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Virtual Taxation: State Taxation of Internet and On-Line Sales

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VIRTUAL TAXATION:
STATE TAXATION OF INTERNET AND ONLINE SALES

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VIRTUAL TAXATION: STATE TAXATION OF INTERNET AND ON-LINE SALES

SABA ASHRAF*

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I. INTRODUCTION

Sales are beginning to take place over the Internet and on-line in significant numbers.¹ As commerce moves from the real world to the virtual world, states will lose needed revenue if sales over the Internet and on-line are nontaxable by states.² This Article examines the possibility of imposing sales and use tax collection obligations on sellers of tangible goods on-line or over the Internet.³ Part II dis-

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

2. See Ilana DeBare, *Cyber-Shopping Costly for Counties*, SACRAMENTO BEE, Aug. 17, 1995, at F1.

3. Note that this Article does not discuss the taxation of Internet service providers (ISPs). Several states have proposed, or have already begun, the taxing of ISPs. A discussion of the taxation of ISPs on their gross receipts is beyond the scope of this Article.

cusses the recent growth of commerce on-line and over the Internet, the resulting problem faced by states of lost revenue in the form of sales tax, and the confusion faced by parties conducting sales over the Internet as to their tax collection obligations. Part III describes the constitutional barriers to the taxation of out-of-state sellers. Part IV analyzes several suggested proposals for the constitutional taxation of out-of-state sellers. Finally, Part V concludes that unless there is a federal legislative solution in the area, states may not impose tax collection obligations on out-of-state sellers that sell over the Internet or on-line without any other presence in-state. Thus, companies and individual vendors are free to engage in tax-free sales on-line or over the Internet.

II. LOSS OF SALES TAX REVENUE ON VIRTUAL SALES

A. Virtual Sales

1. Storefronts on the Internet

The Internet is a large, interconnected network of over 60,000 computer networks,⁴ linking over 55 million people all over the world via phone lines, satellites, and other telecommunications systems.⁵ "Information divided into small 'packets' of data flows through this Weblike structure, hopping from one computer to the next on its way to far-off destinations."⁶ The manipulation of the data is left to the computers on each end.⁷

Information on the Internet is organized into several parts and tools,⁸ the most exciting of which is the World Wide Web (Web). The Web gathers information from all over the Internet.⁹ Instead of seeing information as a line of text, a graphical interface provides users with icons, illustrations, photographs, and sound.¹⁰

A seller with a site on the Web may use it as a virtual storefront.¹¹ By setting up a Web site, the seller can publish information about itself and its products or services by using text and eye-

4. See Robin Gareiss, *The Online Corporation: Choosing the Right Internet Service Provider*, DATA COMMUNICATIONS, Nov. 21, 1995, available in LEXIS, Cmpcom Library, Data File.

5. See World Wide Web User Statistics (visited Feb. 7, 1997) <<http://www.why-not.com/company/stats.htm>>; Rosalind Resnick, *A Network to End All Networks*, PC NOVICE GUIDE TO GOING ONLINE, Dec. 1995, at 114, 114.

6. Alan Phelps, *How the Internet Works*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 12, 12.

7. See *Faces of the Net*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 10, 10.

8. See Rosalind Resnick, *Tooling Through the Internet*, PC NOVICE GUIDE TO GOING ONLINE, Dec. 1995, at 116, 116.

9. See *id.* at 121.

10. See *id.*

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

catching graphics, as well as sound and video clips.¹² Potential customers can point and click their way through the electronic equivalent of four-color magazine ads and thousands of on-line shopping malls.¹³ Consumers can use the Web to compare prices and specifications of products, view multimedia clips of products, and place orders.¹⁴

Consider the example of a woman who wants to buy a new laser printer for a computer she uses in her business. Instead of going to several different computer and electronics stores, she can simply log on to her computer, connect to the Internet, and access the Web pages of several electronics equipment merchants. The Web sites can display the different printers available, describe their features, list their prices, and even show samples of the printers' output. The Web site also can provide answers to frequently asked questions about the products, or provide for a mechanism by which the Web site accepts questions and furnishes answers about the product. After comparing product features and prices, the woman can simply choose the right printer for her and place an order via the Web site itself, saving a great amount of time and energy.

2. Storefronts On-line

A seller/vendor can set up a virtual storefront via a Web site or home page directly on the Internet.¹⁵ Alternatively, a vendor may set up its virtual storefront by contracting with a commercial on-line service (such as America Online, CompuServe, Prodigy, etc.) and leasing space on the commercial on-line service's own network.¹⁶ Commercial on-line services provide organized databases of information such as sports, news, magazines, weather, and most important for our purposes, home shopping.¹⁷ For instance, CompuServe's basic membership currently provides its users with access to more than 125 stores, including department stores such as J.C. Penney and Sears.¹⁸ Similarly, users of America Online can access the marketplace—containing storefronts of merchants primarily offering boutique or specialty items—from the main menu.¹⁹

12. See Reid Goldsborough, *Reaching the Masses*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 92, 92.

13. See Resnick, *supra* note 8, at 121.

14. See Loshin, *supra* note 11, at 87-88.

15. See *id.* at 86.

16. See Richard Egan, *Step into the Internet Through On-Line Services*, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 32, 32.

17. Another important aspect of commercial on-line services is that in addition to the information services they provide, they can provide access to the Internet. See *id.* at 32.

18. See Tracy LeBlanc, *Shop 'Til You Drop*, PC NOVICE GUIDE TO GOING ONLINE, Dec. 1995, at 145, 145.

19. See *id.*

While potential customers can access a virtual storefront set up via a Web site simply by accessing the Internet, they can access a virtual storefront set up on a commercial on-line service's network only if they are subscribers to that particular commercial on-line service, and thus connected to its network.²⁰ Accordingly, if a vendor sets up its virtual storefront by leasing space on the commercial on-line service's network, the virtual storefront will be accessible only by subscribers of the service, not all Internet users.²¹

3. Enormous New Opportunities Opened Up for Electronic Merchants

Merchants are selling goods—such as music, books, flowers, electronic equipment, and practically anything else you can think of—via the Internet and commercial on-line services.²² Some commentators predict that “[c]ybermalls will someday make physical shopping malls as outdated as rotary phones.”²³

Imagine that vendors can take orders for their products twenty-four hours a day, every day of the year, without tying up any extra staff.²⁴ Imagine that they can open international markets for their products, selling anywhere they can deliver.²⁵ Finally, imagine that vendors can turn their customers into their own twenty-four-hour customer support staff.²⁶ It is easy to see that the Internet, particularly the Web, presents a tremendous opportunity for sellers due to its low cost and easy accessibility.²⁷ It offers fertile markets and tantalizing rewards for savvy marketers.²⁸

Consider the previous example of the purchase of a laser printer. A local vendor of electronics whose store is physically located in California probably only sells to customers also located in that geographic area. However, if the vendor has a virtual storefront on the Internet or on-line, then its potential customers are located anywhere the storefront is accessible. Enormous new markets are

20. See Egan, *supra* note 16, at 32-33.

21. A user may obtain a direct connection or access to the Internet by paying an ISP. Alternatively, the user can subscribe to a commercial on-line service to access the Internet. In contrast to ISPs, Internet access is not the only service, or even the main service, that commercial on-line services provide. Rather, commercial on-line services provide organized databases of other information, such as sports, news magazines, weather, and home shopping. See *id.* at 32.

22. See *id.*

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

24. See Loshin, *supra* note 11, at 86.

25. See *id.*

26. See *id.*

27. See Goldsborough, *supra* note 12, at 92.

28. See Loshin, *supra* note 11.

opened up for the vendor. Further, it is much easier for the vendor to service the potential customers over the Internet or on-line than it would be in the real world due to the lack of need for staff to make sales in the virtual world.

B. Problem Faced by States: Lost Revenue

It is estimated that forty-five percent of Internet users look up information about products on the Internet.²⁹ So far, many merchants use their Web sites or spaces on a commercial on-line service's network simply as extensions of their Yellow Pages advertisements.³⁰ The more successful advertisements reproduce their product lines in a kind of on-line catalog, complete with prices, ordering, and delivery information.³¹ The most effective ads also let consumers buy directly from the merchant for instant gratification.³² "While not a large factor in commerce yet, commerce listings are exploding exponentially."³³ A study by Input, a California-based information services research firm, estimated that in 1994, \$20 million worth of business was conducted on-line; in 1995, the number grew to \$40 million, and the 1996 estimate is a staggering \$260 million.³⁴ About 120 new companies each day are signing up for Internet addresses.³⁵ "The number of World Wide Web pages devoted to ads for business or products is growing at a rate of 12 percent a month."³⁶

As commerce grows over the Internet and on-line, so does concern over revenue lost by states because of uncollected sales or use taxes on products sold over the Internet or on-line.³⁷ In fact, state and local authorities fear that their "finances are being undone by rapid changes in global commerce and information technologies, particularly the rise of the Internet."³⁸ In particular, states are extremely concerned about an erosion of their key revenue base: sales taxes.³⁹ "The rise of untaxed commerce on the information superhighway

29. See World Wide Web User Statistics, *supra* note 5.

30. See Loshin, *supra* note 11, at 87-88.

31. See *id.*

32. See Goldsborough, *supra* note 12, at 92.

33. Nathan Newman, Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway, 95 STATE TAX NOTES 186-49, Sept. 26, 1995, available in LEXIS, Sttax Library, Stn File.

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

35. See DeBare, *supra* note 2.

36. See *id.*

37. See Newman, *supra* note 33.

38. *Id.*

39. See *id.*

will be a body blow to local government finances.”⁴⁰ At the touch of a button, consumers can obtain access to the lowest-priced goods throughout the nation, and at the same time avoid sales taxes.⁴¹ Thus, it is feared that “interstate sales may explode over the Internet, leaving state and local government finances in tatters.”⁴² As commerce moves from the regular world to the virtual world, states need to find a way to tax Internet sales.⁴³ Some assert that Internet or on-line sales are “too significant a part of the economy” to suggest that they should be exempt in the long-term from taxation.⁴⁴

C. Companies Confused About Obligations

Companies already engaged in commerce over the Internet are confused about their tax collection obligations.⁴⁵ A July 1996 study by KPMG Peat Marwick illustrates the uncertainty felt by companies.⁴⁶ Nine out of ten executives of American companies engaged in buying and selling over the Internet called for clarification in the governing regulations.⁴⁷ An overwhelming fifty-one percent of the 291 executives surveyed (of companies with gross revenues in excess of \$50 million) stated that the lack of clarity in state and local tax laws governing electronic commerce was inhibiting their involvement with Internet business applications.⁴⁸ An alarming twenty percent admitted that they did not know whether their companies were even subject to sales and transaction taxes on the sale of products and services over the Internet.⁴⁹

It appears that many states are struggling with issues surrounding the taxation of sales over the Internet.⁵⁰ A few have even created study groups to deal with the issues involved.⁵¹ Clear guidelines are

40. *Id.*

41. *See id.*

42. *Id.*

43. *See* Catherine Yang, *New Tolls on the Info Highway?*, *BUS. WK.*, Feb. 12, 1996 at 96, 96 (quoting Multistate Tax Commission General Counsel Paull Mines).

44. *Id.* at 97.

45. *See* KPMG Peat Marwick, *Electronic Commerce: Taxation Without Clarification* (visited Feb. 7, 1997) <<http://usservice.us.kpmg.com/salt/archive/july96/story1.html>>.

46. *See id.*

47. *See id.*

48. *See id.*

49. *See id.*

50. *See* Stacey Singer, *Tax Collectors View Sales on Internet with Distress*, *CHI. TRIB.*, May 15, 1996, at 1.

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

needed for states and for companies already transacting business over the Internet or on-line, or those desiring to do so.⁵²

III. CONSTITUTIONAL BARRIER TO STATES' IMPOSITION OF SALES OR USE TAX

A. Sales and Use Taxes Generally

States impose sales taxes on the sales of goods and services. Retailers and vendors generally collect and then remit the taxes to the state taxing authority.⁵³ For example, if a woman who resides in New York State purchases a laser printer from a merchant also a resident of New York State, the merchant will collect a sales tax from her at the time of the sale. States can only impose a sales tax on intrastate sales transactions.⁵⁴

States that impose a sales tax also invariably impose a compensating use tax to ensure that residents who purchase goods in or from another state will pay the equivalent of a sales tax on the purchase in their state of residence.⁵⁵ Thus, if a woman who resides in New York State purchases a laser printer, via mail-order, from a merchant who is a resident of California with "no physical presence"⁵⁶ in New York State, then the merchant will not collect a sales tax from her at the time of the sale. However, she will be responsible for paying a New York State use tax.

Collecting the use tax from the purchaser, particularly where the purchaser is an individual, is often inefficient and not cost-effective. This is especially so because many consumers do not realize they are subject to the use tax.⁵⁷ One possible solution is to require the out-of-state vendor to collect the tax from the purchaser and remit it to the taxing state.⁵⁸ However, requiring an out-of-state vendor to collect the use tax from the in-state purchaser and remit it to the taxing state presents constitutional problems.⁵⁹

52. See Yang, *supra* note 43.

53. See, e.g., Arthur R. Rosen & Walter Nagel, *Sales and Use Taxes: General Principles*, Tax Mgmt. Multistate Tax Portfolios (BNA) No. 1300, Dec. 22, 1995, at 2.

54. See *id.*

55. See COMMITTEE ON MULTISTATE TAX ISSUES, NEW YORK STATE BAR ASS'N, REQUEST ON GUIDANCE ON THE APPLICATION OF NEW YORK'S SALES AND USE TAXES TO OUT-OF-STATE VENDORS ¶ 6 [hereinafter NYSBA], reproduced in 96 STATE TAX NOTES 47-47, Mar. 8, 1996, available in LEXIS, Sttax Library, Stn File. The use tax is generally equal to the rate of sales tax in the purchaser's state of residence minus the sales tax, if any, paid at the time of sale. See *id.*

56. See *infra* Part III.B for discussion of the "physical presence" requirement.

57. See NYSBA, *supra* note 55, ¶ 7.

58. See *id.*

59. See discussion *infra* Part III.B.

B. Constitutional Barriers

A state cannot impose a sales or use tax collection obligation on an out-of-state seller unless the imposition of the obligation meets certain constitutional jurisdictional requirements.⁶⁰ As discussed below, the Commerce Clause⁶¹ and the Due Process Clause of the Fourteenth Amendment⁶² are constitutional barriers.

1. Governing Supreme Court Cases

The Supreme Court has held that it is unconstitutional for a state to impose a tax collection obligation on an out-of-state seller who has no “physical presence” in, or nexus with, the taxing state.⁶³ In both *National Bellas Hess, Inc. v. Illinois Department of Revenue*⁶⁴ and *Quill Corp. v. North Dakota*,⁶⁵ the two seminal cases on the issue, out-of-state sellers with no physical presence in-state were marketing and selling their goods to in-state residents through mail-order catalogs.⁶⁶ Presumably, the holdings regarding tax collection obligations of sellers with no physical presence in the taxing state also apply to vendors who sell to in-state residents through the Internet or on-line, rather than through mail-order catalogs.

a. *National Bellas Hess, Inc. v. Illinois Department of Revenue*

In *Bellas Hess*, Illinois imposed the duty of use tax collection on *National Bellas Hess, Inc.*, a mail-order house incorporated in Delaware with its principal place of business in Missouri.⁶⁷ *National Bellas Hess* did not maintain any office, sales house, distribution house, warehouse, or other place of business in Illinois; it did not have an agent, salesman, solicitor, or other representative to sell or take orders, to deliver merchandise, to accept payments, or to service merchandise in Illinois; nor did it own any real or personal tangible property in Illinois.⁶⁸ Twice a year, it mailed catalogs and flyers to the company’s active or recent customers throughout the vari-

60. See discussion *infra* Part III.B.1.

61. “The Congress shall have Power to . . . regulate Commerce with foreign Nations, and among the several States . . .” U.S. CONST. art. I, § 8, cl. 3.

62. “No State shall . . . deprive any person of life, liberty, or property, without due process of law . . .” U.S. CONST. amend. XIV, § 1.

63. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 307-08 (1992); *National Bellas Hess, Inc. v. Illinois Dep’t of Revenue*, 386 U.S. 753, 756-60 (1967).

64. 386 U.S. 753 (1967).

65. 504 U.S. 298 (1992).

66. See 386 U.S. at 753; 504 U.S. at 298.

67. See 386 U.S. at 753-54.

68. See *id.* at 754.

ous states.⁶⁹ It received orders through the mail, and then it sent the ordered goods through the mail.⁷⁰

Illinois imposed the use tax collection duty on “retailers maintaining a place of business” in the state.⁷¹ The statute at issue defined a “retailer maintaining a place of business” in Illinois as including any retailer “[e]ngaging in soliciting orders within this State from users by means of catalogues or other advertising, whether such orders are received or accepted within or without this State.”⁷²

The U.S. Supreme Court found that the statute violated the Due Process Clause of the Fourteenth Amendment and the Commerce Clause.⁷³ The Court described the Commerce Clause as pertaining to the justification of the burden imposed on interstate commerce by a particular tax: “State taxation falling on interstate commerce . . . can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys.”⁷⁴

The Court went on to state that the Due Process Clause required fairness.⁷⁵ It explained that the “simple but controlling question [in determining whether it has been violated] is whether the state has given anything for which it can ask [in] return.”⁷⁶ The Due Process Clause required “some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax.”⁷⁷

The Court noted that its previous decisions drew a sharp distinction “between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business.”⁷⁸ It decided that the distinction was a valid one and declined to obliterate it.⁷⁹ Thus, it held that the Due Process Clause and the Commerce Clause required that the seller maintain some sort of presence in the taxing state.⁸⁰

69. See *id.*

70. See *id.* at 755.

71. See *id.*

72. *Id.* (quoting ILL. REV. STAT. ch. 120, § 439.2 (1965)).

73. *Id.* at 756-60.

74. *Id.* at 756 (quoting *Freeman v. Hewit*, 329 U.S. 249, 253 (1946)).

75. See *id.*

76. *Id.* at 756 (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940)).

77. *Id.* (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)).

78. *Id.* at 758.

79. See *id.*

80. The Court also made note of the heavy record-keeping or administrative burden that would be imposed on vendors if they were forced to collect the sales or use tax. The Court stated:

[I]f the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation

b. *Quill Corp. v. North Dakota*

Approximately twenty-five years later, in *Quill Corp. v. North Dakota*,⁸¹ the Supreme Court revisited its *Bellas Hess* holding. Here, *Quill*, a Delaware corporation, sold “office equipment and supplies through catalogs and flyers, advertisements in national periodicals, and telephone calls.”⁸² It had no offices, warehouses, or employees in North Dakota.⁸³ It owned no tangible property in the state, and it delivered all of its merchandise to its North Dakota customers by mail or common carrier from out-of-state locations.⁸⁴

North Dakota required every “retailer” in the state to collect a use tax from each customer and remit it to the state.⁸⁵ The term “retailer” included “every person who engages in regular or systematic solicitation of a consumer market in the state.”⁸⁶ North Dakota filed an action in state court to require *Quill* to collect and pay a use tax on goods purchased for use in the state.⁸⁷ The trial court ruled in favor of *Quill*; the North Dakota Supreme Court reversed.⁸⁸ The U.S. Supreme Court granted certiorari and held that North Dakota could not require *Quill* to collect and pay the use tax.⁸⁹ It concluded that even though a state’s imposition of a tax may be consistent with the Due Process Clause, it may nevertheless violate the Commerce Clause.⁹⁰

The Court first explained that due process jurisprudence had evolved in the twenty-five years since *Bellas Hess* and suggested that some sort of physical presence was no longer necessary for jurisdiction under the Due Process Clause.⁹¹ It explained that it was “an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical pres-

with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National’s interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose “a fair share of the cost of the local government.”

Id. at 759-60 (footnotes omitted).

81. 504 U.S. 298 (1992).

82. *Id.* at 302.

83. *See id.*

84. *See id.*

85. *See id.* (quoting N.D. CENT. CODE § 57-40.2-07 (Supp. 1991)).

86. *Id.* at 302-03 (quoting N.D. CENT. CODE § 57-40.2-01(6) (Supp. 1991)).

87. *See id.* at 303.

88. *See id.*

89. *See id.* at 318.

90. *See id.* at 305.

91. *See id.* at 307.

ence within a State in which business is conducted.”⁹² Looking to its personal jurisdiction decisions as authority, the Court noted it had “abandoned more formalistic tests that focused on a defendant’s ‘presence’ within a State in favor of a more flexible inquiry into whether a defendant’s contacts with the forum” made it reasonable to require it to defend a suit there.⁹³ It overruled *Bellas Hess* insofar as it held that the Due Process Clause required a physical presence in the state.⁹⁴

The Court then analyzed whether the state’s imposition of the tax violated the Commerce Clause.⁹⁵ It noted that because the Due Process Clause and the Commerce Clause were animated by different constitutional concerns and policies, their nexus requirements were different.⁹⁶ The Court stated that, while the Due Process Clause was concerned with fairness, the Commerce Clause, which prohibits any state activity interfering with or burdening interstate commerce, was concerned with the effects of state regulation upon the national economy and with limiting state burdens on interstate commerce.⁹⁷ The Court upheld the physical presence requirement for purposes of the Commerce Clause based upon (1) principles of *stare decisis*, (2) the need to have a “bright-line” rule in the area of sales and use tax which encourages settled expectations and fosters investment by businesses and individuals, and (3) the burden that the imposition of a use tax collection obligation on sellers with no in-state presence would have on interstate commerce.⁹⁸ Thus, *Quill* established that while the Due Process Clause does not require an out-of-state seller to have physical presence in a state before the state may impose a

92. *Id.* at 308 (quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985)).

93. *Id.* at 307.

94. See *id.* at 308.

95. See *id.* at 309.

96. See *id.* at 312.

97. See *id.*

98. See *id.* at 314-18. The Court said:

North Dakota’s use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation’s 6,000 plus taxing jurisdictions. [Further,] “the many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations”

Id. at 313 n.6 (second alteration in original) (quoting *Bellas Hess*, 383 U.S. at 759-60).

use tax collection duty on the seller, the Commerce Clause does require it.⁹⁹

c. *Quill Leaves Open Avenue for Taxation of Out-of-State Sellers*

The Court's holding in *Quill* is significant. Although at first glance it seems the Court precluded the state taxation of out-of-state sellers, a closer reading of *Quill* reveals that the Court did leave an avenue open to achieve this goal.¹⁰⁰ By removing the physical presence requirement for Due Process Clause purposes, but leaving it intact for Commerce Clause purposes, the Court left "open the possibility that *Bellas Hess* could be legislatively preempted by congressional action."¹⁰¹

The Constitution gives Congress plenary power to regulate interstate commerce.¹⁰² This has been interpreted as giving Congress the ultimate power to authorize actions that unduly burden interstate commerce.¹⁰³ Thus, even if the Court finds that an action by a state unduly burdens interstate commerce, because the Constitution gives Congress the power to regulate interstate commerce, Congress can authorize such a violation.¹⁰⁴

By finding that North Dakota's action violated the Commerce Clause (but not the Due Process Clause), the *Quill* Court left to Congress the final decision as to whether state imposition of use tax collection obligations on out-of-state sellers should be barred by a lack of physical presence in the taxing state.¹⁰⁵ The Court recognized as much by stating that its decision that the Commerce Clause required physical presence in the taxing State was

made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. In-

99. See *id.* at 313.

100. See Maryann B. Gall & Laura A. Kulwicksi, *Limitations on States' Jurisdiction to Impose Sales and Use Taxes*, *Tax Mgmt. Multistate Tax Portfolios* (BNA) No. 1420, Jan. 26, 1996, at 15-16.

101. *Id.*

102. See U.S. CONST. art. I, § 8, cl. 3.

103. See *Quill*, 504 U.S. at 318.

104. Compare U.S. CONST. art I, § 8, cl. 3 ("Congress shall have power To . . . regulate Commerce . . . among the several States, . . .") with *id.* amend. XIV, § 1 ("No state shall . . . deprive any person of life, liberty, or property, without due process of law . . ."). Unlike the Commerce Clause, the Due Process Clause does not grant Congress any affirmative power. Thus, the Supreme Court, rather than Congress, has the final say as to whether it has been violated. Congress does not have the power to authorize a violation of the Due Process Clause. See *Quill*, 504 U.S. at 305.

105. See 504 U.S. at 318.

deed, in recent years Congress has considered legislation that would “overrule” the *Bellas Hess* rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.¹⁰⁶

To this day, Congress has not authorized any violations of the Commerce Clause regarding the state taxation of out-of-state sellers.¹⁰⁷

IV. WAYS TO CONSTITUTIONALLY TAX SALES

States are left with the problem of how to constitutionally require merchants, selling taxable goods to in-state customers over the Internet, to collect and remit use taxes to the state, where their only connection with the taxing state is the Internet.¹⁰⁸ This Article analyzes several possible solutions.

A. Congressional Authorization for States to Impose Tax

The obvious solution is to have Congress enact a law authorizing state imposition of use tax collection obligations on out-of-state vendors selling to in-state customers over the Internet or on-line. However, this is not very likely to happen. Numerous bills authorizing such action have been proposed in the past, and they have never progressed beyond subcommittee hearings.¹⁰⁹ Although these bills

106. *Id.* (citations omitted).

107. See *infra* notes 109, 111.

108. See, e.g., *Betts & Booker*, *supra* note 23.

109. Introduced during the late 1980s, prior to the *Quill* decision, the following legislative proposals would have authorized states to tax outside vendors:

- The Main Street Fair Competition Act of 1988, S. 2368, 100th Cong., would have authorized states to collect taxes with respect to sales of tangible personal property by nonresident persons who solicit such sales. Senate Bill 2368 set forth a three-prong jurisdictional standard that must have been satisfied before a state could require an out-of-state seller to collect and remit tax on mail-order sales: (1) the destination of the sale must have been within the taxing state; (2) the out-of-state retailer must have been engaged in regular or systematic solicitation of sales within the taxing state; and (3) the out-of-state retailer's annual sales must have exceeded \$15 million in the United States, or \$750,000 in the taxing state alone. See *id.* § 3.
- The Interstate Sales Tax Collection Act of 1987, H.R. 1242, 99th Cong., would have authorized states to require a retailer engaged in business in-state to collect state and local sales and use taxes on the sale or use of tangible personal property shipped or delivered into the state. The bill defined a “retailer engaged in business in that state” to include: “Any retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any banking, financing, debt collection, telecommunications, or marketing activities occurring in that State or benefits from the location in that State of authorized installation, servicing . . . facilities.” *Id.* The

were aimed at recapturing the revenue lost by the inability to tax out-of-state vendors who sold through mail-order catalogs, presumably, they would have applied to out-of-state vendors selling over the Internet or on-line as well.

Admittedly, before *Quill*, Congress was not likely to consider the proposed bills seriously because, even if it had authorized the burden on interstate commerce, the bills would have nonetheless violated the Due Process Clause.¹¹⁰ However, even since the handing down of the *Quill* decision, similar proposed legislation has come before Congress;¹¹¹ despite the existence of concerns regarding state need for greater revenues, similar to current concerns, Congress

proposal exempted retailers whose annual nationwide gross sales of tangible personal property did not exceed \$5 million. See *id.*

For similar legislation, see the Equity in Interstate Competition Act, H.R. 2230, 101st Cong. (1989); S. 480, 101st Cong. (1989); H.R. 3521, 100th Cong. (1987); H.R. 3549, 99th Cong. (1985); S. 983, 96th Cong. (1979).

110. See *Bellas Hess*, 386 U.S. at 756-60.

111. In February of 1994, Senator Dale Bumpers of Arkansas (a long-time proponent of federal legislation in this context) introduced the Tax Fairness for Main Street Business Act of 1994, S. 1825, 103d Cong., the first post-*Quill* bill dealing with taxation of interstate mail-order sellers. See *id.* The bill authorized states to require out-of-state sellers to collect and remit a state sales tax if the destination of the tangible personal property was in the state, and if the seller's gross receipts from sales of such tangible personal property exceeded \$3 million in the United States, or exceeded \$100,000 in the state. See *id.* § 3. On April 13, 1994, the Senate Small Business Committee heard testimony from business representatives who had a stake in the fate of Senate Bill 1825. See Amy Hamilton, House Small Business Panel Hears Testimony on Interstate Sales Tax Collection, TAX NOTES TODAY, Sept. 28, 1994, available in LEXIS, Fedtax Library, Tnt File:

The House Small Business Subcommittee on Procurement, Taxation and Tourism heard testimony on September 27[, 1994,] on the impact and fairness of giving states the power to collect from mail-order catalog firms the sales taxes incurred from purchases made by out-of-state mail-order customers. Panel chairman James H. Bilbray deemed the hearing a precursor to the 104th Congress, when the House was likely to introduce a bill comparable to S. 1825.

At the time the bill was being considered by the subcommittees, it was said that the current administration was more favorably inclined to this legislation than past administrations because President Clinton had supported such legislation when he was governor of Arkansas. See *id.* The bill, however, was never enacted.

On March 13, 1995, Senator Bumpers introduced a nearly identical bill, the Consumer and Main Street Protection Act of 1995, S. 545, 104th Cong. On April 5, 1995, the New York State Bar Association Tax Section submitted a report on Senate Bill 545, generally supporting, although with some reservations, the expansion of sales tax collection responsibilities of out-of-state vendors. See NYSBA Reports on Bill to Require Out-of-State Vendors to Collect Sales Tax, TAX NOTES TODAY, April 17, 1995, available in LEXIS, Fedtax Library, Tnt File. The last action date on the bill was October 27, 1995.

The Independence for Families Act, H.R. 4414, 103d Cong. (1994), also contained provisions addressing taxation of out-of-state sellers. It authorized state and local governments to require certain out-of-state businesses to collect sales taxes with respect to tangible personal property where the destination of the tangible personal property was in the state. See *id.* § 744. The bill exempted out-of-state sellers with gross receipts from sales of such tangible personal property in the United States exceeding \$3 million, or in the state exceeding \$100,000. See *id.* The bill was never enacted.

never took significant action towards enacting the legislation.¹¹² Congress's past record on similar legislation (even post-Quill proposals) suggests that it is unlikely that such legislation will now be enacted.¹¹³

It is, however, important to note that although a legislative solution has not been provided in the context of catalog sales, some have remarked that such a solution is not foreclosed in the Internet arena.¹¹⁴ "Because electronic sales are not an established industry as catalog sales are, the money and power are not yet behind the industry, forestalling change."¹¹⁵ Some urge that to obtain congressional approval, states should agree to use a portion of the taxes collected to better electronic commerce.¹¹⁶ By having a fund to improve the system, "states would create 'sex appeal' in Washington because there would be a new funding source."¹¹⁷

Furthermore, an important factor that may influence Congress in passing legislation is that, because of recently introduced new software, the record-keeping and administrative burden imposed on out-of-state vendors, which worried the Supreme Court in *Bellas Hess* and *Quill*, has significantly decreased.¹¹⁸ New software, such as TAXWARE, specifically designed for sales over the Internet, can track sales and use tax rates in more than 65,000 tax jurisdictions through zip code information required of a customer before an electronic commerce transaction takes place.¹¹⁹ Perhaps this software will ease Congress's concern that out-of-state sellers will be greatly burdened.¹²⁰

112. For example, at the time Senate Bill 1825 was under consideration, a May 1994 report by the U.S. Advisory Commission on Intergovernmental Relations estimated that total potential revenue from taxation of interstate mail-order sales for 1994 was \$4.57 billion. See *Taxation of Interstate Mail Order Sales: 1994 Revenue Estimates*, GOV'T FIN. REV., Oct. 1994, at 23, 26. However, Senate Bill 1825 never moved beyond subcommittee hearings.

113. See *supra* note 111.

114. See Harriet Hanlon, *MTC Examines Making (Tax) Money on the Internet*, 95 STATE TAX NOTES 150-26, Aug. 4, 1995 (discussing remarks of Stewart Baker, former general counsel for the National Security Agency, currently practicing with an international and technology law firm in Washington, D.C.), available in LEXIS, Sttax Library, Stn File.

115. *Id.*

116. See *id.*

117. *Id.*

118. See Amy Hamilton, *Netscape Installing Software That Will Calculate, Track Sales Taxes on Online Sales*, 95 STATE TAX NOTES 218-40, Nov. 13, 1995, available in LEXIS, Sttax Library, Stn File; AVP Tax Software Available with Netscape Internet Applications, PR Newswire, Nov. 8, 1995, available in LEXIS, News Library, Busdtl File.

119. See Hamilton, *supra* note 118.

120. See *id.*

B. Constitutionality Under the Representational Nexus Theory

An argument exists that the jurisdictional nexus that is required for taxation of out-of-state sellers can be found to exist under a “representational/agency” theory.¹²¹ This argument is based upon a series of Supreme Court cases finding that an out-of-state person has physical presence in the taxing state because it has in-state representatives or agents physically present in the taxing state.¹²² This Article concludes, after examination, that this theory of nexus does not provide jurisdiction over out-of-state merchants selling over the Internet or on-line.

1. Representational Nexus Line of Cases

In *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*,¹²³ the U.S. Supreme Court faced the question of whether Washington State could impose its business and occupation tax¹²⁴ on an out-of-state manufacturer that sold its products in-state but had no property, offices, or employees in Washington, and whose solicitation of business in the state was conducted by a sales representative located there.¹²⁵

The Court held that there was sufficient nexus based upon the presence of the representatives in Washington.¹²⁶ It stated that “the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for the sales.”¹²⁷ The sales representatives acted daily on behalf

121. See R. Scot Grierson, *Constitutional Limitations on State Taxation: States and Use Tax Nexus on the Information Highway*, 96 *STATE TAX NOTES* 35-38, Feb. 21, 1996, available in LEXIS, Sttax Library, Stn File.

122. See e.g., *Tyler Pipe Indus., Inc. v. Washington State Dep’t of Revenue*, 483 U.S. 232, 251 (1987) (holding the existence of in-state representatives created a nexus allowing states to tax).

123. 483 U.S. 232 (1987).

124. Washington imposed a business and occupation tax on “the act or privilege of engaging in business activities in the State.” *Id.* at 234-35 (quoting WASH. REV. CODE § 82.04.240 (1985)). The tax applied “to the activities of extracting raw materials in the State, manufacturing in the State, making wholesale sales in the State, and making retail sales in the State. The measure of the selling tax is the ‘gross proceeds of sales.’” *Id.* at 236 (footnotes omitted).

125. See *id.* at 249. Although *Tyler Pipe* concerned the imposition of the business and occupation tax, rather than a sales or use tax, it appears that the nexus requirements for both types of taxes are the same. This conclusion is based upon the fact that the two cases the *Tyler Pipe* Court cited as supporting its holding, *Scripto, Inc. v. Carson, Sheriff*, 362 U.S. 207 (1960), and *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), concerned use taxes. See 483 U.S. at 250.

126. See *Tyler Pipe*, 483 U.S. at 251.

127. *Id.* at 250 (quoting *Tyler Pipe Indus. v. Dep’t. of Revenue*, 715 P.2d 123, 126 (Wash. 1986)).

of Tyler Pipe by calling on its customers and soliciting orders.¹²⁸ Through sales contracts, the representatives maintained and improved Tyler Pipe's name recognition, market share, goodwill, and individual customer relations.¹²⁹ The sales representatives provided Tyler Pipe with virtually all of its "information regarding the Washington market, including product performance, competing products, pricing, market conditions and trends, existing and upcoming construction products, customer financial liability, and other critical information of a local nature concerning the Washington market."¹³⁰

Similarly, in *Scripto, Inc. v. Carson, Sheriff*,¹³¹ *Scripto, Inc.*, a Georgia corporation engaged in the business of selling mechanical writing instruments, did not "own, lease, or maintain any office, distributing house, warehouse, or other place of business in Florida, or have a regular employee or agent there."¹³² Orders for its products were solicited by ten "jobbers," or salesmen, who were residents of Florida and were designated as independent contractors by their agreements with *Scripto*.¹³³ Based upon the presence of the ten salesmen conducting continuous local solicitation in Florida, the Court found that there was a sufficient nexus for collection of the use tax from *Scripto*.¹³⁴

In *Standard Pressed Steel Co. v. Department of Revenue of Washington*,¹³⁵ *Standard Pressed Steel Co.*, a manufacturer of industrial and aerospace fasteners, challenged the constitutionality of the business and occupation tax that Washington levied on *Standard's* receipts from its sales to Boeing, its principal Washington customer.¹³⁶ *Standard's* only presence in-state was one employee, an engineer who operated out of his home.¹³⁷ His primary duty was to consult with Boeing regarding its anticipated needs and requirements for aerospace fasteners and to follow up any difficulties in the use of the product after delivery.¹³⁸ The Court upheld the constitutionality of the imposition of the tax.¹³⁹

128. See *id.* at 249.

129. See *id.*

130. *Id.* at 250 (quoting *Tyler Pipe*, 715 P.2d at 127).

131. 362 U.S. 207 (1960).

132. *Id.* at 209.

133. See *id.*

134. See *id.* at 211.

135. 419 U.S. 560 (1975).

136. See *id.* at 562.

137. See *id.* at 561.

138. See *id.*

139. For similar facts and holdings, see *General Trading Co. v. State Tax Commission of the State of Iowa*, 322 U.S. 335 (1944), and *Felt & Tarrant Manufacturing Co. v. Gallagher*, 306 U.S. 62 (1939).

2. Application of Representational Nexus Theory to Internet and On-Line Sales

At least one scholar had argued that "states can apply the express rule of these agency/representative . . . cases to persuade courts and administrative tribunals to find substantial nexus"¹⁴⁰ for out-of-state sellers. An examination reveals that this theory cannot serve as the basis for jurisdiction over out-of-state merchants selling over the Internet or on-line.

a. Commercial On-Line Service Serving as Agent of Registered Seller

Some argue that states have jurisdiction to tax out-of-state vendors, who lease space on a commercial on-line service's network and register with them as sellers, by virtue of the commercial on-line service's physical presence¹⁴¹ in-state.¹⁴² June Summers, director of the Multistate Tax Commission's National Nexus Program, asserts that a commercial on-line service such as CompuServe has hardware, and thus physical presence, in every state.¹⁴³ R. Scot Grierson, a tax attorney, contends that

[u]nder the agency/representative nexus analysis . . . a [vendor/seller] offering its service through the CompuServe network may have nexus with a given jurisdiction because of its relationship with CompuServe, i.e., because CompuServe is acting as the seller's in-state representative. In this instance, the . . . seller's relationship with CompuServe is directly "associated with the taxpayer's ability to establish and maintain a market in the state for the sales."¹⁴⁴

Accordingly, supporters of the agency theory in the context of on-line sales reach the conclusion that the commercial on-line service's in-state physical presence provides a nexus for taxation of the out-of-state vendors registered as sellers with the commercial on-line service.¹⁴⁵

140. Grierson, *supra* note 121 (making argument with respect to nexus for commercial on-line service providers).

141. Commercial on-line services have a "physical presence" in almost every state because they have a mainframe, in which they store their data, in almost every state. See *id.*

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

143. See Hanlon, *supra* note 114.

144. Grierson, *supra* note 121 (making argument with respect to sellers of information as opposed to tangible goods) (quoting *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232, 250 (1981)).

145. See *id.*

The problem with viewing commercial on-line service providers as representatives of the kind in the Tyler Pipe line of cases is that they do not perform the types of activities on behalf of the vendor that the Tyler Pipe representatives performed.¹⁴⁶ The commercial on-line services merely carry the vendor's "advertisement" or information into every state, much like the U.S. Postal Service delivers an advertising pamphlet, or a magazine carries an advertisement into every state.¹⁴⁷ Accordingly, basing nexus jurisdiction on the physical presence of a commercial on-line service would be very similar to basing nexus jurisdiction on the physical presence of the U.S. Postal Service or other mail carrier in every state, or on a magazine, distributed in every state, in which the out-of-state seller advertises.

Tyler Pipe provides that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."¹⁴⁸ The Court noted that the sales representatives acted daily on behalf of Tyler Pipe by calling on its customers and soliciting orders.¹⁴⁹ They maintained and improved the name recognition, market share, goodwill, and individual customer relations of the seller.¹⁵⁰ They provided Tyler Pipe with virtually all its information regarding the Washington market, including product performance, competing products, pricing market conditions and trends, and customer financial liability.¹⁵¹ Similarly, in *Scripto*, the salesmen were actively engaged in Florida as representatives of the seller for the purpose of attracting, soliciting, and obtaining Florida customers.¹⁵² In *Standard Pressed Steel*, the representative consulted with a major purchaser of the taxpayer's product regarding its anticipated needs and requirements for the product, and followed up with consultation as to any difficulties in the use of the product.¹⁵³

Commercial on-line services do not perform the same types of activities that the in-state representatives performed in the agency line of cases.¹⁵⁴ Although commercial on-line services put vendors in

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

147. See *id.*

148. 483 U.S. at 250.

149. See *id.* at 251.

150. See *id.* at 249.

151. See *id.* at 250.

152. See 362 U.S. at 209.

153. See 419 U.S. at 561.

154. It is noteworthy that *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), also has been cited as a case supporting the agency/representative theory of nexus. See *Grierson*, supra note 121. Specifically, it is cited to suggest that the agency/representative theory of nexus establishes jurisdiction

touch with customers all over the world, and in some cases provide services such as payment collection, they do not engage in active solicitation on behalf of the seller, or provide the type of customer support services the Tyler Pipe representatives did.¹⁵⁵ Accordingly, the agency/representative theory does not establish nexus over out-of-state vendors selling through commercial on-line services.

b. Telecommunications Provider Serving as In-State Agent or Representative

A related argument for establishing jurisdiction over vendors who lease space on a commercial on-line service's network is that the in-

over an out-of-state seller regardless of the nature of the activities the agent performs on behalf of the seller. See *id.* This is somewhat misleading. In the case, National Geographic, a nonprofit corporation with headquarters in the District of Columbia, maintained two offices in California that solicited advertising copy for National Geographic's monthly magazine. See 430 U.S. at 552. The two offices performed no activities related to National Geographic's operation of a separate line of business—its mail-order business for the sale of maps, atlases, globes, and books. See *id.* Orders for these items were mailed from California directly to National Geographic's Washington, D.C., members and magazine subscribers, or on order forms contained in the magazine. See *id.* Deliveries were made by mail from National Geographic's Washington, D.C., or Maryland offices. See *id.* National Geographic challenged the constitutionality of California's use tax, as applied to its mail-order activities in California.

The Court found that the requisite nexus for the imposition of the use-tax-collection obligation. See *id.* at 556. It found that National Geographic was "present" in California based on its maintenance of two offices in California. See *id.* In so finding, the Court was not troubled by the fact that the activities carried on by the two offices in California were wholly unrelated to National Geographic's mail-order business, and explained that

the relevant constitutional test to establish the requisite nexus for requiring an out-of-state seller to collect and pay the use tax is not whether the duty to collect the use tax relates to the seller's activities carried on within the State, but simply whether the facts demonstrate "some definite link, some minimum connection, between [the State and] the person . . . it seeks to tax."

Id. at 561 (alteration in original) (quoting *Miller Bros. v. Maryland*, 347 U.S. 340, 344-345 (1954)).

It is important to note that the requisite nexus was based on National Geographic's actual physical presence in the state, not the presence of National Geographic's agents or representatives in-state. See *id.* at 556. The two offices located in California were not acting as agents of National Geographic, or owned or run by entities separate from National Geographic; they were owned and run by National Geographic. Thus, the language of National Geographic to the effect that nexus may be found without regard to the nature of the activity carried on within the state is not relevant for determining whether nexus based on an agency/representative theory exists. See *id.* at 560.

155. Where the vendor is selling digitized versions of traditionally tangible personal property (such as books or music), and the commercial on-line service actually helps deliver the digitized information, the assertion is made that the commercial on-line service, which is delivering the product being sold, is acting as an in-state representative of the seller because it is directly "associated with the taxpayer's ability to establish and maintain a market in the state for the sales." Grierson, *supra* note 121 (quoting Tyler Pipe, 483 U.S. at 250). However, the commercial on-line service is acting no differently from the U.S. Postal Service when it delivers shopping catalogs, as well as ordered merchandise, to an in-state customer. Thus, it is difficult to see why the agency/representative argument has any more force when the product being sold by the out-of-state seller is digitized information delivered by the commercial on-line service rather than a tangible good.

state telecommunications infrastructure that allows for delivery of the seller's storefront serves as the physical presence in-state.¹⁵⁶ Commercial on-line services typically supplement the reach of their own networks through agreements with other telecommunications providers to ensure delivery of their product in the various states.¹⁵⁷ Some commentators suggest that the telecommunications provider effectively acts as the conduit through which the information of the seller must travel to take advantage of the benefits of the market state.¹⁵⁸ Thus, it is urged that the telecommunications provider essentially acts as the seller's in-state distributor or representative.¹⁵⁹

This reasoning can be extended to argue that the telecommunications provider serves as the basis for jurisdiction over out-of-state vendors selling to in-state customers over the Internet. Internet service providers (ISPs) use the telecommunications infrastructure for delivery of information, so that the telecommunications provider, who controls the telecommunications infrastructure, acts as an in-state representative of the vendor whose message it allows to be delivered.¹⁶⁰

This argument is flawed. Again, the telecommunications providers merely carry the vendor's information into the taxing state. They do not engage in active solicitation or perform other services similar to those provided by the Tyler Pipe representatives.

Additionally, the argument assumes that the physical presence of a representative of the vendor's representative is sufficient to provide jurisdiction over the vendor: the vendor contracts with the ISP or commercial on-line service, who contracts with the telecommunications provider, who in turn has the in-state physical presence. This goes beyond the holding of Tyler Pipe and similar cases. Tyler Pipe held that the in-state physical presence of a representative of the seller may serve as the basis of jurisdiction over the seller.¹⁶¹ If the physical presence of a representative of a vendor's representative can serve as the basis of jurisdiction, then conceivably a state could establish jurisdiction over practically anyone.

156. See *id.*

157. See *id.*

158. See *id.*

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

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

161. See 483 U.S. at 249-50.

Furthermore, the argument appears to assume that there is one person or centralized figure who owns or acts on behalf of the telecommunications infrastructure over which the message travels to reach its destination. There is no such centralized figure. The telecommunications infrastructure is controlled by many different parties.¹⁶² Thus, it is unclear who exactly is serving as the out-of-state vendor's representative. Additionally, it is important to note that emerging technology, such as microwaves, satellites, and radio-waves, will be used to transmit information over the Internet in the future.¹⁶³ Thus, there may not be any "physically present" telecommunications equipment in-state upon which jurisdiction may be based.

c. Other Agency Theories

It has been urged that a state has jurisdiction over an out-of-state seller because the ISPs have a physical presence in the state and are representatives of the vendor.¹⁶⁴ Some suggest that states may obtain jurisdiction over out-of-state vendors selling over the Internet or on-line because of the in-state presence of credit card payment systems they use.¹⁶⁵ These representational nexus theories fail to take account of the relationship between the in-state representative and the seller. To serve as the basis of jurisdiction for tax purposes, the representative must perform solicitation or customer service activi-

162. [I]t often is said that "no one" owns the Internet. In fact, the 'Net is owned by many someones who all control their own pieces of it. When a network is connected to the Internet, it is generally understood that some of the resulting traffic will have nothing to do with local computers. System operators let this data flow by on its way to other destinations. . . . The present Internet is a loose collection of huge networks run largely by giant phone companies such as MCI and Sprint, connected at several major points with many smaller regional net[w]orks.

Alan Phelps, Ready, Set, Click: The Internet Races into the Mainstream, PC NOVICE GUIDE TO THE INTERNET, June 1996, at 6, 7-8.

On the regional level, smaller state-wide or multi-state backbones carry data to local servers where users dial in or connect via special dedicated lines. . . . High-speed lines connect larger cities while small conduits fan out to local access points. The system is connected to the larger Internet at several points. . . . [At the national level,] [i]n the United States, Internet traffic is carried through a variety of networks. . . . Two of the largest systems are run by telephone giants Sprint and MCI. Their backbones carry much of the long-distance Internet communications across the continent. Regional networks wire into the larger systems and each other at many places, producing a system that can easily route round local malfunctions. Four main Network Access Points (NAPs) located around the country offer high-speed switching between the biggest networks.

Phelps, *supra* note 6, at 13.

163. See ELLSWORTH & ELLSWORTH, *supra* note 1, at 36-37.

164. See David Brunori, ABA Tax Section Meeting: State Panel Debates Future of Internet Taxation, UDITPA, 96 STATE TAX NOTES 94-24, May 14, 1996, available in LEXIS, Sttax Library, Stn File.

165. See Hanlon, *supra* note 114 (statement of Stewart Baker).

ties of the same magnitude and nature as those of the Tyler Pipe representatives, thus allowing the establishment and maintenance of a market by the seller in the taxing state.¹⁶⁶ The representatives in the above-cited theories do not perform activities similar to those of the Tyler Pipe representatives.

Thus, the theories of representational nexus do not establish jurisdiction over out-of-state vendors selling over the Internet or on-line. It is interesting to note, however, that the Multistate Tax Commission's current draft of nexus guidelines adopts a representational nexus approach in the area of Internet sales.¹⁶⁷

C. Changing the Definition of "Physical Presence"

Some might suggest that in light of changing technology, the present physical presence definition may be outmoded and in need of revision.¹⁶⁸ As technology advances and becomes more widespread, it becomes exceedingly easy for persons to engage in activities in various jurisdictions, without physical presence within the jurisdiction.¹⁶⁹ The virtual presence of a seller in a state allows her to advertise her product, demonstrate it, obtain and accept orders, provide customer support, and obtain customer feedback—nearly all the activities in which physical presence would have allowed her to en-

166. See 483 U.S. at 249-50.

167. The current MTC Guidelines state:

Physical Presence: An out-of-state business is, or is deemed to be, physically present in the taxing state for possible application of that state's sales or use tax when the business engages in one or more of the following activities beyond a de minimis level:

....

(7) maintains in the taxing State by private contract, and not by purchase from a common carrier in the common carrier's status as common carrier, telecommunications linkage that permits, the out-of-state business to establish and maintain a market in the taxing State

MULTISTATE TAX COMM'N, NEXUS GUIDELINE FOR APPLICATION OF A TAXING STATE'S SALES AND USE TAX TO A REMOTE SELLER § II.C.7 (draft of Oct. 25, 1994). The examples in the guidelines of nexus include:

(a) Activities of a contract carrier that is the actual in-state deliverer (service provider) of the very transaction that is the actual object of what is being sold.

(b) Advertising directed at in-state persons through local newspapers or periodicals or local television, radio, or other local means of electronic transmission.

(c) Maintenance of a dedicated or virtual telecommunications network that facilitates or promotes the market of the out-of-state business in the taxing State.

....

(f) Regular use of a financial network, such as a credit or debit card system, that facilitates or promotes the market of the out-of-state business in the taxing State.

Id. § III.A.4.

168. See Betts & Booker, *supra* note 23.

169. See *id.*

gage.¹⁷⁰ Further, as Virtual Reality Transfer Protocol (VRTP) becomes available, virtual showrooms and product demonstrations can become part of the Web.¹⁷¹ Consumers will be able to virtually walk through a showroom or mall, drive a car, use a computer, or talk to technical support personnel using the Web.¹⁷²

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

While changing the definition of physical presence to include virtual presence seems an appealing and simple solution, it presents problems. By changing and expanding the definition of physical presence, and in effect equating nonphysical presence in a state with physical presence, the state legislative bodies would be writing the constitutional requirement of physical presence out of existence.¹⁷³

No one would dispute that it would be unconstitutional for a state legislature, in response to *Bellas Hess* and *Quill*, to enact a statute providing that the presence of mail-order catalogs in-state of an out-of-state seller constituted physical presence of the seller in the state.¹⁷⁴ It is important to note that there is no real difference between a seller making sales to in-state customers over the Internet and a seller making sales to in-state customers via mail-order catalogs. There is no meaningful difference between a customer receiving a catalog in the mail and then dialing up a phone number to place an order, and a customer accessing a seller's Web site and placing an order via the Web site itself. Certainly the customer can place the order more immediately on the Web site, without having the intermediate step involved of picking up a telephone to place her order, and have questions about the product answered, so that she can obtain instant gratification. However, one type of presence is no closer to falling within the definition of "physical presence" than the other.

170. See Loshin, *supra* note at 11, 86-88.

171. See ELLSWORTH & ELLSWORTH, *supra* note 1, at 292.

172. See *id.*

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

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

V. CONCLUSION

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

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