Guildera, *E-Commerce Panel’s Attempt to Agree on Internet Sales Tax Policy Collapses*, WALL ST. J., Mar. 22, 2000, at B2. In April 2000, Virginia Governor James Gilmore submitted the ACEC’s recommendation that Congress extend the present moratorium on new E-commerce taxes for another five years. Acting on this recommendation, the House overwhelmingly passed legislation extending the moratorium to 2006. Internet Nondiscrimination Act of 2000, H.R. 3709, 106th Cong. (2000). Interestingly, one amendment to this bill expressed support for a “streamlined non-multiple and non-discrimination tax system.” H.R. 3709 § 4. The amendment is a strong endorsement of the Streamlined Sales Tax System. Currently, the Senate’s version of the House bill, S. 2028, 106th Cong. (2000), is still in the Commerce, Science, and Transportation Committee.

6. See NGA News Release, *supra* note 3, ¶ 5.

burdens of tax collection.”<sup>7</sup> More specifically, the SSTS was developed to achieve the following three fundamental policy objectives: (1) to establish a uniform system that reduces the administrative burden of sales and use tax collection for all types of commerce, (2) to equalize the tax collection responsibilities of remote and local sellers, and (3) to preserve the sovereignty of individual state and local governments.

The SSTS is designed to remedy the confusion arising from the complicated sales and use tax regime currently in place. For example, although the consumer ultimately is responsible for paying the sales and use tax on the sale of a taxable good or service under the current regime, few consumers are aware of this responsibility.<sup>8</sup> This is largely because states rely almost exclusively upon the seller to collect the sales and use tax at the time of sale, and they rarely enforce consumer compliance with use tax laws. Consumers therefore are under the popular misconception that sales and use taxes are imposed upon the seller.<sup>9</sup> Despite this consumer misconception, the states continue using the current collection practice because they consider it to be the strategically optimal way to maximize collection effectiveness.<sup>10</sup> In the overwhelming majority of instances in which the remote seller does not collect the use tax, the state does not have an enforcement mechanism to recover the use tax from the consumer.<sup>11</sup> Consequently, restrictions upon the state’s power to

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7. Executive Summary, Streamlined Sales Tax Project 2 [hereinafter SSTS Executive Summary] (on file with the North Carolina Law Review).

8. See Robert J. Cline & Thomas S. Neubig, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*, 1999 ST. TAX TODAY 128-11, July 6, 1999, ¶ 40, at LEXIS, LEXSTAT, 1999 STT 128-11.

9. A plausible school of thought regarding sales tax reform is that the states should educate the consumer regarding her liability for use tax on goods purchased out-of-state but used in-state and enforce use tax compliance at the individual level before overhauling the current sales tax system. See Public Expenditure Council, *Ohio Council Report Addresses Collection of Sales Tax on Internet Purchases*, 2000 ST. TAX TODAY 103-22, May 26, 2000, ¶ 55, at LEXIS, LEXSTAT, 2000 STT 103-22.

10. The rationale is that because one seller may collect tax from thousands of individual consumers, collecting sales and use tax from the seller maximizes tax collections and minimizes administrative costs. See generally *Nat’l Geographic Soc’y v. Cal. Bd. of Equalization*, 430 U.S. 551, 555 (1977) (recognizing the impracticability of collecting use tax from individual consumers rather than from the remote seller). Theoretically, the administrative savings of not collecting tax at the consumer level exceed any lost revenue resulting from this collection strategy.

11. Cf. AARON LUKAS, TAX BYTES: A PRIMER ON THE TAXATION OF ELECTRONIC COMMERCE 8 (CATO Inst. Ctr. Trade Pol’y Studies, Trade Policy Analysis No. 9, 1999), <http://www.freetrade.org/pubs/pas/tpa-009.pdf> (on file with the North Carolina Law Review) (citing a 1996 survey by the Software Industry Coalition that reported buyers of products from remote sellers were not likely to remit the use tax owed to their home

require an out-of-state seller to collect use tax threaten to diminish the state's sales tax base.

Any attempt by a state to require a remote vendor to collect use tax is subject to the Supreme Court's interpretation of the Due Process and Commerce Clauses in mail-order cases.<sup>12</sup> The constitutional analysis of a state tax statute acts as a bifurcated limitation that releases the remote seller from the obligation to collect use tax if it lacks a "substantial nexus" to the taxing jurisdiction.<sup>13</sup> Due to the ease with which a seller may create a Web site and offer goods and services to consumers in states where the seller has no physical presence, E-commerce presents a formidable tax collection problem.<sup>14</sup> Absent substantive reform in the collection of use tax on interstate commerce, the states will continue to lose use tax revenue that buyers clearly owe under existing laws.<sup>15</sup>

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state). Two key factors drive this lack of use tax compliance. First, most buyers are unaware of their responsibility to pay a use tax on taxable purchases from remote sellers. Second, the states exhibit a reluctance to enforce use tax laws.

12. See, e.g., *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967).

13. In *Quill*, the Court held that an out-of-state mail-order company with no physical presence in North Dakota had no duty to collect use tax on sales to North Dakota residents. 504 U.S. at 301. This decision affirmed the bright-line physical presence requirement established by the Court in *Bellas Hess*. See *id.* at 317-18 (citing *Bellas Hess*, 386 U.S. at 758-60).

14. Before the Internet became a well-developed medium for commercial and consumer transactions, the target market for most small businesses was confined to their local geographical area. The arrival of the Internet, however, enabled many small businesses to sell their goods and services to buyers in formerly unreachable markets. See Dan Morse, *Individual Outlet Owners Set Up Own E-Commerce Sites*, WALL ST. J., Mar. 28, 2000, at B2.

15. A seldom discussed alternative to the use tax collection problem is for the states to enforce use tax liabilities at the consumer level. Few states actively enforce the requirement that an in-state buyer pay use tax on purchases from out-of-state sellers. North Carolina and Michigan are the only two states to incorporate the use tax as a line item on their income tax returns. Interestingly, North Carolina collected \$4.3 million in use tax for tax year 1999, the first year it attempted to collect use tax via the individual income tax return. Interview with Charles Collins, Director, Sales & Use Tax Division, N.C. Dep't of Revenue, Raleigh, N.C. (Oct. 6, 2000).

The Southeastern Association of Tax Administrators (SEATA), has developed an effective information exchange agreement in which twelve states share information regarding sales to buyers from the other member states. In the ten years since the agreement was signed, the twelve member states have collected \$69.8 million in use tax revenue that would not otherwise have been collected. See Press Release, \$69.8 Million in Use Tax Collected in 10 Years Through Information Exchange Agreement, at <http://www.re.state.la.us/pressrel/PR071699.htm> (last modified July 16, 1999) (on file with the North Carolina Law Review). To illustrate the effectiveness of the SEATA exchange agreement, suppose a Tennessee buyer purchased furniture from a North Carolina manufacturer that had no duty to collect Tennessee use tax on the sale. Under the

Faced with the possibility of losing billions of dollars in sales and use tax revenue to E-commerce,<sup>16</sup> the states recently have addressed this issue with a sense of urgency.<sup>17</sup> Given the national importance of developing a pragmatic solution to E-commerce tax issues and the high revenues involved, the states have a definite interest in establishing a means to collect sales and use taxes on Internet transactions.<sup>18</sup> Any proposed solution, however, must “not unduly burden interstate commerce”<sup>19</sup> and must operate within the current

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exchange agreement, North Carolina provides Tennessee with the names and addresses of all Tennessee buyers who made purchases in North Carolina, the amount of the purchases, and the amount of North Carolina sales tax paid on the transactions, if any. Subsequently, Tennessee sends a use tax questionnaire to the identified buyers. The questionnaire functions as a use tax return in which Tennessee buyers report the total amount of purchases from out-of-state sellers and pay the corresponding amount of Tennessee use tax. In this hypothetical, even if the Tennessee buyer paid North Carolina sales tax, he would still owe additional Tennessee use tax because Tennessee’s use tax rate is higher than North Carolina’s rate.

16. A study initially published in February 2000 by the University of Tennessee Center for Business and Economic Research estimates that E-commerce will cause approximately \$10.8 billion in lost sales and use tax revenue nationwide by 2003. Donald Bruce & William F. Fox, *E-Commerce in the Context of Declining State Sales Tax Bases*, 53 NAT’L TAX J. (forthcoming December 2000) (manuscript at 1, on file with the North Carolina Law Review). Though this estimate may seem outlandish, the Boston Consulting Group has estimated that E-commerce revenues will grow from \$109 billion at the close of 1999 to as much as \$2 trillion in 2003. *Id.* (manuscript at 10 n.11). On MSNBC’s *Hardball with Chris Matthews*, Jim Barksdale, former Netscape CEO, was asked to comment on the University of Tennessee study. He opined that most E-tailers would be willing to collect use tax if the current sales and use tax system was simplified. *Hardball with Chris Matthews* (MSNBC television broadcast, Oct. 23, 2000).

Another study analyzing the effect of E-commerce on sales and use tax collection concluded that the negative impact on state treasuries is largely a byproduct of the states’ poor enforcement of the current use tax. *See* Cline & Neubig, *supra* note 8, ¶ 40. This study also estimated the total lost revenue from Internet transactions in 1998 to be \$170 million, which is less than 0.1% of all state and local sales and use tax revenues. *Id.* ¶ 30.

17. In March 2000, several state governments organized the Streamlined Sales Tax Project to develop and implement the Streamlined Sales Tax System (SSTS). Thirty-nine states have since joined the project in some capacity. SSTS Executive Summary, *supra* note 7, at 1. A steering committee comprised of sales and use tax experts from state departments of revenue created four work groups—Tax Base and Exemption Administration; Tax Rates, Registration, Returns, and Remittances; Technology, Audit, Privacy, and Paying for the System; and Sourcing and Other Simplifications—to address the key issues related to the collection of sales and use tax on all types of commerce. *Id.*

18. Sales and use tax is the largest single source of revenue for most states. *NGA Online, Facts and Figures*, at <http://www.nga.org/Internet/TaxSources.asp> (last visited Nov. 15, 2000) (on file with the North Carolina Law Review). According to the NGA, sales and gross receipts tax revenue represents almost fifty percent of the total tax revenue for all states. *Id.*

19. *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992).

framework of Due Process Clause and Commerce Clause jurisprudence.<sup>20</sup>

This Note examines the policy issues behind the current push for sales and use tax reform and evaluates the merits of the SSTS—the conceptual framework states are most likely to implement.<sup>21</sup> Part I identifies four key tax policy objectives that should be incorporated in any proposal to reform the current sales and use tax system. These policy objectives establish the core principles for the Note’s analysis of both the SSTS and any other proposal to collect sales and use tax on E-commerce.<sup>22</sup> Part II sets forth the proposed SSTS and evaluates it in light of the current political landscape.<sup>23</sup> Part III measures the SSTS against the tax policy objectives established in Part I.<sup>24</sup> The Conclusion then provides some observations about the SSTS and the future direction of the power struggle between state governments and private industry.<sup>25</sup>

## I. TAX POLICY OBJECTIVES FOR STATE TAXATION OF E-COMMERCE

The elusive and transient nature of E-commerce largely defines the tax policy objectives that should apply to state taxation of this new economic frontier. E-commerce uses an interconnected system of “computer networks to facilitate transactions involving the production, distribution, sale, and delivery of goods and services” to

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20. The notice theme, which is based upon “traditional notions of fair play and substantial justice” associated with the Due Process Clause, when coupled with the “substantial nexus” requirement under the Commerce Clause, significantly limits a state’s ability to collect use tax on interstate commerce. See *Morse*, *supra* note 2, at 1129. Furthermore, *Quill* clearly established the constitutional test as a two-prong analysis. *Quill*, 504 U.S. at 313.

21. At least technically, all states exempt business-to-business sales (B2B) for resale from the retail sales tax base, and most states also exempt sales of components to be used in the production of property for resale. See 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶¶ 14.02–14.03 (3d ed. 1998). In early 2000, B2B exchange sites were predicted to explode in popularity. A recent article in the *Wall Street Journal*, however, recounts the surprising failure of many B2B sites. Jason Anders, *B2B: Yesterday’s Darlings*, WALL ST. J., Oct. 23, 2000, at R8. The ultra-competitive nature of the B2B market, coupled with the fact that many industries decided to create their own B2B exchanges, resulted in the unforeseen demise of many B2B businesses. *Id.*

This Note limits its analysis of E-commerce taxation to the collection of sales and use tax on business-to-consumer transactions.

22. See *infra* notes 26–118 and accompanying text.

23. See *infra* notes 119–68 and accompanying text.

24. See *infra* notes 169–198 and accompanying text.

25. See *infra* note 199 and accompanying text.

the consumer.<sup>26</sup> Online retailers (“E-tailers”) create a “virtual” marketplace in which goods, both tangible and intangible, and services are immediately available for consumption with the point and click of a mouse.<sup>27</sup> The purchase and delivery of intangible goods and services can occur without the remote seller establishing even a scintilla of physical presence in the taxing jurisdiction. These characteristics of E-commerce beg the ultimate question of whether the current sales and use tax system—designed in the 1930s to cover face-to-face retail transactions and shaped by modern constitutional limitations on the states’ power to burden interstate commerce—is equipped to handle the challenges of the digital age in a fair and equitable manner.

This Part identifies four primary sales and use tax policy objectives that are applicable to both E-tailers and traditional “bricks-and-mortar” retailers. The policy objectives include (1) modifying the current physical presence-based nexus standard, (2) incorporating a “throwback” default rule to source transactions, (3) fostering tax-competitive equality, and (4) reducing the complexity of the current sales and use tax system.

*A. Modify the Nexus Standard to Reflect the Non-Physical Nature of E-Commerce*

Clarifying and possibly expanding the current nexus standard,<sup>28</sup> especially as it relates to the collection of use tax from remote sellers, is a crucial issue in the debate surrounding multi-state taxation of E-commerce.<sup>29</sup> Conceptually, the nexus inquiry is similar to the “minimum contacts” test for personal jurisdiction under the Due Process Clause<sup>30</sup>—both serve as the threshold determination of a state’s power over a party. Due to this similarity, courts were often tempted to collapse the nexus evaluation into the due process

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26. Howard E. Abrams & Richard L. Doernberg, *How Electronic Commerce Works*, 14 TAX NOTES INT’L 1573, 1573 (1997).

27. See Morse, *supra* note 2, at 1128.

28. “Nexus” is a term of art that describes the existence of “sufficient contacts or connections” between a taxing jurisdiction and the taxpayer. Karl A. Frieden & Michael E. Porter, *The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce*, Part IV.A (1996), at <http://www.caltax.org/andersen/part4.htm> (on file with the North Carolina Law Review).

29. See Tony Foley, *18th National Institute on SALT Focuses on Nexus, M & A, Pass-Through Entities, and Other Issues*, CCH TAX NEWS DIRECT, at 1 (1999) (on file with the North Carolina Law Review).

30. U.S. CONST. amend. XIV; *Int’l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945).



analysis.<sup>31</sup> In addition, the Commerce Clause<sup>32</sup> also factored into the nexus analysis because use tax collection involves interstate commerce.<sup>33</sup> Historically, the courts maintained that the Due Process Clause and the Commerce Clause placed similar constitutional constraints upon a state's power to compel a remote seller to collect use tax.<sup>34</sup>

In *Quill Corp. v. North Dakota*,<sup>35</sup> the Supreme Court held for the first time that the nexus requirements of the Due Process and Commerce Clauses do not address the same concerns.<sup>36</sup> The Court departed from precedent and reasoned that "the 'substantial nexus' requirement is not, like due process 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."<sup>37</sup> Thus, the Court held that the bright-line physical presence requirement, previously established in *National Bellas Hess, Inc. v. Department of Revenue*<sup>38</sup> as an essential element of the nexus analysis for both the Due Process and Commerce Clauses, was no longer necessary for the due process nexus analysis.<sup>39</sup> Consequently, *Quill* overruled earlier decisions to the extent that they

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31. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 312-13 (1992).

32. U.S. CONST. art. I, § 8, cl. 3 (granting Congress the power "[t]o regulate commerce . . . among the several States").

33. See Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 434 (1997) [hereinafter Hellerstein, *State Taxation of Electronic Commerce*].

34. See, e.g., *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 248-51 (1987); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 756-58 (1967).

35. 504 U.S. 298 (1992). *Quill* was a mail-order company that sold office equipment and supplies. *Id.* at 302. It maintained offices in Illinois, California, and Georgia. *Id.* Aside from its 3000 customers in North Dakota, *Quill* had no other ties to the state. *Id.* North Dakota initiated the suit to compel *Quill* to collect use tax on its sales to North Dakota residents. *Id.* at 303. The Supreme Court held that North Dakota's attempt to collect use tax from *Quill* constituted an unconstitutional burden on interstate commerce. *Id.* at 317-18.

36. *Id.* at 312.

37. *Id.* at 313 (quoting *Complete Auto*, 430 U.S. at 279; *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)). In his strongly worded dissent, Justice White characterized this interpretation as "an uncharted and treacherous foray into differentiating between the 'nexus' requirements under the Due Process and Commerce Clauses." *Id.* at 325 (White, J., dissenting). Justice White also noted that *Quill* was the first case in which the Supreme Court found "sufficient contacts for due process purposes but an insufficient nexus under the Commerce Clause." *Id.* (White, J., dissenting).

38. 386 U.S. 753 (1967).

39. *Quill*, 504 U.S. at 305-08. Removing the physical presence requirement from the due process analysis provides less of a constitutional challenge to the states' taxing authority. See *id.*

held that “the Due Process Clause requires physical presence in a State for the imposition of [a] duty to collect a use tax.”<sup>40</sup>

Although its holding abandoned the physical presence requirement for Due Process Clause purposes, the *Quill* Court reaffirmed this requirement for the Commerce Clause nexus analysis.<sup>41</sup> Following *Quill*, a state court may exercise personal jurisdiction over an out-of-state taxpayer under the due process “minimum contacts” standard,<sup>42</sup> but if the taxpayer does not have some physical presence in the state, the state may not impose a duty to collect use tax under the Commerce Clause.<sup>43</sup> Consequently, the substantial nexus inquiry involves a determination of what activities and connections to the taxing jurisdiction constitute the physical presence necessary to establish nexus under the Commerce Clause.

In *Complete Auto Transit, Inc. v. Brady*,<sup>44</sup> the Supreme Court established a four-part test to determine whether a state tax unduly burdens interstate commerce and thus is unconstitutional under the Commerce Clause.<sup>45</sup> Under this test, the Court will uphold a state tax law challenged under the Commerce Clause if the “tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”<sup>46</sup> *Quill* relied on the first prong of the *Complete Auto* test to

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40. *Id.* at 308.

41. *Id.* at 317–18.

42. *See id.*

43. *See id.* The Court emphatically rejected North Dakota’s contention that the nexus requirements for the Due Process and Commerce Clauses are the same. *Id.* at 312. If North Dakota’s argument had prevailed, however, the constitutional limitations upon a state’s taxing power would be severely compromised. Under North Dakota’s argument, a state could impose a duty to collect use tax so long as an out-of-state seller satisfied the due process “minimum contacts” standard without establishing a physical presence in the state. *See id.* Some commentators argue that *Quill* essentially removed the Due Process Clause as a hurdle to a state’s desire to impose a use tax collection responsibility on remote sellers. Hellerstein, *State Taxation of Electronic Commerce*, *supra* note 33, at 440 n.55; Fred O. Marcus, *Nexus on the Information Superhighway*, at <http://www.nasbo.org/resource/taxfee/marcus01.htm> (last modified Sept. 26, 1997) (on file with the North Carolina Law Review).

44. 430 U.S. 274 (1977). *Complete Auto Transit*, a Michigan-based motor carrier for General Motors, transported automobiles manufactured in Michigan from the railway yard in Jackson, Mississippi, to local auto dealers. *Id.* at 276. *Complete Auto Transit* argued unsuccessfully that applying a Mississippi franchise tax to interstate commerce violated the Commerce Clause. *Id.* at 277. The Court rejected *Complete Auto Transit*’s argument that interstate commerce is immune from state taxation and held that the Mississippi franchise tax did not violate the Commerce Clause. *See id.* at 288–89.

45. *See id.* at 279; Marcus, *supra* note 43.

46. *Complete Auto*, 430 U.S. at 279.

hold that a remote seller must have a “substantial nexus” with the taxing jurisdiction before the remote seller is obligated to collect use tax for that jurisdiction.<sup>47</sup> Unfortunately, neither *Complete Auto* nor *Quill* adequately defined what level of physical presence<sup>48</sup> qualifies as a “substantial nexus.”<sup>49</sup> Under a strict interpretation of *Quill*, minimal physical presence in the taxing jurisdiction could generate an obligation to collect use tax. Although post-*Quill* case law does not develop this issue clearly, the Court designed the physical presence requirement to provide a bright-line test that signified to the taxpayer and the state that the imposition of a use tax collection responsibility could now withstand a Commerce Clause challenge.<sup>50</sup>

The key question in Part I of this Note is whether the physical presence nexus standard established in *Quill* remains viable in the often non-physical E-commerce context. The server system, which interfaces with the E-tailer’s Web site to facilitate online transactions, illustrates the difficulties a state faces when trying to fit E-commerce within the current sales and use tax system.<sup>51</sup> Arguably, a server system is a tangible manifestation of the taxpayer’s physical presence in the taxing state and thus creates a “substantial nexus” with the state. Treating servers as *prima facie* evidence of a taxpayer’s

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47. *Quill*, 504 U.S. at 312–13.

48. Unanswered questions include the following: (1) whether a de minimis allowance provides a safe harbor from incidental contact with the taxing jurisdiction, (2) whether affiliated companies share nexus, and (3) whether intangible property triggers nexus. See Marcus, *supra* note 43.

49. For the most part, state courts bear the burden of interpreting what “substantial nexus” means. See *id.* State courts have interpreted “substantial nexus” in terms of economic nexus, temporary in-state presence, affiliate nexus, and in-state agents or employees. See *id.* Justice White, who dissented from the majority opinion in *Quill*, predicted that the Court’s failure to define the level of physical presence necessary to establish “substantial nexus” would produce much litigation. *Quill*, 504 U.S. at 330–31 (White, J., dissenting). This ill-defined standard creates an environment in which the states can aggressively impose use tax collection obligations on remote sellers and force these sellers to either settle the assessment or resort to costly litigation. See *id.* (White, J., dissenting). Based upon the large number of cases addressing this issue, the states have been quite active in imposing use tax collection responsibilities on remote sellers. See Marcus, *supra* note 43.

50. The Court acknowledged that recent Commerce Clause jurisprudence preferred a flexible weighing analysis to the more formalistic physical presence test applied in *Bellas Hess*. *Quill*, 504 U.S. at 314. Nevertheless, the Court used *stare decisis* to defend the continued validity of the *Bellas Hess* physical presence rule. *Id.* at 314–18. In support of its holding in *Quill*, the Court also noted that *Bella Hess*’s bright-line rule had produced settled expectations in the mail-order industry in the twenty-five years since the case was decided. *Id.* at 316.

51. See Org. for Econ. Co-operation & Dev., *Electronic Commerce: The Challenges to Tax Authorities and Taxpayers* 6 (Nov. 18, 1997), at [http://www.oecd.org/daf/fa/e\\_com/turku\\_e.pdf](http://www.oecd.org/daf/fa/e_com/turku_e.pdf) (on file with the North Carolina Law Review).

physical presence in a state, however, is not a suitable principle to adopt<sup>52</sup> because Web sites can detect heavy traffic areas on the Internet and automatically reroute transactions through another server in a different state, thus complicating a state's efforts to determine the taxpayer's level of presence in that state.<sup>53</sup> Hence, a growing number of commentators support modifying *Quill's* physical presence test in favor of a nexus standard more reflective of the elusive nature of E-commerce.<sup>54</sup>

Despite the difficulty in determining taxpayers' physical presence in E-commerce transactions, most state courts have been reluctant to adopt an alternative nexus theory.<sup>55</sup> One alternative that has gained

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52. For example, in April 2000, the Virginia Department of Taxation issued a private letter ruling announcing that the mere use of a server located in Virginia does not create nexus for the Web site. Va. Ruling of Comm'r PD 00-53, 2000 WL 985992, at \*2 (Va. Dep't Tax. Apr. 14, 2000). Additional contacts are required before Virginia considers the nexus relationship established. *Id.*

53. See Kelley L. Mayer, Note, *Reform of United States Tax Rules Governing Electronic Commerce Transfer Pricing*, 21 T. JEFFERSON L. REV. 283, 288 n.31 (1999). The "shifting presence" issue also impacts the allocation of income among taxing jurisdictions because a state may have a valid claim to a portion of the income if a server located in that state was used to conduct the transaction.

54. See Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 295 (1997) [hereinafter McLure, *Taxation of Electronic Commerce*]. Professor McClure asserts that "economic nexus" is the appropriate standard to apply to E-commerce but emphasizes that the standard must be accompanied by "greater uniformity of state sales taxes and de minimis rules that would exempt out of state vendors making small amounts of sales into a state from the duty to collect use taxes." *Id.* at 296; see also Walter Hellerstein, *Transactional Taxes and Electronic Commerce: Designing State Taxes That Work in an Interstate Environment*, 50 NAT'L TAX J. 593, 597 (1997) (encouraging "a fresh approach that essentially 'reverse engineers' the nexus issue"); Morse, *supra* note 2, at 1166-67 (expressing concern that *Quill's* physical presence requirement prevents effective taxation of E-commerce); Anna M. Hoti, Comment, *Finishing What Quill Started: The Transactional Nexus Test for State Use Tax Collection*, 59 ALB. L. REV. 1449, 1476-84 (1996) (supporting a test that limits the nexus analysis to the transaction in question rather than to an evaluation of the remote sellers' other contacts with the taxing state).

55. See generally Craig J. Langstraat & Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 AKRON TAX J. 1, 1-2 (1999) (discussing the theory and constitutionality of economic nexus). Agency nexus and affiliation nexus are two variations of economic nexus that approach the physical presence issue in a less direct manner. See *id.* at 5. Some states have successfully argued that a relationship with an in-state agent or employees may satisfy *Quill's* physical presence requirement for "substantial nexus." See, e.g., *Carapace, Inc. v. Limbach*, No. 90-R-825, 1993 Ohio Tax LEXIS 950, at \*6 (Ohio Bd. Tax App. May 28, 1993) (holding that nexus is established when an out-of-state seller employs an in-state representative to conduct its business). Under the affiliate nexus alternative, the nexus relationship of a single member of an affiliated company is imputed to all members of the affiliate. See Marcus, *supra* note 43. Thus, a state could impose a use tax collection responsibility on a company with no physical presence in the taxing state if an affiliate of the company maintains "substantial nexus" with the state. See *id.* To date, however, no state court has imposed a collection

support from the academic community and some state courts, however, is *economic nexus*, which is defined without reference to the remote seller's physical presence in the taxing jurisdiction.<sup>56</sup> The remote seller's delivery of purchased goods or services for final consumption or use triggers an economic nexus with the delivery state.<sup>57</sup> Put another way, "[t]axable activity should imply nexus."<sup>58</sup> An economic nexus creates the presumption that a remote seller must collect sales and use tax on every taxable sale, thereby substantially expanding a state's power to tax.<sup>59</sup> To minimize the administrative and compliance burdens on small businesses, economic nexus should incorporate a *de minimis* threshold to eliminate the collection responsibility of a remote seller with only a small amount of gross sales in a particular jurisdiction.<sup>60</sup> Although adoption of the economic nexus standard requires judicial action, the power to determine the *de minimis* threshold of economic activity should be reserved to the state legislature.

The transient nature of E-commerce creates the common scenario in which the *Quill* physical presence-based nexus standard prevents a state from collecting sales and use tax revenue from an out-of-state seller who generates millions of dollars in annual sales to in-state buyers only because the seller lacks a physical presence in the state.<sup>61</sup> *Quill* allows remote sellers to benefit financially from transactions with a state's residents and to utilize the state's infrastructure without incurring an obligation to collect use tax on the seller. Conversely, and much to the delight of the states, economic nexus eliminates the physical presence requirement and focuses

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responsibility on a remote seller merely on the basis of the nexus of a corporate affiliate. See *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693, 696-97 (Ohio 1995) (holding that Ohio may not impute the nexus of a parent company to a wholly-owned subsidiary with no physical presence in the state); *Current, Inc. v. State Bd. of Equalization*, 29 Cal. Rptr. 2d 407, 411-12 (Cal. Ct. App. 1994) (requiring either an agency relationship or a piercing of the corporate veil before nexus can be attributed to corporate affiliates).

56. Professors Charles McLure and Matthew N. Murray advocate the merits of economic nexus. McLure, *Taxation of Electronic Commerce*, *supra* note 54, at 295-96; Matthew N. Murray, *Telecommunications Services and Electronic Commerce: Will Technology Break the Back of the Sales Tax?*, 1997 ST. TAX TODAY, Jan. 30, 1997, ¶ 39, at LEXIS, LEXSTAT, 97 STN 20-41. Establishing a low physical presence threshold allows the court to apply the economic nexus analysis, which weighs a remote seller's economic contacts with the taxing jurisdiction.

57. Murray, *supra* note 56, ¶ 39.

58. McLure, *Taxation of Electronic Commerce*, *supra* note 54, at 395.

59. See Langstraat & Lemmon, *supra* note 55, at 4.

60. McLure, *Taxation of Electronic Commerce*, *supra* note 54, at 395-96.

61. See generally *id.* at 365-66 (arguing for a new approach to the nexus issue that makes the remittance and collection of sales and use tax administratively feasible).

primarily upon whether the remote seller's financial activities within the taxing jurisdiction exceed the de minimis threshold. Under an economic nexus analysis, a court may consider factors such as the remote seller's number of customers in the state, gross sales generated from residents of the taxing jurisdiction, and marketing efforts purposefully directed toward the state.<sup>62</sup> Including these additional factors in the nexus calculation leads to a more equitable result because a state's ability to collect use tax does not turn solely upon whether the remote seller maintained a physical presence in that state. Further, in light of the elusive nature of E-commerce, reliance upon a seller's economic connections with the state creates a more complete justification for requiring a remote seller to collect use tax.

Nexus determines which states have the power to require a remote seller to collect sales and use tax. The first step in the states' effort to reform the sales and use tax system therefore should be to modify the traditional nexus standard to reflect a remote seller's economic connections with a taxing jurisdiction. Nevertheless, under any nexus analysis, multiple taxing jurisdictions may have power over a remote seller. To avoid multiple taxation only one state may actually exercise that power. Siting principles then determine which state is entitled to exercise the ultimate authority to require remote sellers to collect use tax.

*B. Incorporate a "Throwback" Default Rule in Destination-Based Siting Principles*

Under the current sales and use tax system, a transaction is sourced based on where the end-consumer uses the product.<sup>63</sup> This approach to sourcing interstate transactions is known as destination-based siting and works well when the seller is aware of the purchaser's location or the place of final consumption. E-commerce,

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62. Murray, *supra* note 56, ¶ 39.

63. NAT'L TAX ASS'N, COMMUNICATIONS AND ELECTRONIC COMMERCE TAX PROJECT, FINAL REPORT 29, at <http://www.ntanet.org/ecommerce/final.pdf> (last visited Nov. 15, 2000) (on file with the North Carolina Law Review) [hereinafter NTA FINAL REPORT]. The NTA report represented a three-year collaborative effort by members of state and local governments, taxpayer and industry organizations, and members of academia, who joined forces to work through extremely complex tax issues. See David Brunori, *Interview: Kendall L. Houghton on Business Advocacy, Nexus, and the MTC*, 1999 ST. TAX TODAY 210-14, Nov. 1, 1999, at LEXIS, LEXSTAT, 1999 STT 210-14. Although the work of this project preceded the creation of the ACEC, the ACEC garnered most of the media attention because of its congressional mandate to study the E-commerce tax issue.

however, presents a situation in which the online seller often does not know where the buyer is located, much less where the item will be consumed.<sup>64</sup> The seller's difficulty in determining the buyer's location impairs the allocation of the transaction to the sales and use tax base of the appropriate state.<sup>65</sup> If the remote seller cannot determine the buyer's situs,<sup>66</sup> neither the seller nor the state have a starting point for the all-important nexus analysis.<sup>67</sup> In other words, the remote seller has no way of determining which taxing jurisdiction may lawfully assert a claim to the use tax generated by a sale or whether she has a satisfactory nexus relationship with that jurisdiction. Thus, the current destination-based approach creates tremendous collection difficulties when the buyer's situs is unknown or difficult to determine.<sup>68</sup>

Although states have traditionally applied destination-based situsing, the emergence of E-commerce threatens the continued applicability of this approach.<sup>69</sup> In the search for a workable solution to the unknown situs problem, some commentators argue that an origin-based approach is more suitable for E-commerce.<sup>70</sup> Under an origin-based system, the taxing jurisdiction is the state where the

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64. For example, the Internet sale of digitized products and services such as software is very difficult to track because the seller does not need a postal address to deliver the item. Consequently, the seller probably never knows where the item is ultimately consumed.

65. Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on Emerging Issues*, 52 U. MIAMI L. REV. 691, 709 (1998) [hereinafter Hellerstein, *Emerging Issues*] (discussing the difficulties associated with identifying the location of an online buyer).

66. Situs refers to the location where the transaction occurred. Sandi Owen, Note, *State Sales & Use Tax on Internet Transactions*, 51 FED. COMM. L.J. 245, 247 (1998).

67. At the transactional level, knowledge of the buyer's situs dictates what state is involved in the nexus analysis. Although a remote seller is probably aware of the states where it has an established nexus relationship, this knowledge is irrelevant if the seller does not know the buyer's situs.

68. In situations where the seller cannot identify the consumer's location, the seller is required to make a good faith attempt to determine it. Hellerstein, *Emerging Issues*, *supra* note 65, at 703-04. Unless the seller can trace the transaction to the buyer's situs, no sales and use tax will be paid to the unknown destination state. *Id.*

69. NTA FINAL REPORT, *supra* note 63, at 30.

70. In a debate with Frank Shafroth of the NGA regarding the SSTS, Adam Thierer of the Heritage Foundation argued that "an origin-based system is the only possible solution that fits within the founding fathers' constitutional construct and the commercial jurisprudence that emerged from it." NGA's Shafroth, *Heritage's Thierer on "Streamlined" Proposal, Origin-basing for E-Commerce*, 2000 ST. TAX TODAY 15-17, Jan. 24, 2000, ¶ 46, at LEXIS, LEXSTAT, 2000 STT 15-17 [hereinafter *Shafroth/Thierer Debate*].

transaction originated rather than where the item is consumed.<sup>71</sup> Proponents of an origin-based sales and use tax system point to the predictability of this approach as its key benefit.<sup>72</sup> Nevertheless, this approach, which arguably eases the administrative burden of sales and use taxes on remote sellers, effectively creates an export duty on outbound commerce.<sup>73</sup> With the origin state imposing the sales tax, the aggregate sales price offered to consumers is increased to reflect this additional cost of doing business in the taxing jurisdiction. Including sales tax on all outbound sales skews purchasing decisions in favor of sellers from no-tax and low-tax jurisdictions.<sup>74</sup> Consequently, a state adopting the origin-based approach places online sellers from that state at a competitive disadvantage in interstate commerce.<sup>75</sup> While the predictability and apparent

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71. See Paul Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581, 584 (1997). To illustrate the origin-based approach, assume that an online seller operates exclusively on the Internet and maintains its warehouse and headquarters in Delaware. This structure provides the maximum sales and use tax benefits for the online seller because origin-basing gives Delaware the exclusive authority to tax this sale. Because Delaware's current tax regime does not exercise this authority, however, this transaction is tax-free from a sales and use tax perspective. Such favorable treatment will create another "race to the bottom" in which Delaware and the four other states without a sales and use tax—Alaska, Montana, New Hampshire, and Oregon—compete for the prize of attracting the greatest number of remote sellers to their states. *Id.* at 586.

72. See *id.*

73. Origin basing distorts the sales and use tax base in favor of states with a large manufacturing presence because the tax is based on production. Thus, high-export states may generate more sales and use tax revenue than states exporting fewer goods and services. See Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving Sovereignty in a Digital World*, 14 ST. TAX NOTES 1169, 1174 (1998) [hereinafter McLure, *Tax Assignment Problem*].

74. Remote sellers based in states with high sales tax rates are even further disadvantaged because they must either increase the mark-up to compensate for the higher tax rate or absorb the higher cost in the form of lower profits. For example, in Raleigh, North Carolina, the combined state and local sales and use tax rate is 6%, whereas in Nashville, Tennessee, the highest combined rate is 8.25%. Assuming the initial cost to produce or acquire a good is the same for sellers from both states, the Nashville-based seller must mark up the sales price at least an additional 2.25% to preserve a profit margin identical to the seller from Raleigh. Thus, on a \$10,000 sale, a consumer who purchased a good from the Raleigh seller would save \$225 due to the difference in sales tax rates. For state and local sales and use tax rate information in North Carolina and Tennessee, see N.C. Dep't of Revenue, *Frequently Asked Questions About Sales and Use Tax*, at <http://www.dor.state.nc.us/faq/sales.html> (last modified Jan. 13, 2000) (on file with the North Carolina Law Review); Tenn. Dep't of Revenue, *Sales and Use Tax—Frequently Asked Questions*, at <http://www.state.tn.us/revenue/faq.htm#SALES> (last modified Nov. 2, 2000) (on file with the North Carolina Law Review).

75. If all states do not adopt origin-based principles, states that do adopt these principles will encounter a long-term decrease in sales tax revenue because origin taxation



simplicity of origin taxation are initially appealing, the practical impediments of this approach reveal that this sourcing scheme is even more problematic than the current destination-based system.<sup>76</sup>

Although neither the current destination-based approach nor the origin-based alternative fully remedies the unknown situs problem encountered in E-commerce, numerous commentators argue for the continued application of destination-based situsing principles to preserve neutral tax treatment of goods and services regardless of the seller's location.<sup>77</sup> Unlike origin taxation, whose tax rate structure fluctuates with the seller's location, the applicable sales tax rate in destination-based taxation remains constant for buyers in the same taxing jurisdiction. Thus, similarly situated buyers are liable for the same amount of sales and use tax, which in turn creates a level playing field for remote sellers and protects in-state sellers from sellers based in states without a sales tax.<sup>78</sup> Even though destination taxation produces a more equitable result than origin taxation, the key question remains how state governments should resolve the unknown situs problem within a destination-based tax system.

Requiring the seller to determine the online buyer's situs arguably violates the *Quill* Court's strong admonition to the states to simplify and clarify the sales and use tax system on a nationwide basis. Namely, the compliance and enhanced administrative burdens of such determinations are the primary concerns of a destination-based sourcing scheme. The extent to which online sellers deal with anonymous buyers is an often overlooked factor that discounts these concerns.<sup>79</sup> Similar to their bricks-and-mortar counterparts, online sellers have a strong business interest in identifying their customer

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encourages companies to relocate to states applying destination-based principles. See Mines, *supra* note 71, at 586.

76. Hellerstein, *Emerging Issues*, *supra* note 65, at 703.

77. See generally William F. Fox & Matthew N. Murray, *The Sales Tax and Electronic Commerce: So What's New?*, 50 NAT'L TAX J. 573, 575 (1997) ("[A] destination tax should be adopted to the maximum extent possible to obtain neutral treatment of services delivered from different locations."); Hellerstein, *Emerging Issues*, *supra* note 65, at 703 (asserting that the buyer's billing address should establish the sale's situs); McLure, *Tax Assignment Problem*, *supra* note 73, at 1174 (noting that "state sales taxes are, in principle, levied on a destination basis"); Mines, *supra* note 71, at 581-82 & n.5 (citing authorities that support the conclusion that destination-based taxation is preferable to an origin-based taxation).

78. As illustrated previously, remote sellers from states with either lower sales tax rates or no sales tax possess a competitive advantage over a local seller in a high tax state. See *supra* note 74. The more elastic the demand for the desired good or service, the more significant this advantage becomes.

79. Mines, *supra* note 71, at 584-85.

base<sup>80</sup> in order to employ more effective marketing efforts targeted at specific populations, which in turn presumably generates additional sales revenue. This incentive to identify the customer base should limit the number of transactions involving anonymous buyers. Further, to minimize any unnecessary burden the unknown situs problem may create for small businesses, a state may adopt a de minimis threshold for total sales.<sup>81</sup> Remote sellers with sales below the specified amount would be exempt from collecting the sales and use tax when they cannot determine a buyer's situs following a reasonable investigation.<sup>82</sup> Nevertheless, the unknown situs problem still lingers for remote sellers with sales in excess of the threshold amount.

Most states need look no further than their own income tax provisions to discover the most plausible solution to the unknown situs issue. The "throwback" rule<sup>83</sup> is a common state income tax principle that sources taxable income to the origin state when the destination state is unable to tax the income. This recapture concept would function equally well as a safety net in a destination-based sales and use tax system when the situs of the transaction is indeterminable. Rather than allowing an otherwise taxable sale to escape taxation because of the unknown situs issue, the "throwback" rule allows the origin state to recapture the sale into its sales tax base.<sup>84</sup> Incorporating this principle as a default mechanism resolves

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80. *See id.*

81. *See Mines, supra* note 71, at 584–85. The threshold amount could be based upon an aggregate amount of gross sales—quarterly, semi-annually, or annually—or on a transactional basis.

82. *See id.*

83. *See, e.g., UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT* § 16, 7 U.L.A. 353–54 (1985) (establishing the "throwback" rule). The "throwback" rule applies only when the destination state is unable to tax the income. *Id.* A state's election not to tax the income does not trigger the throwback rule. Thus, if the destination state exempts the transaction from taxation in that state, the throwback rule does not empower the origin state to recapture the income. *Id.*

An alternative to the throwback rule is the "throwaround" rule. *See Hellerstein, Emerging Issues, supra* note 65, at 704–05. Although more complicated than the throwback rule, the throwaround rule results in equitable resourcing because sales to anonymous buyers are apportioned to all states where the seller makes taxable sales via E-commerce. *Id.* Due to the additional complexities of the throwaround apportionment, the Court is more likely to find the throwback rule to be in accord with *Quill's* demand for simplification.

84. *See id.* at 705 n.42. If no mechanism is in place for the buyer to notify the seller of his location or if the buyer refuses to provide this information, the seller applies the sales tax rate of the origin state and adds the appropriate sales tax to the total amount due from the buyer. Thus, the anonymous buyer cannot avoid paying sales tax.

the unknown situs problem raised by E-Commerce and preserves the national sales and use tax base.

C. *Foster Tax-Competitive Equality Among Similarly Situated Economic Actors*

E-commerce raises serious tax issues because it threatens economic neutrality and equity in tax policy.<sup>85</sup> The principle of tax-competitive equality suggests that state sales and use tax should be applied to E-commerce in the same manner it is applied to retail transactions at the local mall.<sup>86</sup> As described in the White House's *Framework for Global Electronic Commerce*, "[n]o tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions."<sup>87</sup> Thus, the states should strive to "maintain competitive equality between similarly situated economic actors."<sup>88</sup>

The relative ease with which an E-tailer currently may avoid "substantial nexus" with a state, thereby sidestepping sales and use tax collection responsibility, provides the remote vendor with a decisive advantage over the bricks-and-mortar retailer who must collect and remit the sales tax and file the appropriate tax forms.<sup>89</sup> Consequently, bricks-and-mortar retailers claim that the current system discriminates against local retailers while granting online retailers a competitive advantage<sup>90</sup> because consumers can purchase the same product or a close substitute online for a comparable price without paying sales tax.<sup>91</sup>

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85. McLure, *Taxation of Electronic Commerce*, *supra* note 54, at 295.

86. See Hellerstein, *State Taxation of Electronic Commerce*, *supra* note 33, at 481.

87. President William J. Clinton & Vice President Albert Gore, Jr., *A Framework for Global Electronic Commerce*, at <http://www.iitf.nist.gov/eleccomm/ecommm.htm> (last visited Nov. 15, 2000) (on file with the North Carolina Law Review).

88. Hellerstein, *State Taxation of Electronic Commerce*, *supra* note 33, at 481.

89. See Morse, *supra* note 2, at 1145.

90. See *McLure Testimony*, *supra* note 2, ¶ 5. Jeff Bezos, the founder and CEO of Amazon.com, has indicated publicly that sales tax issues were a significant factor in his company's decision not to locate its operations in California. David Streitfeld, *Booking the Future; Does Amazon.com Show that Publishing Clicks on the Internet?*, WASH. POST, July 10, 1998, at A1. Avoiding nexus with California allows Amazon.com to sell taxable goods to California residents and not collect California sales and use tax. Based on Bezos' comments, Amazon.com saw this "loophole" as a tremendous opportunity to create a competitive advantage in the marketplace. *Id.*

91. University of Chicago economist Austan Goolsbee found that consumers in high sales tax jurisdictions were more likely to purchase products online than consumers in low sales tax jurisdictions. Austan Goolsbee, *In a World Without Borders: The Impact of Taxes on Internet Commerce*, 115 Q.J. ECON. 561, 562 (May 2000), available at <http://gsbwww.uchicago.edu/fac/austan.goolsbee/research/intertax.pdf> (last visited Nov. 15,

Moreover, with few E-tailers required to collect sales and use tax and with even fewer consumers properly reporting the use tax on Internet purchases, consumers who are either financially unable to enter the online marketplace or technologically unsophisticated are also subject to a form of economic discrimination—frequently referred to as the “digital divide.”<sup>92</sup> The high costs of entering the E-commerce marketplace effectively force the economically underprivileged consumer to purchase goods from the local bricks-and-mortar retailer who adds the sales tax to the purchase. Meanwhile, the wealthier consumer who can afford the computer and the Internet access fee is able to purchase the same goods without paying a sales and use tax. Not only is the E-tailer probably not under a duty to collect sales and use tax, but the state is not likely to enforce the online consumer’s use tax obligation. By favoring the wealthier consumer who can secure the means to Internet access, the current sales and use tax system arguably functions as a regressive tax.<sup>93</sup>

#### D. Reduce the Complexity of the Current Sales and Use Tax System

In addition to fostering competitive equality in the application of the sales and use tax, most state tax policy experts agree that uniform standards and definitions should be developed to reduce the administrative complexities of the current sales tax system.<sup>94</sup> In its Final Report on the Communications and Electronic Commerce Tax Project, the National Tax Association (NTA) identified three key factors responsible for the complexity of state and local sales tax

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2000). Professor Goolsbee asserts that consumer sensitivity to sales tax rate fluctuations, which motivates consumers living near geographic borders to cross the border and purchase the desired goods in a lower tax jurisdiction, also spurs consumers to engage in E-commerce because the online transaction is widely held (incorrectly, however) to be tax free. *Id.* Given the analogous relationship to consumers living in geographic border areas, the tax price elasticities of E-commerce are large, which indicates that enforcement of sales and use tax on Internet purchases may reduce online purchases by as much as twenty-four percent. *Id.*

92. In October 2000, the U.S. Department of Commerce released its fourth report in the last five years documenting the “digital divide.” Robert J. Shapiro & Gregory L. Rohde, *Introduction* to U.S. DEP’T OF COMMERCE, *FALLING THROUGH THE NET: TOWARD DIGITAL INCLUSION* xiii (2000) (on file with the North Carolina Law Review). This report cites statistics indicating that the disparity is narrowing. *Executive Summary*, in U.S. DEP’T OF COMMERCE, *FALLING THROUGH THE NET: TOWARD DIGITAL INCLUSION* at xv, xv–xviii.

93. The net effect of this form of economic discrimination is that the consumers who could benefit the most from this quirk in the administration of sales and use tax are denied this opportunity for the very reason they need this benefit.

94. See Hellerstein, *State Taxation of Electronic Commerce*, *supra* note 33, at 481.

regimes.<sup>95</sup> First, sales tax rates may fluctuate within the same state because of the numerous local governments that are authorized to impose local sales taxes in addition to the state sales tax.<sup>96</sup> Second, the lack of consistent and uniform definitions of taxable goods and services that comprise the tax base places a significant burden on interstate commerce.<sup>97</sup> Third, to comply with state and local sales tax laws, multi-state sellers also encounter a differing array of administrative and compliance requirements.<sup>98</sup> These three factors evidence the undue burden on interstate commerce that the Supreme Court addressed in *Quill*.<sup>99</sup>

With forty-six states and approximately 7600 jurisdictions across the country levying sales and use taxes, a strong case can be made for creating uniformity among the taxing jurisdictions.<sup>100</sup> The *Quill* Court underscored this point when it held that North Dakota's use tax unduly burdened interstate commerce.<sup>101</sup> Although the Court noted the necessary complexity of the sales and use tax system due to the sheer number of taxing jurisdictions, it opened the door for Congress to legislate the extent to which the states may burden remote sellers with the duty to collect and remit use taxes.<sup>102</sup> To date, Congress has not accepted this invitation.<sup>103</sup> Currently, the complexity of the sales and use tax system reflects Congress's deference to the states on matters perceived to be purely state-related.

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95. NTA FINAL REPORT, *supra* note 63, at 8.

96. *Id.* at 12–15 (arguing that the “current rate structure complicates sales tax administration in the areas of assigning appropriate tax rates, sourcing transactions, and filing tax returns”).

97. *See id.* at 19–28 (contending that tax base simplification is needed because the current lack of uniformity makes tax compliance difficult for multi-state sellers who are subject to different definitions and classifications in each jurisdiction where the seller has nexus).

98. *See id.* at 50 (“State and local sales taxes and their administration are confusing and burdensome.”). The NTA project identified the following three approaches to enhance administrative simplification: (1) the base state approach, (2) the real time approach, and (3) a modification of the current system. *See id.* at 51–74.

99. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 312–18 (1992).

100. NTA FINAL REPORT, *supra* note 63, at 12.

101. *Quill*, 504 U.S. at 312.

102. *Id.* at 318.

103. Congress views sales and use tax reform as a state and local issue and thus is not willing to take the political risks involved with such a reform effort. Telephone Interview with Eddie Bringham, Senior Tax Manager, Arthur Andersen LLP (Mar. 3, 2000). Politically, Congress stands to gain very little if it champions the states' campaign to reform the sales and use tax system. *See id.* Hence, the House's recent extension of the moratorium on new Internet taxes is not surprising. *See Internet Nondiscrimination Act of 2000*, H.R. 3709, 106th Cong. (2000).

Even with a slightly different classification structure implemented in each state, E-commerce further complicates the traditional distinctions between goods and services. Proper classification of an item as either a good or a service is the initial step in determining whether the transaction is taxable for sales and use tax purposes.<sup>104</sup> If the item initially is classified as a good, it then must be sub-classified as either tangible or intangible.<sup>105</sup> In developing uniform definitions and classifications, the states should pay special attention to digitized goods and, given the increasing ability of some goods to take on both tangible and intangible traits, should reconsider the traditional presumption that tangible goods are taxable and intangible goods are not.<sup>106</sup> To simplify the taxation of all goods, the states should consider moving away from an enumeration approach and toward an exception-based approach in which a sale of goods—tangible or intangible—is presumed taxable unless a statutory exemption applies. The exception-based approach should reduce confusion for businesses remitting sales and use taxes in multiple states. Under such an approach, sales of tangible goods are generally taxable.

In contrast to the presumption of the taxability of the sale of goods, most transactions involving services are presumed not taxable unless the applicable statute states otherwise.<sup>107</sup> With an increasingly service-driven economy,<sup>108</sup> state lawmakers should rethink the appropriateness of continuing the sales and use tax preference for services that are consumption-based.<sup>109</sup> If the sales and use tax is

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104. See Morse, *supra* note 2, at 1130–39 (defining and classifying taxable sales). This Note addresses the need for a uniform system of definitions and classifications more fully *infra* notes 178–83 and accompanying text.

105. The purchase of goods with both tangible and intangible characteristics illustrates the tax consequences involved in making this sub-classification. For example, if a consumer purchases computer software at a retail store, sales tax is added to the cost of the transaction. If the consumer purchases the software online and downloads it directly to her computer, however, the online merchant does not have a duty to collect the sales and use tax under *Quill* unless the merchant has a physical presence in the state. See *Quill*, 504 U.S. at 314–18. For ambiguous items such as software, reference to other sources of commercial law may be helpful in resolving definitional issues. See, e.g., U.C.C. § 9-105 (1978) (defining goods and services); Rev. U.C.C. § 9-102(a)(44), (75) (2000) (same).

106. For example, computer software, music, and literary works are frequently distributed and sold in either a tangible or intangible form.

107. Morse, *supra* note 2, at 1130.

108. In 1965, the sale of goods accounted for sixty-seven percent of the gross domestic product, but in 1992 this figure was only fifty-two percent. *Id.* at 1131.

109. Most, if not all, European nations apply value added tax (VAT) to goods and services at a rate between fifteen and twenty-five percent. JOEL SLEMRD & JON BAKIYA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX

truly a tax on consumption, it should also apply to services that are “consumed.”<sup>110</sup> Maintaining this “highly arbitrary” dichotomy between goods and services discriminates against consumers who prefer to satisfy personal needs with goods instead of services.<sup>111</sup> Perhaps the most compelling argument for the states to extend sales and use tax to at least consumption-oriented services is the increased ease of administration resulting from no longer distinguishing between the goods and services components of a particular item.<sup>112</sup> Similar treatment of goods and certain services will move the states one step closer to satisfying *Quill*’s demand for simplification of the sales and use tax system.

The key to national reform efforts that rely upon greater uniformity among the states, such as the SSTS, will rest largely upon the degree to which the states are willing to compromise their sovereignty. Under the current sales and use tax system, each state and some local governments have broad powers to determine tax rates, the tax base, and the administration of their sales tax.<sup>113</sup> More so than any other reform, the development of a uniform system of definitions and classifications provides multi-state sellers with a consistent reference to assist them in calculating the tax base for each state.<sup>114</sup> Although a common classification system infringes slightly upon the states’ sovereignty, each state retains the more important

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REFORM 201-03 (2d ed. 2000); Daniel Barlow, *VAT Aspects of E-commerce*, at <http://www.deloitte.co.uk/ebusiness/vataspectsecom.htm> (last visited Nov. 11, 2000) (on file with the North Carolina Law Review).

110. See Walter Hellerstein et al., *Commerce Clause Restraints on State Taxation After Jefferson Lines*, 51 TAX L. REV. 47, 103 (1995) (arguing that sales and use taxes should extend to services, such as personal automobile repair, residential landscaping, and hairdressing).

111. See 2 HELLERSTEIN & HELLERSTEIN, *supra* note 21, ¶ 12.03 (defining fundamental sales and use tax principles). An auto repair bill illustrates this dichotomy. Although sales tax is applied to the parts, or “goods” used to repair the car, sales tax is not applied to the labor, or “service” component, of the amount due.

112. See NTA FINAL REPORT, *supra* note 63, at 19.

113. See *id.*

114. The NTA project evaluated four sources for uniform definitions and classifications of products and services. NTA FINAL REPORT, *supra* note 63, at 19-22. The alternative sources included the United States Harmonized Tariff Schedule, the North American Industrial Code, the Bureau of Labor Statistics Expense Code, and the United Nations Centralized Product Classification Scheme. *Id.* The United Nations scheme was considered the best starting point for developing uniform tax base definitions because it included categories for all goods and services involved in both domestic and international transactions. See *id.* at 22.

power of determining which goods and services on the uniform list are taxable.<sup>115</sup>

In *Quill*, the Court restated earlier cases holding that the Commerce Clause “prohibits discrimination against interstate commerce and bars state regulations that unduly burden interstate commerce.”<sup>116</sup> This subtle reminder of prior Commerce Clause jurisprudence led some state leaders to speculate that the Court was not firmly wedded to the physical presence requirement and that substantial simplification of the sales and use tax system could persuade the Court to move away from the physical presence requirement.<sup>117</sup> A point of agreement in the E-commerce sales tax debate is the need to simplify the sales and use tax system so that the compliance burden is manageable and the administrative costs are not excessive.<sup>118</sup> Consequently, increased simplicity of administration is a key factor to be considered in evaluating the Streamlined Sales Tax System (SSTS).

## II. THE STREAMLINED SALES TAX SYSTEM

The SSTS<sup>119</sup> marks the first attempt by either the states or Congress to respond to *Quill*'s concerns regarding the overly complex and unduly burdensome sales and use tax system.<sup>120</sup> Congress arguably has no vested interest in the outcome of this issue, and its apparent unwillingness to pass legislation stipulating the extent to which the states may burden interstate commerce with an obligation to collect use taxes is therefore understandable. From Congress's perspective, sales and use taxation is predominantly a state and local

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115. Industry representatives on the NTA project advocated vesting the taxable or nontaxable determination solely with the state and requiring that local governments conform with the state-determined tax base. *Id.* at 19.

116. 504 U.S. 298, 312 (1992) (citations omitted).

117. South Dakota Governor William Janklow, an outspoken supporter of the SSTS, argued that the overwhelming compliance burden on remote sellers was a significant factor motivating the *Quill* Court to rule in favor of the mail-order company. See David Hardesty, *E-Commerce Tax Commission Limps Toward Dallas*, E-COMMERCE TAX NEWS (Dec. 17, 1999) at <http://www.ecommercetax.com/doc/121799.htm> (on file with the North Carolina Law Review). Thus, the Governor asserted that simplifying the sales tax administration and the compliance burden would remove the “undue burden on interstate commerce” that the Court addressed in *Quill*. *Id.*

118. See Hellerstein, *State Taxation of Electronic Commerce*, *supra* note 33, at 481.

119. At the time of this writing, the Streamlined Project has not released the final version of the SSTS. The Streamlined Project continues to consider new elements and to conduct public hearings regarding the SSTS. Streamlined Sales Tax Project: Proposals for Consideration at October 26, 2000 Public Hearing 1 (on file with the North Carolina Law Review).

120. See *Quill*, 504 U.S. at 311–16.



issue with only minimal federal implications. Congress's inaction since *Quill* seems to indicate that it is content to let the states take the first step toward resolving this complicated issue. Even though the SSTS responds to *Quill's* demand for simplification of the sales and use tax system, *Quill* expressly left this issue with Congress.<sup>121</sup> Consequently, the Streamlined Sales Tax Project's ("Streamlined Project") reluctance to seek congressional blessing of the SSTS is somewhat surprising.<sup>122</sup>

In an effort to satisfy *Quill*, the SSTS seeks "to simplify and modernize sales and use tax administration."<sup>123</sup> Unlike other proposals, the SSTS does not offer a detailed step-by-step implementation schedule;<sup>124</sup> rather, it provides a broad-based, principled approach that allows the states to work together to determine the specific details. Within this collaborative framework, the SSTS is designed to accomplish the following two objectives: (1) significantly reduce, if not eliminate, the current compliance and administrative burdens imposed upon remote sellers; and (2) preserve state and local sovereignty.<sup>125</sup> The SSTS intends to employ advanced technology and software to accomplish these objectives.<sup>126</sup>

Merchants who join the SSTS may choose from four business and technology models.<sup>127</sup> The models range from the full-service Certified Service Provider (CSP),<sup>128</sup> who functions as the sellers'

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121. *Id.* at 318.

122. According to Tim Masanz, an NGA staff member, the NGA fears that any effort to secure congressional support for the SSTS may backfire and result in a permanent moratorium on the collection of all E-commerce taxes, including sales and use tax. See Telephone Interview with Tim Masanz, Staff Member, National Governors' Ass'n. (Feb. 25, 2000). Mr. Masanz detailed the NGA's intense lobbying efforts to prevent Congress from banning the collection of all taxes on E-commerce when Congress debated the Internet Tax Freedom Act in 1998. *Id.* Thus, the NGA strongly prefers to avoid congressional intervention. *Id.*

123. SSTS Executive Summary, *supra* note 7, at 1.

124. In September 1997, the NTA undertook the Communications and Electronic Commerce Tax Project to study the taxation of communication and E-commerce. Two years later, the project ended in deadlock. Because the NTA Project became too detail-oriented and lost focus on the big picture, it illustrates that decisions regarding specific details should be left to the states' discretion.

125. See SSTS Executive Summary, *supra* note 7, at 1-2.

126. See *id.*

127. Streamlined Sales Tax System: Business and Technology Models 1 (Sept. 1, 2000 Working Draft) [hereinafter Draft SSTS Business & Technology Models] (on file with the North Carolina Law Review).

128. See *id.* Credit card companies would be ideal candidates for the CSP system. A state may enter agreements with multiple CSPs or may elect to designate only one CSP following a competitive bidding process. On a national level, CSPs function as the central

agent for sales and use tax collection and administration,<sup>129</sup> to merchants who continue to handle all sales and use tax related matters themselves.<sup>130</sup> The full-service model shifts the sales tax administration and compliance burden to CSPs, who bear the ultimate responsibility for calculating, collecting, reporting, and remitting the appropriate amount of sales and use tax.<sup>131</sup> Additionally, the seller is no longer subject to a sales and use tax audit unless the state suspects fraudulent activity or the seller maintains a substantial nexus relationship with the state.<sup>132</sup> The remaining two models are limited to the calculation of the tax due on the transaction.<sup>133</sup> The seller can either use a Certified Automation System (CAS) or its own proprietary software to perform this calculation. Because these latter two models involve only tax computations and no other compliance function, the seller remains liable for remitting the correct amount of sales and use tax due.<sup>134</sup>

Implementing the SSTS requires that sellers possess technology capable of conducting high-speed data transmissions to and from the CSP or CAS.<sup>135</sup> To prevent consumers from noticing a delay in the sales tax calculation, the sellers and these third party service providers must be able to exchange information instantaneously.<sup>136</sup>

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collection mechanism for remittance of sales and use tax. Participating states are charged with the certification and oversight of CSPs. *See id.*

The *Wall Street Journal* criticized the Trusted Third Party model, the predecessor to CSPs, for removing the anonymity of the sales tax. *See* Editorial, *George's Web*, WALL ST. J., Jan. 28, 2000, at A18. Unlike income taxes, the states currently possess no means to track how much sales tax each consumer pays on an annual basis. *Id.* The *Wall Street Journal*, however, feared that the Trusted Third Party would create a mechanism providing the states with the capacity to track consumer purchases, and thus arguably invade taxpayer privacy. *Id.*

129. From a sales tax compliance perspective, the CSP assumes responsibility for the two main compliance-related responsibilities currently assigned to the seller—preparing sales and use tax returns and remitting tax collections to the appropriate state or states. Removing the seller from the compliance aspect of sales and use tax collection eliminates the threat of a sales tax audit. *See* Draft SSTS Business & Technology Models, *supra* note 127, at 2.

130. *Id.*

131. *Id.*

132. *See id.*

133. *Id.*

134. *Id.*

135. *See id.* The seller must possess the technology necessary to transmit confidential information—the amount of the transaction, the classification of the item purchased, and the buyer's location—in a secure manner to the CSP, who then utilizes this information to determine the amount of sales and use tax due. *See id.*

136. Some E-tailers currently outsource the sales tax calculation to a third party. Yahoo.com, for example, offers to calculate the state tax due on transactions that flow through its Web site, but the tax determination is not made concurrently with the sale.

Along these lines, the CSP and CAS must develop and provide software to participating sellers that will help sellers determine the taxability of the transaction, the appropriate tax rate, and the amount of tax due at the time of sale.<sup>137</sup> The software is intended to interact seamlessly with sellers and buyers so that no party is noticeably aware of the tax collection process.<sup>138</sup> With consumers' privacy in mind, the software will require a minimum number of inputs to calculate the tax liability. Mandatory information will include at least the sales amount, a goods or services classification,<sup>139</sup> and a geo-code,<sup>140</sup> which is based on the delivery address, to source the transaction.

Consumers who use credit cards to pay for the taxable items present a tremendous opportunity for CSPs to expedite the remittance of collected sales tax to the appropriate state because credit card companies can transfer the collected taxes directly to the CSPs who subsequently remit the funds to the appropriate state or local government.<sup>141</sup> The SSTS also calls for state and local governments to fund the development of this system and the transactional fees associated with its operation.<sup>142</sup> While the CSP component of the SSTS is its most widely discussed feature, the

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Stated differently, a consumer may select items to purchase and submit his credit card number without knowing until a few days later how much tax will be added to the sales price. The SSTS relies upon the seller's access to adequate technology to prevent this type of unnecessary delay. Streamlined Sales Tax Project, Public Hearing on Proposals 72 (Sept. 29, 2000) (on file with the North Carolina Law Review) [hereinafter SSTS September 2000 Public Hearing].

137. See Draft SSTS Business and Technology Models, *supra* note 127, at 1–3.

138. *Id.*

139. Following the development of a unified system of definitions and classifications, the classification determination should be much simpler. The classification decision dictates the taxability of the transaction. See *supra* notes 104–15 and accompanying text.

140. To protect the consumer's privacy, the seller will provide the CSP or the CAS with a geo-code rather than the consumer's delivery address. The provided software will convert the delivery address into a geo-code, which the software will use to determine the transaction's situs. See SSTS September 2000 Public Hearing, *supra* note 136, at 29–30.

141. Other submissions to the ACEC also have supported the notion of electronically transferring sales tax collections to the appropriate states shortly after the tax is collected rather than waiting until the end of the quarter. See Robert D. Atkinson & Randolph H. Court, *Internet Taxation: A Software Solution*, 4 (Sept. 1, 1999), at [http://www.ppionline.org/ppi\\_ci.cfm?contentid=621&knlgAreaID=107&subsecid=126](http://www.ppionline.org/ppi_ci.cfm?contentid=621&knlgAreaID=107&subsecid=126) (on file with the North Carolina Law Review); Clifford A. Farmer & Gregory M. McCauley, *STC's Proposal to the Advisory Commission on Electronic Commerce: The Sales Tax Clearinghouse*, (Nov. 12, 1999), at <http://www.taxch.com/ACECProp.htm> (on file with the North Carolina Law Review).

142. See SSTS Executive Summary, *supra* note 7, at 2. The SSTS calls for remote sellers to facilitate the collection of use tax when the current nexus standard would not otherwise impose such an obligation.

proposal's long-term goal of adopting a unified classification and definition system may yield greater substantive results.

Participation in the proposed sales tax scheme is elective for both the states and sellers; thus widespread participation from both constituencies is necessary for the proposal to succeed. If this reform effort is adopted on a nationwide basis, the states stand to collect significantly more sales and use tax revenue than would be expected under the current scheme. This increased revenue allows the states to fund the development of the SSTS and to pay the transaction fees once the plan is operational. As indicated by the thirty-nine states already involved in the Streamlined Project, a large number of states probably will adopt the SSTS rather than risk being denied the opportunity to collect use tax from remote sellers.<sup>143</sup> The determinative factor in the success of this proposal, therefore, will be whether remote sellers are willing to enroll in the SSTS. Even if all state and local taxing jurisdictions adopt the SSTS, remote sellers beyond the reach of *Quill's* nexus standard cannot be required to participate without an expansion of the current nexus standard.<sup>144</sup> Because the success of the SSTS hinges in large part on a high percentage of seller participation, the Streamlined Project therefore must market the SSTS as extremely seller-friendly.

Surprisingly, the Streamlined Project disagrees with the proposition to expand the nexus standard and argues that the current physical presence nexus standard is sufficient to accomplish its objectives.<sup>145</sup> The Streamlined Project believes that, with proper incentives, remote vendors without a "substantial nexus" relationship with the taxing jurisdiction, and thus not under a duty to collect sales and use tax, will freely participate in the proposed sales tax system.<sup>146</sup>

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143. Although the SSTS does not recommend modifying the current nexus standard, states that elect not to participate in this initiative will continue to find that *Quill's* nexus standard severely hampers their ability to collect sales and use tax from remote sellers. See *supra* notes 28–50 and accompanying text.

144. Forcing a remote seller who lacks "minimum contacts" with a taxing jurisdiction to participate in the SSTS raises strong Due Process Clause concerns. See *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945). If the due process threshold is not met, the state has no jurisdiction over the remote seller. Furthermore, the remote seller with no physical presence in the taxing state may disregard that state's impassioned plea for all sellers doing business in the state to enroll in the SSTS. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 316–18 (1992).

145. Interview with Charles Collins, *supra* note 15.

146. The SSTS uses a carrot and stick approach to encourage reluctant sellers to register with the SSTS. As an incentive to enroll in the system, the plan promises to eliminate the seller's administrative and compliance burden of sales and use tax collection, as well as to eliminate the threat of an audit. For sellers who elect not to participate in the SSTS, however, the state revenue departments will probably use aggressive nexus

If the Streamlined Project is correct, the current nexus standard is no longer an obstacle assuming that remote sellers voluntarily agree to collect the use tax due on the transaction. Relying on this less than convincing end-run around the nexus trap, the SSTS adopts a two-step approach to accomplish its comprehensive objective of simplifying sales and use tax administration and collection so as to comply with *Quill's* admonition.<sup>147</sup>

The primary objective of the states participating in the Streamlined Project is to develop a less burdensome system of sales and use tax collection<sup>148</sup> through a multi-state, collaborative effort.<sup>149</sup> Specifically, the SSTS encourages the states to minimize and preferably eliminate the compliance burden and other seller-related costs currently incurred in the collection and remittance of sales and use tax.<sup>150</sup> To this end the SSTS employs five key features: (1) uniform definitions within tax bases, (2) simplified exemption administration, (3) rate simplification, (4) uniform sourcing rules, and (5) uniform audit procedures.<sup>151</sup> The Streamlined Project has organized four work groups to study and resolve the issues associated with implementing these features.<sup>152</sup> As the work groups release specific proposals during the development phase, the Streamlined Project convenes periodic hearings to allow the public to comment.

Following the initial developmental phase, the states will be prepared to adopt uniform laws and administrative practices as the foundation for the implementation of the SSTS.<sup>153</sup> The Streamlined Project intends for the SSTS to become a uniform system with "one classification system for products, one set of definitions on exemptions, and a one-stop audit process for all states and local governments."<sup>154</sup> Some critics of the SSTS view implementation of this proposal as the first step on the road to a national sales tax.<sup>155</sup> To

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arguments and sales tax audits to intimidate nonparticipating sellers into joining the system.

147. See SSTS Executive Summary *supra* note 7, at 2.

148. Proponents of the SSTS argue that the radical simplification of sales and use tax laws is a necessary precursor to subsequent judicial approval of any attempt to collect sales and use tax from remote sellers. See *McLure Testimony*, *supra* note 2, ¶¶ 7, 12. *Quill's* strong condemnation of the current sales and use tax system as unnecessarily complex also encourages an emphasis upon simplification. See *Quill*, 504 U.S. at 313 n.6.

149. See SSTS Executive Summary *supra* note 7, at 1.

150. *Id.* at 1-2.

151. *Id.* at 1.

152. *Id.*

153. *Id.* at 2.

154. *Id.* at 6.

155. See *George's Web*, *supra* note 128.

counter these attacks, the Streamlined Project asserts that a uniform classification structure does not infringe upon a state's sovereign power to determine the sales tax base or its own tax rates.<sup>156</sup> Although the creation and adoption of a uniform system may present the greatest hurdle for the states in their quest to simplify sales and use tax collection, E-commerce's threat to state coffers may provide sufficient motivation for the states to relinquish a small degree of sovereignty in return for increased sales and use tax revenue.

The Streamlined Project has identified two strategic areas in the struggle to simplify the administration of the sales and use tax system. First, states should develop uniformity in product codes and definitions, situs rules, and procedures to administer exempt transactions.<sup>157</sup> Although the Streamlined Project does not stipulate how this objective should be accomplished, the best solution draws upon the initially proposed regulatory "consensus board."<sup>158</sup> Similar to the make-up of the Streamlined Project, this board would be composed of representatives appointed by participating state departments of revenue. This board would oversee the states' administration of the SSTS to ensure uniformity.<sup>159</sup> Second, the SSTS should limit the frequency with which participating states may change administrative matters, such as their tax rates or list of exempt transactions.<sup>160</sup> Currently, the Streamlined Project is evaluating four alternatives to simplify the tax rate structure.<sup>161</sup> A common theme resonating in these options involves limiting a participating state's ability to make unilateral changes to the SSTS as adopted in that

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156. See *Shafroth/Thierer Debate*, *supra* note 70, ¶ 27. Thierer referred to the SSTS as "the creation of a new de facto national sales tax cartel." *Id.*

157. See SSTS Executive Summary *supra* note 7, at 2.

158. The initial proposal submitted to the ACEC called for the creation of a "consensus board" to monitor the consistent application of the SSTS.

159. The board, comprised of representatives from participating states, would act as a regulatory body to monitor the uniform application of sales and use tax laws. Following unification, participating states would lose their ability to adopt unilateral changes to product classification, exemption definitions, or situsing rules. All proposed modifications to the uniform rules would be presented to the consensus board for approval. If the change is passed and incorporated into the uniform system of sales and use tax laws, participating states must comply with it. The consensus board would issue approved changes only once a year. Nat'l Governors' Ass'n, Streamlined Sales Tax System for the 21st Century, <http://www.nga.org/internet/proposal.asp> (last visited Nov. 15, 2000) (on file with the North Carolina Law Review) [hereinafter SSTS for the 21st Century].

160. See SSTS September 2000 Public Hearing, *supra* note 136, at 10.

161. See *id.* at 9. The four alternatives are (1) limit a participating state's ability to use local option rates, (2) adopt measures easing compliance with myriad of local option rates, (3) shift some of the administrative burden of local option rates to the states, and (4) use technology to reduce the administrative difficulties related to local option rates. *Id.*

particular state. One possible alternative not presently under consideration requires states intending to make changes to their SSTS to provide advance notice to other participating states. At least one critic of the SSTS adamantly disdains any such limiting provision and argues that uniformity inherently requires the participating states to forsake their sovereignty.<sup>162</sup> Nevertheless, the Streamlined Project maintains that these limitations are necessary to achieve the desired simplification of the administrative burdens of sales and use tax collection. Realistically, most state and local governments approve modifications to their sales and use tax laws only once a year, often during budget debates. If the “change window” coincides with the budget approval process, most states should not have a problem with limiting their modifications to once a year.

Implementation of the SSTS will require a mixture of multi-state agreements and uniform legislation.<sup>163</sup> To this end, the Executive Committee of the National Conference of State Legislatures (NCSL) unanimously adopted model legislation in late January 2000 authorizing states to enter discussions with other states regarding the development of the SSTS.<sup>164</sup> In addition to allowing various state departments of revenue to begin the multi-state discussions, the legislation permits states to participate in pilot programs to test the operational effectiveness of the SSTS.<sup>165</sup> The NCSL expects several states to pass some variation of the model legislation before the end of 2000.<sup>166</sup> Moreover, the Streamlined Project is moving forward with step one of the proposed SSTS regardless of whether Congress extends the current moratorium.<sup>167</sup> Because the SSTS does not seek

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162. See *Shafroth/Thierer Debate*, *supra* note 70, ¶ 38.

163. See SSTS Executive Summary, *supra* note 7, at 2.

164. Press Release, National Conference of State Legislatures, *NCSL Adopts Model Legislation to Simplify Sales Tax Collection* (Jan. 20, 2000), at <http://ncsl.org/programs/fiscal/tcpres01.htm> (on file with the North Carolina Law Review). Given the role of the National Conference of State Legislatures (NCSL) as one of the sponsors of the SSTS proposal, its adoption of model legislation to kick-start the development of the SSTS is not surprising.

165. See STREAMLINED SALES TAX SYSTEM FOR THE 21ST CENTURY ACT § 4 (National Conference of State Legislatures 2000).

166. Either by statute or by executive order, twenty-seven states have agreed to become “participating states” that support the NGA’s Streamlined Tax Project. *List of Participating States*, at <http://www.geocities.com/streamlined2000/participatingstates.html> (Sept. 20, 2000) (on file with the North Carolina Law Review). Another twelve states have expressed serious interest in the SSTS but lack the required legislative or executive authorization to vote on matters before the Streamlined Project. *Id.*

167. See David Hardesty, *States Move on Their Own to Tax E-Commerce*, E-COMMERCE TAX NEWS (Feb. 6, 2000), at <http://www.ecommercetax.com/doc/020600.htm> (on file with the North Carolina Law Review).

congressional affirmation, proponents of the SSTS do not feel compelled to delay state legislative action pending the outcome of any congressional action.<sup>168</sup> Fully aware that the political dynamics of an election year may delay final congressional action on E-commerce taxation, the Streamlined Project has seized the advantage. In less than one year, the Streamlined Project has made tremendous progress in the development phase. It is scheduled to release model legislation in late December 2000 that will allow state legislatures to consider actual implementation of the SSTS.

### III. MEASURING THE STREAMLINED SALES TAX SYSTEM AGAINST THE FOUR TAX POLICY OBJECTIVES

For the most part, the SSTS compares favorably with the four fundamental tax policy objectives set forth in Part I. Consistent with the notion of tax-competitive equality,<sup>169</sup> the SSTS seeks to create a level playing field for all businesses.<sup>170</sup> Namely, the SSTS seeks to establish parity between remote sellers, who are not required to collect use tax unless a “substantial nexus” exists with the taxing jurisdiction, and local sellers, who are required to collect sales tax on all taxable transactions, to foster tax-competitive equality among similarly situated economic actors.<sup>171</sup> This desire to establish equity and fairness in the retail marketplace and to reduce the remote seller’s tax advantage over the local retailer is probably the most compelling argument in favor of the SSTS’s proposed systematic overhaul of the sales and use tax collection process.<sup>172</sup> Though

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168. See *Shafroth/Thierer Debate*, *supra* note 70, ¶ 39.

169. See *supra* notes 85–93 and accompanying text.

170. In testimony before the Senate Budget Committee, Michigan Governor John Engler called upon the Senate to keep tax policy neutral. *Testimony by Governor John Engler, Michigan, Before the Senate Budget Committee on Internet Taxation in the New Millennium*, at <http://www.nga.org/Internet/Testimony20000202Internet.asp> (Feb. 2, 2000) (on file with the North Carolina Law Review) [hereinafter *Engler Testimony*]; see also Charles Babington, *Clinton Backs Web Sales Taxes*, WASH. POST, Feb. 29, 2000, at E4 (citing fairness concerns as a driving factor to collect sales and use tax on E-commerce). Governor Engler denounced the present two-tiered sales tax system that favors E-tailers over traditional retailers as “good for clicks, bad for bricks.” *Id.* Treasury Secretary Lawrence Summers also supports taxation of E-commerce because of the current disparity in tax treatment of E-tailers and bricks-and-mortar retailers. See Martin Crutsinger, *Summers: Web Shouldn’t Be Tax Haven* (last modified Feb. 23, 2000), at [http://dailynews.yahoo.com/h/ap/20000223/tc/summers\\_interview\\_1.html](http://dailynews.yahoo.com/h/ap/20000223/tc/summers_interview_1.html) (on file with the North Carolina Law Review).

171. See *McLure Testimony*, *supra* note 2, ¶ 12.

172. Both Governor Engler and Professor McLure stressed the unfairness argument rather than the more technical arguments in favor of E-commerce taxation during their



preferential tax treatment of E-tailers was arguably justified when E-commerce was in its infancy and needed help to survive, recent reports suggest that such a de facto tax break is no longer necessary. Because E-commerce now represents an established segment of the global economy,<sup>173</sup> no apparent commercial justification to continue the current sales and use tax policy favoring E-commerce over local sellers exists. In light of these changed conditions, the SSTS provides a workable solution that equalizes the sales and use tax collection responsibilities of E-tailers and bricks-and-mortar retailers.

Simplifying the current sales and use tax structure is a prerequisite to requiring remote sellers to collect taxes.<sup>174</sup> Currently, multi-state businesses must apply a variety of definitions to the same product if the product is sold in different states. In addition, multi-state businesses have a collection responsibility and filing requirement in the states where they have a physical presence.<sup>175</sup> Upon audit, a mistake in determining the product's taxability can lead to a notice of deficiency for which the business is responsible.<sup>176</sup> As articulated in *Quill*, the lack of uniformity in the current system adds unnecessary complexity to compliance with sales and use tax laws.<sup>177</sup>

The SSTS makes a tremendous effort to simplify the current sales and use tax structure through the creation of uniform standards and definitions and the elimination of most of the seller's compliance responsibilities.<sup>178</sup> The *Quill* Court seemed to use the physical presence requirement as an excuse to limit the reach of state laws that were unduly burdensome on interstate commerce,<sup>179</sup> leaving the door open for congressional clarification of the nexus standard or a subsequent judicial modification.<sup>180</sup> The nationwide adoption of a

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testimonies before the Senate Budget Committee in early February 2000. See *Engler Testimony*, *supra* note 170; *McLure Testimony*, *supra* note 2, ¶ 4.

173. *McLure Testimony*, *supra* note 2, ¶ 4.

174. *Quill Corp. v. North Dakota* revealed that simplification of the sales and use tax system was a significant factor in the Supreme Court's determination of whether the duty to collect use tax "unduly burden[s] interstate commerce." 504 U.S. 298, 312 (1992).

175. Under *Quill*, physical presence in a taxing jurisdiction creates nexus, which generates a sales and use tax return filing requirement. See *id.* at 317-18.

176. Assuming the seller has a nexus relationship with the taxing jurisdiction, she is responsible for any shortfall that results from her failure to collect sufficient tax from the consumer at the point of sale. When the seller does not have a nexus with the taxing jurisdiction, the buyer is completely responsible for the use tax due on the sale because the remote seller is under no duty to collect the tax.

177. See *id.* at 313 n.6 (describing how North Dakota's use tax demonstrates the notion that sales and use tax can interfere with interstate commerce).

178. See *supra* notes 153-62 and accompanying text.

179. See *Quill*, 504 U.S. at 318-19.

180. See *id.* at 318.

uniform system of definitions and classifications is probably sufficient to satisfy *Quill's* demand for simplification of the current sales and use tax system.<sup>181</sup> Thus, a state enrolled in the SSTS would probably prevail over a remote seller with substantial economic ties to the state if a *Quill*-like case arose again.<sup>182</sup> Also, the Court did not suggest that filing sales and use tax returns in each state where the seller has a nexus relationship created an unnecessary burden for multi-state businesses. Nonetheless, the SSTS eliminates most of sellers' tax compliance responsibilities and, more importantly for sellers that adopt the CPS model, removes the audit threat and the risk of a tax deficiency notice unless negligence or fraud causes the insufficient collection.<sup>183</sup> Through a unified system of definitions and classifications and minimal compliance requirements, the SSTS provides a far less complex sales and use tax structure for all types of commerce. Assuming that the Streamlined Project succeeds in this regard, the next question becomes whether sellers will support the SSTS.

Without an expanded nexus standard to compel sellers to enroll in the SSTS, the SSTS relies upon incentives to entice sellers to join the system voluntarily. The compliance and audit elimination aspects of the SSTS seem designed more to attract remote sellers with no physical presence in the taxing jurisdiction to register with the SSTS than to persuade the Court to overrule *Quill's* physical presence requirement for nexus.<sup>184</sup> Even with the promise of no compliance requirements, no audit, and no risk of additional tax liability, a remote seller not required to collect use tax appears to gain little by enrolling in the SSTS. This lack of strong incentives among remote sellers with no nexus to the taxing jurisdiction will probably limit seller participation in the early stages of implementation.<sup>185</sup>

The plan's reliance on voluntary participation initially seems misplaced. A deeper evaluation, however, reveals a well-conceived strategy that eventually may lead to a win-win situation for the states. Although the states prefer that remote sellers voluntarily register with the SSTS in all states where the seller conducts business, the

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181. See Telephone Interview with Richard Prem, Amazon.com, Director of State and Local Taxation (Mar. 3, 2000) (theorizing that strong evidence of simplification may motivate the Court to modify its current nexus standard).

182. See Telephone Interview with Tim Masanz, *supra* note 122 (expressing the NGA's interest in a nexus modification).

183. See Draft SSTS Business & Technology Models, *supra* note 127, at 2.

184. See *Shafroth/Thierer Debate*, *supra* note 70, ¶¶ 79–81.

185. See *id.*

SSTS puts any state that implements the plan in a tremendous position to prevail in the courts on an alternative nexus theory.<sup>186</sup> A test case most likely will arise where a taxing jurisdiction asserts a more aggressive nexus position based on economic ties rather than physical presence and issues a notice of deficiency against a remote seller who elects not to join the SSTS.<sup>187</sup> With the first states expected to enact legislation implementing the SSTS as early as the next legislative sessions, the test case would not reach the Supreme Court until many years after the states begin the implementation phase. Assuming that the majority of states adopt the plan, the states should have a persuasive argument that the SSTS satisfies *Quill's* demand for the simplification of the sales and use tax system.<sup>188</sup> Thus, the states can argue that *Quill's* physical presence nexus standard should be overturned because the SSTS has eliminated the unduly burdensome elements of the sales and use tax structure and implemented a collection mechanism conducive to interstate commerce.

The SSTS paves the way for the judicial modification of nexus to reflect the non-physical nature of E-commerce. The states should advocate economic nexus as the most appropriate alternative nexus theory for the courts to adopt because the expansive reach of economic nexus solves a variety of sales tax issues.<sup>189</sup> Furthermore, economic nexus is easy to administer in that all sellers with net sales in excess of the state-defined de minimis amount have a sales and use tax collection responsibility.<sup>190</sup> Even though the judicial modification strategy probably requires more time to implement than a statutory modification, the states should be willing to wait for the courts to expand nexus rather than pursue a more risky statutory expansion through congressional action.<sup>191</sup> Given the Streamlined Project's

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186. Although the proposal expresses no desire to expand the current nexus definition, the voluntary nature of the SSTS renders the probability of maintaining the current standard doubtful. Thus, the claim that the proposal does not intend to modify the current nexus standard arguably is misleading. It therefore should be removed from the proposal given the likelihood that the proposal will lead to a judicial modification of nexus.

187. Richard Prem envisioned a monumental court battle between a state that adopts the SSTS and an E-tailer with significant sales to residents of that state but no physical presence. See Telephone Interview with Richard Prem, *supra* note 181.

188. Assuming a large number of states adopt the SSTS by the time the test case arises, the states' strongest argument for overturning *Quill* is the radical simplification of state sales and use tax systems. See Telephone Interview with Tim Masanz, *supra* note 122 (opining that the complexity of the sales and use tax system was largely responsible for the Court's ruling in *Quill*); Telephone Interview with Richard Prem, *supra* note 182 (same).

189. See *supra* notes 55–62 and accompanying text.

190. See *supra* notes 55–62 and accompanying text.

191. See Telephone Interview with Tim Masanz, *supra* note 122 (arguing that congressional support is not required for the states to implement the SSTS).

desire to avoid congressional intervention, this strategy demonstrates the shrewdness necessary to “reengineer” the sales and use tax system.

In addition to nexus modification, another technical element of the SSTS involves the use of destination-based situsing principles to source transactions to the appropriate state. Although the SSTS does not directly address E-commerce’s unknown situs problem, the proposal’s use of software to calculate the correct sales and use tax liability helps resolve this issue. To determine the product’s destination, the software should require the online buyer to enter the zip code for the location where the goods will be used or consumed before the E-tailer can approve the transaction.<sup>192</sup> If the buyer refuses to provide this information, the software should prohibit the transaction from proceeding.<sup>193</sup> E-tailers may be granted a limited power to override the delivery address requirement in the circumstances specified by the “consensus board.”<sup>194</sup> Thus, the software would act as an internal control to minimize, if not eliminate, sales to anonymous buyers.

Even though the suggested software enhancement should capture the desired delivery address, the states should apply the “throwback” rule to sales to unknown buyers.<sup>195</sup> The “throwback” rule re-sources a sale to the origin state when the buyer’s destination is unknown.<sup>196</sup> If the destination-based system does not incorporate a similar reallocation mechanism, sales to unknown buyers will probably escape sales and use taxation because the destination state

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192. See *supra* note 140.

193. If the states require all CSP software to include this feature, online buyers must either comply with the request to provide the desired information or purchase the good from a traditional retailer who will definitely add sales tax to the purchase. As to whether collecting sales and use tax will adversely affect E-tailers, a recent study by *CIO Magazine* suggests that consumers are indifferent to the collection of sales and use tax on E-commerce. See *CIO Magazine Study Reveals Top Five Concerns About Online Purchasing*, at [http://www.cio.com/info/releases/122099\\_onprchsng.html](http://www.cio.com/info/releases/122099_onprchsng.html) (Dec. 20, 1999) (on file with the North Carolina Law Review); see also *Sales Taxes Won't Change Online Buying Habits, Survey Shows*, at <http://www.nga.org/Internet/CIOSurvey.asp> (last visited Nov. 15, 2000) (citation omitted) (discussing results of the survey).

194. The originally proposed SSTS created the consensus board to ensure that a state cannot unilaterally change product classifications, exempt definitions, or alter sourcing rules. See SSTS for the 21st Century, *supra* note 159. If the consensus board also determined the specific situations in which a seller may override the required delivery address field, the states would retain greater control over the seller’s discretion.

195. See *supra* notes 83–84 and accompanying text.

196. See *supra* notes 83–84 and accompanying text.

cannot be determined. Thus, the most significant benefit of the "throwback" rule is the preservation of the national sales tax base.<sup>197</sup>

In addition to this technical improvement, the SSTS creates a conceptual framework that levels the playing field for all businesses and reduces the complexities of the current sales and use tax system. The more technical issues, however, do not seem to be as well-developed, demonstrating that the SSTS is a conceptual framework, not a "how-to" manual.<sup>198</sup> Nonetheless, the SSTS provides a solid foundation upon which to base sales and use tax reform.

### CONCLUSION

As a result of the E-commerce explosion, the current sales and use tax system is at a crossroads. The states basically have the following two alternatives: (1) implement a comprehensive reform effort such as the SSTS, or (2) maintain the current system and enforce the already existing laws. Although each alternative theoretically renders the same result in terms of total sales and use tax collected, the SSTS is the better alternative because it simplifies the current complicated tax structure, eases administration, and is adaptable to the rapidly changing world of E-commerce.

If the states choose to implement the SSTS, the greatest obstacle they must overcome is political resistance. Moreover, states must act quickly as the continued viability of the current sales and use tax system will be threatened as E-commerce increases its share of total retail sales.<sup>199</sup> To prepare for the political battle that will ensue, the states should enhance consumer understanding of sales and use tax. As more consumers understand that the Internet Tax Freedom Act (IFTA) does not exclude E-commerce from all forms of taxation, they will begin to see the current unfair advantage E-tailers have over traditional retailers.

Now is the time to reform sales and use tax laws.

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197. See *supra* notes 83–84 and accompanying text.

198. See *supra* text accompanying notes 124–25.

199. On March 2, 2000, the U.S. Department of Commerce announced that the government will track E-commerce sales information and release this information quarterly. For the second quarter of 2000, retail E-commerce sales reached \$5.5 billion. See U.S. Dep't of Commerce, *Retail E-Commerce Sales in Second Quarter 2000 Increased 5.3 Percent from First Quarter 2000*, *Census Bureau Reports*, at <http://www.census.gov/mrts/www/current.html> (Aug. 31, 2000) (on file with the North Carolina Law Review).