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COMMENTS

THE INTERNET TAX FREEDOM ACT: CONGRESS TAKES A BYTE OUT OF THE NET

Matthew G. McLaughlin⁺

To understand the complexities of Internet taxation, consider the following hypothetical: John is looking for a new television set. After browsing at several retailers in his area, he returns home and logs on to the Internet. While on-line, John finds the Web-page of the out-of-state manufacturer of the television he wants to purchase; in fact, the set is selling for one hundred dollars less than at the local store. John sends his secured credit card number across the Internet and, in less than two weeks, the set arrives on his doorstep.

If John had purchased his new television from a local retailer, in almost every state, he would pay a state-imposed sales tax.¹ If he had purchased his set from a retailer outside of the state, the state in which he lived would most likely impose a use tax in lieu of collecting a sales tax.² Because John purchased his television from an on-line company out-of-state, however, he avoided paying either tax. Or did he? What if John did not buy a television, but instead purchased software or commenced a service contract on-line?

The United States Constitution invests all power to regulate interstate

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1. See *infra* note 7 and accompanying text (stating that forty-five states and the District of Columbia impose some form of sales tax).

2. See 68 AM. JUR. 2D *Sales and Use Tax* § 189 (1993). A sales tax is levied on in-state transactions, whereas a use tax is imposed on out-of-state transactions that otherwise would be subject to a sales tax had they been consummated in-state. See *id.* A use tax, thought of as a complement to a sales tax, is designed to prevent evasion of the sales tax. See *id.* But see James Eads et al., *National Tax Association Communications and Electronic Commerce Tax Project Report No. 1 of the Drafting Committee*, 13 STATE TAX NOTES 1255, 1263 (1997) [hereinafter *NTA Report*] (suggesting that different treatment of use taxes in the multi-jurisdictional context may prevent them from operating always in a complementary fashion).

The statutory provisions of both taxes generally are similar, and at least one court has found it unnecessary to differentiate between the two. See *Morrison-Knudson Co. v. State Bd. of Equalization*, 135 P.2d 927, 932 (Wyo. 1943) (finding that the State legislature intended to apply the same rules and principles to sales and use taxes, as evidenced by the lack of contrary language in the statute).

commerce with Congress.³ Further, the Supremacy Clause ensures that all laws made pursuant to the Commerce Clause preempt state action.⁴ Despite the fact that nothing in the Constitution gives Congress power over intrastate commerce, courts have expanded the scope of Congress's commerce power to reach activity with little apparent interstate contact.⁵ State power, even in the realm of purely intrastate commerce, is not unfettered however, but is restricted by the Due Process Clause of the Fourteenth Amendment.⁶

Forty-five states and the District of Columbia impose a sales tax—a levy on commerce conducted within the state's borders—on items in commerce.⁷ These same states also impose a use tax on goods and services purchased out-of-state but destined for in-state consumption.⁸ Under typical use tax statutes, consumers who purchase out-of-state goods for use in-state are responsible for calculating the applicable use tax and remitting that amount to the state.⁹ Consumers rarely comply with the

3. See U.S. CONST. art. I, § 8, cl. 3. The Commerce Clause gives Congress the exclusive power to “regulate [c]ommerce with foreign Nations, and among the several States, and with the Indian Tribes[.]” *Id.*

4. See *id.* art. VI (“This Constitution, and the Laws . . . which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land”); see also *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 209 (1824) (explaining that “the word ‘to regulate’ [in the Commerce Clause] implies in its nature, full power over the thing to be regulated, [and] it excludes, necessarily, the action of all others that would perform the same operation on the same thing”).

5. See, e.g., *Katzenbach v. McClung*, 379 U.S. 294, 304 (1964) (finding that because a substantial portion of food served at a restaurant had moved in interstate commerce, and because the restaurant served interstate travelers, the Commerce Clause could be employed to eliminate racial discrimination at a restaurant); *Wickard v. Filburn*, 317 U.S. 111, 127-28 (1942) (holding that the collective effect of farmers storing wheat for personal use would be adverse to interstate commerce and could, therefore, be regulated under the Commerce Clause).

6. See U.S. CONST. amend. XIV, § 1 (providing that “[n]o State shall . . . deprive any person of life, liberty, or property, without due process of law”).

7. See David C. Blum, Comment, *State and Local Taxing Authorities: Taking More Than Their Fair Share of the Electronic Information Age*, 14 J. MARSHALL J. COMPUTER & INFO. L. 493, 494 n.6 (1996). The remaining five states, Alaska, Delaware, Montana, New Hampshire, and Oregon, while not imposing a “sales tax” per se, impose some type of tax on purchases. See *id.*

8. See, e.g., CAL. REV. & TAX. CODE § 6201 (West 1998); GA. CODE ANN. § 48-8-30(a), (c) (1995); N.J. STAT. ANN. § 54:32B-6 (West 1986); OHIO REV. CODE ANN. § 5741.02 (Anderson 1996); TENN. CODE ANN. § 67-6-210 (1994); TEX. TAX CODE ANN. § 151.101 (West 1992); VA. CODE ANN. § 58.1-604 (Michie 1997).

9. See, e.g., N.J. STAT. ANN. § 54:32B-6 (statute imposing use tax); § 54:32B-12 (requiring collection of use tax); § 54:32B-18 (directing methods for payment of tax collected under § 54:32B-12); see also 144 CONG. REC. S230 (daily ed. Jan. 29, 1998) (statement of Sen. Bumpers) (stating that sales and use taxes are payable whether the purchase was made at the store, through the mail, or on-line).

law, because they are often unaware that a tax exists; thus, to collect the back taxes, the state would have to pursue the multitude of individuals who are buying goods from out-of-state vendors for use in the taxing state.¹⁰ As an alternative, states have sought to impose the responsibility to collect and remit use taxes on the vendors themselves.¹¹

Before a state can charge vendors with a responsibility to collect and remit sales and use taxes on transactions, however, it must have legal authority, or jurisdiction, over the actors in commerce.¹² In order to obtain this jurisdiction to tax, the state must satisfy certain requirements under the Commerce and Due Process Clauses; specifically, it must demonstrate that the vendor has sufficient contact within its borders.¹³ Typically, a court will find jurisdiction to tax where the commercial actor, by establishing retail facilities in the taxing state, appeals specifically to the consumers there.¹⁴ This jurisdictional analysis becomes difficult in situations where the connection between the taxing state and the commercial actor is attenuated, such as when goods and services are sold over the Internet.¹⁵ A number of states have enacted laws that require businesses selling goods on the Internet to collect sales and use taxes on the products they sell and then to remit the amounts to the state in which the consumer lives.¹⁶ With the value of Internet transactions approaching six

10. See 144 CONG. REC. S230. In introducing Senate Bill 1586, the Consumer and Main Street Protection Act of 1998, Senator Dale Bumpers (D-AR) cited the billions of dollars lost each year by state and local governments because of uncollected use taxes. See *id.* This delinquency is due in part to most mail-order companies not informing their customers of their legal obligations or misleading them into believing that no obligation exists. See *id.* Senate Bill 1586 attempts to alleviate this problem by authorizing states to impose use tax collection burdens on out-of-state vendors. See S. 1586, 105th Cong. § 3(a) (1998).

11. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 301 (1992) (seeking to impose use tax collection responsibilities on an out-of-state vendor).

12. See Christina R. Edson, *Quill's Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce*, 49 TAX LAW. 893, 894-95 (1996).

13. See *id.* at 895.

14. See *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 364 (1941) (upholding Iowa's requirement that companies collect use taxes from in-state consumers when they maintain facilities in the state).

15. See Edson, *supra* note 12, at 893 ("State revenue agencies . . . have been forced to apply outdated statutes and court decisions . . . when analyzing the taxation of companies that . . . do not have the traditional 'physical presence' within the state . . .").

16. See Tim Huber, *State, Local Governments Looking for Access to Potential Internet Tax Dollars*, WEST'S LEGAL NEWS, April 15, 1996, available in 1996 WL 259457 (describing existing state statutes that impose taxes on various transactions completed over the Internet); see also Matthew Petrillo, *Tax Law Changes Will Hit Telecom Companies of All Types; State Battlegrounds Emerging*, STATE & LOC. COMM. REP., August 8, 1997, at 4-5 [hereinafter *Tax Law Changes*] (describing the current debate regarding Internet taxation and noting that Tennessee and Texas already tax Internet commerce).

billion dollars per year by the end of this century, states are racing to grasp this new source of revenue.¹⁷

Because each jurisdiction employs a tax rate independent of the others however, a business is faced with the administrative burden of calculating and reporting the sales and use taxes for each state that taxes its Internet business.¹⁸ Moreover, in some cases, the only contact that a seller may have with the taxing state is the phone line that enables the consumer to log on to the Internet.¹⁹

Due in part to both the administrative confusion and amount of revenue at stake, the Federal Government has taken notice of state action in this area.²⁰ The Internet Tax Freedom Act (ITFA), recently signed into law by President Clinton, imposes a moratorium on certain new taxes on Internet transactions.²¹ In addition, the Department of the Treasury

17. See Gregg Keizer, *Online Money Matters*, COMPUTER LIFE, August 1996, at 46, available in 1996 WL 7987471. In addition to a 6¼% state sales tax, if users dial a Texas phone number or a toll-free number within the state to access an Internet access provider, local governments can add a 2% local tax. See Huber, *supra* note 16, at *1. A spokesman for the Texas Comptroller's office characterized Internet access "as a taxable telecommunications service." *Id.*

Although it is unclear what long-term action, if any, Congress will take in the area of Internet taxation, there has been much discussion about the ability of the states to absorb fiscal responsibilities imposed by Congress in the current era of devolution and their corresponding need to secure new, viable sources of revenue. See Robert Tannenwald, *Come the Devolution, Will States Be Able to Respond?*, 14 STATE TAX NOTES 357, 357 (1998). In his article, Tannenwald reports that some policymakers have expressed concern that states will be unable to cope with new fiscal responsibilities due to public resistance to higher taxes. See *id.* Tannenwald points out that the burden of general sales and property taxes as a percentage of overall state and local revenue has increased since the 1980s. See *id.* at 366. Moreover, as public demand declines for those consumable goods that constitute more traditional sources of state tax revenue, such as gasoline, tobacco, and hard liquor, the burden on other sales and property taxes increases. See *id.* at 365. States, however, are hesitant to broaden their tax bases through increased levies on corporations, given the transient nature of today's business and competition from other states to attract business within their borders. See *id.* at 366. This fact is evidenced by the trend by states to tax the consumer (through a sales or use tax), and not the vendor, for goods and services sold over the Internet. See *id.*; *infra* notes 166-171 and accompanying text (describing different state paradigms for taxing information services and other intangible property).

18. See Blum, *supra* note 7, at 495-96.

19. See *Inset Sys., Inc. v. Instruction Set, Inc.*, 937 F. Supp. 161, 165 (D. Conn. 1996) (finding by the United States District Court for the District of Connecticut that it had jurisdiction where corporation's only contact with citizens of the taxing state was through an advertisement posted on the Internet).

20. See *Tax Law Changes*, *supra* note 16, at 5.

21. See S. 442, 105th Cong. (1998); H.R. 1054, 105th Cong. (1997). Senator Ron Wyden (D-OR) introduced Senate Bill 442, known as the "Internet Tax Freedom Act." See S. 442. Representative Christopher Cox (R-CA) introduced companion legislation, designated House Bill 1054, in the House of Representatives. See H.R. 1054. The ITFA was enacted as part of House Bill 4328, the omnibus appropriations legislation for fiscal 1999.

anxiously is studying the issue and its potential for revenue growth.²²

This Comment addresses the Federal Government's role in the evolution of Internet taxation. First, this Comment examines the way states obtain jurisdiction to tax an out-of-state actor in commerce. Noting the similarities between the mail-order and electronic commerce industries, this Comment analyzes case law concerning the taxation of mail-order sales to infer the constitutional requirements of Internet taxation. This Comment then considers state action in this arena, theories offered for and against applying these requirements to Internet commerce, and finally, the impact that the ITFA will have in this regard. While this Comment supports the ITFA, it argues for the adoption of a new standard that can be applied readily to Internet taxation.

I. THE EXPANSION OF STATE TAXING POWERS ON A NEW BREED OF INTERSTATE COMMERCE: INTERNET TRANSACTIONS

A. *Limitations on the Jurisdiction to Tax: The Due Process and Commerce Clauses*

The greatest challenge to state taxation of Internet transactions is the taxing state's ability to obtain jurisdiction to tax.²³ This power is similar to in personam jurisdiction, but differs in its focus and in the actors involved.²⁴ In personam jurisdiction must be obtained by a court prior to asserting judicial authority over an individual.²⁵ Likewise, a state legislature must obtain taxing jurisdiction over individuals before it can collect money from them in the form of taxes.²⁶ Despite the difference in authorities who seek to assert their jurisdiction, namely, the courts and the legislature, the constitutional standards for each inquiry are similar.²⁷

See H.R. 4328, 105th Cong., tit. XI, sec. 1100 (1998). President Clinton signed House Bill 4328 into law on October 21, 1998. See *The Internet Tax Freedom Act Home Page* (visited Nov. 3, 1998) <<http://www.house.cox.gov/chriscox/nettax>>.

22. See generally *Selected Tax Policy Implications of Global Electronic Commerce* (visited Mar. 3, 1998) <<ftp://ftp.fedworld.gov/pub/tel/internet.txt>> (discussing, in a paper published in November 1996 by the Department of the Treasury's Office of Tax Policy, federal income tax policy and administrative issues presented by developments in communications technology and electronic commerce).

23. See Edson, *supra* note 12, at 894-95.

24. See *id.*

25. See *id.*

26. See *id.*

27. See *id.* at 896. It should be noted, however, that the constitutional standards for personal and taxing jurisdiction are not entirely the same. See *id.* For example, it has been easier for a court to assert jurisdiction over a corporation than for a state to assert jurisdiction to tax. See *id.* Furthermore, in obtaining personal jurisdiction, the Commerce Clause is not implicated; however, in asserting taxing jurisdiction, the Commerce Clause

It is useful, therefore, to examine briefly the evolution of personal jurisdiction jurisprudence and its application to Internet taxation.

1. *The Due Process Clause and Erosion of the Minimum Contacts Test*

A survey of the relevant caselaw on personal jurisdiction evinces a move from rigid physical requirements to a more ephemeral standard. Beginning with the seminal case of *Pennoyer v. Neff*,²⁸ the Supreme Court examined the Due Process Clause as a bar to asserting personal jurisdiction over an individual who owned property in the state but did not reside there.²⁹ The *Pennoyer* Court held that due process required that the defendant be within the sitting court's jurisdiction, by either service of process within the state or voluntary appearance.³⁰ More than fifty years later, in *International Shoe Co. v. Washington*,³¹ the Supreme Court reassessed *Pennoyer's* rigid physical presence requirement.³² The Court held that if a defendant was not in the forum state, due process required only that he have "certain minimum contacts" with the state such that asserting jurisdiction did not offend "traditional notions of fair play and substantial justice."³³

joins the Due Process Clause in limiting the power of the states to act. *See id.*

28. 95 U.S. 714 (1877).

29. *See id.* at 733-34. In *Pennoyer*, Neff challenged a default judgment that had been entered against him by asserting that he was not a resident of the state, was not personally served with process, and had not appeared in court. *See id.* at 719-20.

30. *See id.* at 733. In requiring the physical presence of the defendant, the Court held that default judgments entered against out-of-state defendants on the basis of mere publication of process would be, if upheld, "the constant instruments of fraud and oppression." *Id.* at 726. Personal service was required, the Court held, because in most cases, absent defendants never saw the published notices. *See id.*

31. 326 U.S. 310 (1945).

32. *See id.* at 316. International Shoe, a Delaware corporation with approximately one dozen Washington-based salesmen, challenged a Washington employment tax. *See id.* at 313-15. It argued that its business affairs within the taxing state were insufficient to amount to the presence required for the state to assert jurisdiction. *See id.* at 315. The Supreme Court made only brief mention of the constitutionality of Washington's ability to tax the corporation. *See id.* at 321. Following the Supreme Court of Washington and its own precedent, the Court held that the taxation of labor within the forum state was a valid exercise of state taxing power. *See id.* (citing *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937)).

33. *Id.* at 316 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)). In addressing the unique nature of corporate *presence*, the Court held that

[s]ince the corporate personality is a fiction, although a fiction intended to be acted upon as though it were a fact, it is clear that unlike an individual its "presence" without, as well as within, the state of its origin can be manifested only by activities carried on in its behalf by those who are authorized to act for it. To say that the corporation is so far "present" there as to satisfy due process requirements, for purposes of taxation or the maintenance of suits against it in the courts of the state, is to beg the question to be decided. For the terms "present" or

Even as the *International Shoe* Court's minimum contacts test gained wide acceptance, the Court, in *McGee v. International Life Insurance Co.*,³⁴ continued to lower the constitutional hurdle.³⁵ The *International Life* Court ensured that due process jurisprudence would keep up with economic progress by adopting a "substantial connection" test.³⁶ It did so because industrial improvements had made it easier to conduct business with little contact with the forum state.³⁷ Additionally, modern transportation enabled a company to travel with less difficulty to a forum state to answer a complaint.³⁸ Taking these factors into consideration, the Court in *International Life* found that the insurance company had manifested a substantial connection with California as the insured was a state resident and her premiums were mailed from the state.³⁹

In *World-Wide Volkswagen Corp. v. Woodson*,⁴⁰ the Court further broadened *International Life*'s substantial connection test to reach actors who purposefully had availed themselves of the benefits and protections of the forum state.⁴¹ In addition, it examined the defendant's contacts

"presence" are used merely to symbolize those activities of the corporation's agent within the state which courts will deem to be sufficient to satisfy the demands of due process. Those demands may be met by such contacts of the corporation with the state of the forum as make it reasonable, in the context of our federal system of government, to require the corporation to defend the particular suit which is brought there.

Id. at 316-17 (citations omitted) (emphasis added).

34. 355 U.S. 220 (1957).

35. *See id.* at 222 ("Looking back over this long history of litigation a trend is clearly discernable toward expanding the permissible scope of state jurisdiction over foreign corporations and other nonresidents."). In *International Life*, a beneficiary under a life insurance policy in California sued a Texas insurance company to collect under the policy. *See id.* at 221. *International Life* argued that the judgment rendered against it in California was not enforceable because the company had no office, no personnel, and only one policy holder in California, and therefore lacked the minimum contacts required by *International Shoe*. *See id.* at 221-22.

36. *See id.* at 223.

37. *See id.* Reflecting on the modernization of business, the Court recognized that state jurisdiction over non-resident individuals and corporations was becoming increasingly expansive. *See id.* at 222. The Court attributed this trend to a paradigmatic shift in the method of business since the days of *Pennoyer*, where a strict physical presence in the forum state was required to assert in personam jurisdiction. *See id.* The Court noted that the "nationalization of commerce" had created a business atmosphere in which commercial transactions traversed state boundaries and more business could be conducted by way of the mails without any personal contact. *See id.* at 223. The result of the nationalization, the Court found, was the relative ease with which a corporation could defend itself in a state where it had no physical presence but engaged in economic activity. *See id.*

38. *See id.* at 223.

39. *See id.*

40. 444 U.S. 286 (1980).

41. *See id.* at 297 (quoting *Hanson v. Denckla*, 357 U.S. 235, 253 (1958)). In *World-*

with the forum state to determine whether they were such that he could foresee being brought into court there.⁴² Although the Court held ultimately that Oklahoma could not obtain jurisdiction over World-Wide Volkswagen, its decision further weakened the Due Process Clause's protections over actors in interstate commerce by shifting the analysis from a tautological examination of the defendant's contacts to one that focused on that individual's reasonable expectations of being haled into court.⁴³

Five years after *World-Wide Volkswagen*, the Supreme Court, in *Burger King Corp. v. Rudzewicz*,⁴⁴ finally dismantled *Pennoyer's* rigid physical requirements.⁴⁵ In *Burger King*, the Court reasoned that, in cases where an out-of-state actor in commerce conducted a substantial amount of business through the mail and over wire services, it obviated the Due Process Clause's physical presence requirement.⁴⁶ In so doing, the Court rejected physical presence as a jurisdictional requirement when a corporate entity "purposefully direct[s]" its actions towards citizens of another state.⁴⁷

Wide Volkswagen, a New York resident brought a products liability suit in Oklahoma after he was involved in a motor vehicle accident there. *Id.* at 288. In his suit, he named as co-defendants the car manufacturer, its importer, its regional distributor, World-Wide Volkswagen Corporation (a New York resident), and its retailer (also a New York resident). *See id.* World-Wide Volkswagen challenged the state court's exercise of its long-arm statute over it for lack of personal jurisdiction on the bases that it was a New York corporation, did no business in Oklahoma, did not ship or sell any products to that state, did not have an agent there, and did no advertising there. *See id.* at 288-89.

42. *See id.* at 289. Although the Court held that the contacts between World-Wide Volkswagen and Oklahoma were too attenuated to support a finding of jurisdiction, it found that a non-resident corporation could be subject to suit in a forum state if its sales arise from the efforts of the manufacturer to serve that state. *See id.* at 289, 297.

43. *See id.* at 292-95. The Court held that World-Wide Volkswagen had no contact that would render it susceptible to jurisdiction in Oklahoma. *See id.* at 295. The Court noted further that it had abandoned the "shibboleth" of *Pennoyer's* rigid requirements, but did not expressly overrule the case. *Id.* at 293.

44. 471 U.S. 462 (1985).

45. *See id.* at 476. The Court noted that, while the defendant's physical presence within the state would enhance the state's ability to assert jurisdiction over the defendant, the absence of physical presence did not preclude it from asserting such jurisdiction. *See id.*

46. *See id.* In *Burger King*, a Florida corporation sued its Michigan franchisee for breach of contract. *See id.* at 464. The defendant franchisee claimed that he was a Michigan resident and, therefore, lacked minimum contacts with Florida. *See id.* The Court held that Burger King's suit did not violate the Due Process Clause, because the franchise agreement signed by the parties required payments to be sent to the corporate headquarters in Florida and provided the defendant with notice that he might be haled into court there. *See id.* at 480.

47. *See id.* at 476. The Court, quoting *International Life*, observed the economic changes taking place that enabled businesses to conduct more business in the forum state without being present there. *See id.* at 474. It then noted that, although a corporation's

2. State Taxation of Interstate Commerce: The Commerce Clause and "Nexus" Theory

Pennoyer and its progeny were concerned with a court's ability to assert jurisdiction over an out-of-state actor, and focused primarily on the Due Process Clause as a limit on that power.⁴⁸ A state that is seeking to obtain jurisdiction to tax, however, also must be concerned with the Commerce Clause's prohibition on interference with interstate commerce.⁴⁹ Much of the Supreme Court's jurisprudence regarding state taxation of interstate commerce, therefore, hinges on whether a state places an undue burden on actors in that arena.⁵⁰ In much the same way the *International Shoe* Court inquired into the existence of minimum contacts, the courts that have addressed state taxation look to the sufficiency of the connection, or nexus, between the state and the activity that it seeks to tax.⁵¹

In *Complete Auto Transit, Inc. v. Brady*,⁵² the Supreme Court considered what it termed the "perennial problem" of determining the validity of a state levying a tax on the "privilege of doing business" in that state.⁵³ In that case, Mississippi attempted to tax an out-of-state motor carrier who brought motor vehicles to dealers throughout the state.⁵⁴ The carrier, Complete Auto, challenged the Mississippi tax on constitutional grounds; specifically, it argued that Mississippi's tax on the privilege of

physical presence in the forum state would "enhance a potential defendant's affiliation with a [s]tate," the absence of such physical presence will not defeat jurisdiction per se. *Id.* at 476.

48. See *id.* at 471-72; *World-Wide Volkswagen*, 444 U.S. at 291; *Shaffer v. Heitner*, 433 U.S. 186, 207 (1977); *McGee v. International Life Ins. Co.*, 355 U.S. 220, 222 (1957); *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) ("[D]ue process requires . . . certain minimum contacts with [the forum] such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'"); *Pennoyer v. Neff*, 95 U.S. 714, 728 (1877) (conducting a procedural due process analysis and concluding that "[n]o person is required to answer in a suit on whom process has not been served, or whose property has not been attached").

49. See *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 178-80 (1995) (evaluating whether a tax on interstate bus tickets violated the Constitution); *Goldberg v. Sweet*, 488 U.S. 252, 266-68 (1989) (determining whether a state telecommunications tax was unconstitutional); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 364-65 (1941) (questioning whether a state tax placed a substantial burden on interstate commerce).

50. See generally *Jefferson Lines, Inc.*, 514 U.S. at 179-84 (tracing the development of Commerce Clause jurisprudence).

51. See *Goldberg*, 488 U.S. at 262-64 (finding that the only states with a sufficient connection to impose a telecommunications tax were those where the call was charged and those where it was billed or paid).

52. 430 U.S. 274 (1977).

53. See *id.* (quoting *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 101 (1975)).

54. See *id.* at 275-76.

doing business within its borders violated the Commerce Clause.⁵⁵

In support of its argument, *Complete Auto* cited *Spector Motor Service v. O'Connor*,⁵⁶ in which the Supreme Court held that a tax on the privilege of doing business was unconstitutional per se when applied to purely interstate commercial activity.⁵⁷ The *Complete Auto* Court, however, noted that the *Spector* rule had been questioned since its inception,⁵⁸ and ultimately overruled it.⁵⁹ Instead, the Court held that a standard lower than per se invalidity should be applied when considering taxes that are tailored to the nature of the commerce involved.⁶⁰

In *Complete Auto*, the Court drew a distinction between a tax on the privilege of doing interstate business, which would be unconstitutional, and a tax on the benefits and protections provided by the taxing state to out-of-state actors operating in that state, which would be valid.⁶¹ It then cited Justice Rutledge's four-part test, first offered in *Memphis Natural Gas v. Stone*,⁶² for determining whether a sufficient nexus exists between the tax and the vendor's activity in the taxing state: whether (1) "the activity [was] sufficiently connected to the State to justify a tax;"⁶³ (2) "the tax [was] fairly related to the benefits provided the taxpayer;"⁶⁴ (3) "the

55. *See id.* at 277. The Mississippi statute assessed "privilege taxes for the privilege of engaging or continuing in business or doing business within this state." MISS. CODE ANN. § 27-65-13 (1997).

56. 340 U.S. 602 (1951). In that case, Connecticut imposed a tax, measured by apportioned net income, on the franchise of a Missouri trucking company for the privilege of carrying on business within the state. *See id.* at 603. The Court held that a tax on the privilege of doing business is unconstitutional if it is applied to commerce that is exclusively interstate. *See id.* at 610.

57. *See Complete Auto*, 430 U.S. at 283-84, 289.

58. *See id.* at 284-87; *see also* *Railway Express Agency v. Virginia*, 358 U.S. 434, 441 (1959) (holding that the *Spector* rule encouraged the use of semantics that could render an otherwise valid tax unconstitutional).

59. *See Complete Auto*, 430 U.S. at 288-89. In overruling *Spector*, the Court noted that the *Spector* rule "ha[d] no relationship to economic realities." *Id.* at 279.

60. *See id.* at 288-89 n.15.

61. *See id.* at 281-82 (citing Justice Reed's plurality opinion in *Memphis Natural Gas Co. v. Stone*, 335 U.S. 80, 88-93 (1948)).

62. 335 U.S. 80 (1948).

63. *Complete Auto*, 430 U.S. at 287. This question becomes the "nexus" issue that courts must grapple with in determining whether the state can require an out-of-state vendor to collect and remit use taxes. *See* 68 AM. JUR. 2D *Sales and Use Tax* § 205 (1993).

64. *Complete Auto*, 430 U.S. at 287. Closely associated with the nexus theory, this second requirement "is premised on whether the [forum] state has given anything for which it can ask return." *Great Am. Airways v. Nevada State Tax Comm'n*, 705 P.2d 654, 658 (Nev. 1985). It is used to prevent a state from imposing collection and remittance responsibilities on a vendor if the vendor "does not benefit from services provided by the [] state." *Tennessee Gas Pipeline Co. v. Marx*, 594 So. 2d 615, 618 (Miss. 1992).

This requirement does not mandate an accounting of those state services beneficial to

tax discriminate[d] against interstate commerce,”⁶⁵ and (4) “the tax [was] . . . fairly apportioned,”⁶⁶ that is, it was not applied to the activity conducted outside the borders of the taxing state.⁶⁷ Ultimately, the Court found that it did not need to apply this test, because the sole issue raised by *Complete Auto* on appeal was whether a tax “on the privilege of doing business” was unconstitutional *per se*.⁶⁸ Nevertheless, the sufficient nexus test announced in *Complete Auto* became the standard for Commerce Clause analysis in the area of state taxation of out-of-state actors doing business in the state.⁶⁹

B. Application of Substantial Nexus Theory to the Mail Order Industry: Bellas Hess and the Unified Test

The first prong of the *Complete Auto* test, whether a sufficient connection or “nexus” exists between the vendor and the taxing state, provides a framework for the courts’ analysis of jurisdiction in mail-order cases.⁷⁰

the vendor in any given transaction. See *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 199 (1995). By the same token, the states are not required to allocate money collected in use taxes to those services that the vendor enjoys. See *id.* The practical effect of this requirement is that vendors engaging in interstate commerce may be made to pay their fair share of state expenses from which they derive no direct benefit. See *id.* at 199-200.

65. *Complete Auto*, 430 U.S. at 287. This prohibition forbids a state from taxing out-of-state commerce at a higher rate than it taxes in-state commerce. See *Great Am. Airways*, 705 P.2d at 658. A state’s taxing strategy generally will survive if out-of-state taxes are levied at the same rate as in-state taxes. See *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 648 (1994). In cases where the out-of-state taxes operate to discourage out-of-state business in favor of those in-state, the Court has held such economic protectionism invalid *per se*. See *id.* at 649-50 (holding that a discrepancy between the burdens imposed by sales and use taxes discriminates against interstate commerce and is unconstitutional).

66. *Complete Auto*, 430 U.S. at 287. In order for a state use tax to be fairly apportioned, it must not be duplicative or subject to an already taxed activity, or incident to double taxation. See *Great Am. Airways*, 705 P.2d at 657. A use tax must be structured so that if every state were to impose a similar tax, there would be no multiple taxation. See *Tennessee Gas*, 594 So. 2d at 618; *Quotron Sys., Inc. v. Limbach*, 584 N.E.2d 658, 660 (Ohio 1992) (holding that “if every state taxed the receipt of information via computer equipment, as Ohio does, only one state, the state of receipt, would tax each transaction”).

67. See *Complete Auto*, 430 U.S. at 282. In *Memphis Natural Gas*, a 5-4 decision, the Supreme Court held that the state was acting within constitutionally permissible limits when it levied a tax on out-of-state companies for the protection afforded those companies within the state’s borders. See *Memphis Natural Gas*, 335 U.S. at 96. In his concurrence, Justice Rutledge sustained the tax on the grounds that it was fairly apportioned, nondiscriminatory, and did not subject the company to double taxation of its interstate activity. See *id.* at 96-97 (Rutledge, J., concurring).

68. See *Complete Auto*, 430 U.S. at 288-89.

69. See *supra* notes 63-66 and accompanying text (describing the elements of the *Complete Auto* test and their application to later case law).

70. See Steven J. Forte, *Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?* 15 J. MARSHALL J. COMPUTER & INFO. L. 203, 214

The mail-order industry serves as a useful analog to Internet commerce.⁷¹ In the same way mail-order consumers peruse a catalog, on-line shoppers browse a vendor's Web-page.⁷² In both cases, consumers can order without leaving their homes and can quickly receive wares shipped from out-of-state vendors via a common carrier.⁷³

As early as 1967, in *National Bellas Hess, Inc. v. Department of Revenue*,⁷⁴ the Court sought to determine whether a physical presence in the taxing state was necessary for that state to have jurisdiction to tax.⁷⁵ In *Bellas Hess*, a Missouri mail-order company challenged an Illinois statute requiring out-of-state mail-order companies to collect and remit use taxes.⁷⁶ *Bellas Hess* did not operate any facility in Illinois.⁷⁷ In fact, its only contact with the state was through the mail-order catalogs that it sent to its customers by United States mail or a common carrier.⁷⁸ However, under the relevant Illinois statute, even this limited contact with the taxing state was sufficient to classify *Bellas Hess* as having a place of business in the state.⁷⁹

Bellas Hess challenged the Illinois statute on both due process and Commerce Clause grounds.⁸⁰ The Court considered both challenges, acknowledging that the tests for validity in each case were closely related.⁸¹ For due process concerns to be satisfied, the Court required that the state justify its taxation of the seller on the ground that the seller is paying for the benefits he receives from the taxing state.⁸² Implicitly under this rule, the Court reasoned, the controlling question is whether the seller has derived any benefit from the taxing state for which he can be expected to pay.⁸³ In its Commerce Clause analysis, the Court found that

(1997) (terming the first prong of the *Complete Auto* test "the most troublesome prong to any state attempting to collect use tax from Internet vendors").

71. See *id.* at 204 (indicating the similarities between mail-order and Internet purchaser conveniences).

72. See *id.*

73. See *id.*

74. 386 U.S. 753 (1967).

75. See *id.* at 754.

76. See *id.*

77. See *id.*

78. See *id.*

79. See *id.* at 755 (citing ILL. REV. STAT. ch. 120, § 439.2 (1965), that defined a "[r]etailer maintaining a place of business in [the] State," to include those who "[e]ngag[ed] in soliciting orders within [the] State from users by means of catalogues . . . whether such orders are received or accepted within or without [the] State").

80. See *id.* at 756.

81. See *id.*

82. See *id.* (citing *Freeman v. Hewit*, 329 U.S. 249, 253 (1946)).

83. See *id.* (citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1962)); see also

the states have used the same principles to justify requirements that the seller collect and remit use taxes on interstate sales.⁸⁴ It noted that the Constitution requires a minimum connection between the state and the entity it seeks to tax.⁸⁵

The Court distinguished *Bellas Hess* from previous cases in which it had allowed the state to impose a tax on the seller.⁸⁶ While the Court had upheld the authority of the states to impose tax liability on interstate sellers in the past, it had never held that a state may impose a burden on a seller whose only contact with the state is through the United States mail or a common carrier.⁸⁷ The Court explained that, if it were to allow the Illinois statute to stand, it would have to ignore this distinction.⁸⁸ Instead, it reasoned that the distinction was valid and that there was no commercial activity that was as purely interstate as the mail-order business implicated in *Bellas Hess*.⁸⁹ The Court struck down the Illinois statute, holding that both the Due Process and Commerce Clauses required more than mere use of the mails; the seller must maintain some sort of physical presence in the taxing state.⁹⁰

In dicta, the Court posited that if it allowed Illinois to impose such a burden, there would be nothing to stop every state from imposing the same tax.⁹¹ Moreover, the Court noted, the administrative difficulties posed by different tax rates, exemptions, and requirements on the interstate seller would bear little resemblance to the fair share of costs for the benefits provided by the local government.⁹²

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 277 (1977) (noting that the Missouri Supreme Court found that Complete Auto received a benefit from the taxing state in the form of police protection of the general citizenry).

84. See *Bellas Hess*, 386 U.S. at 756.

85. See *id.* (citing *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)); see also *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 362-63 (1941) (upholding the state's authority to tax a mail-order company where it maintained retail facilities in the taxing state); *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62, 67-68 (1939) (upholding the state's power to impose liability on sales arranged by local agents in the taxing state).

86. See *Bellas Hess*, 386 U.S. at 758.

87. See *id.*

88. See *id.*

89. See *id.* at 759.

90. See *id.* at 758. The Court noted that

[i]n order to uphold the power of Illinois to impose use tax burdens . . . [it] would have to repudiate totally the sharp distinction which [prior Court decisions] have drawn 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

Id.

91. See *id.* at 759.

92. See *id.* at 759-60.

In *National Geographic Society v. California Board of Equalization*,⁹³ the Court considered whether National Geographic's presence in California was a sufficient nexus to subject it to a tax.⁹⁴ The Court held that California could constitutionally levy a tax on National Geographic, because the company, through its business activities, had established a relationship with the forum state.⁹⁵

National Geographic operated two offices in California, each staffed with four persons.⁹⁶ Although the primary function of these two offices was to solicit advertising for the magazine,⁹⁷ California sought to tax the sale of National Geographic's publications through its mail-order business.⁹⁸ The California offices had made some over-the-counter sales of similar merchandise; however, they had not carried on any activities related to the mail-order business.⁹⁹ The California Supreme Court ruled that when a company does a substantial amount of business through mail-order, the slightest presence within the taxing state, even if it is unrelated to the mail-order business, will satisfy constitutional concerns.¹⁰⁰

On appeal, the United States Supreme Court held that National Geographic was liable for the tax.¹⁰¹ The Court noted however, that National Geographic's connection to California was considerably higher than the connection required by the slightest presence standard employed by the lower court.¹⁰² It therefore instructed that its decision to uphold the lower court's ruling was not to be construed as an affirmation of the slightest presence standard, but rather as a ruling based on National Geographic's business presence in California satisfying the higher sufficient nexus threshold.¹⁰³

93. 430 U.S. 551 (1977).

94. *See id.* at 554.

95. *See id.* at 556.

96. *See id.* at 554 & n.2.

97. *See id.*

98. *See id.* at 554. California requires "every retailer engaged in business in [California] and making sales of tangible personal property for storage, use, or other consumption in [California]" to collect a use tax. CAL. REV. & TAX CODE § 6203 (West 1998). California law also imputes liability for required taxes to the vendor regardless of whether he collects the tax. *See id.* § 6204.

99. *See National Geographic*, 430 U.S. at 552.

100. *See National Geographic Soc'y v. State Bd. of Equalization*, 547 P.2d 458, 462 (Cal. 1976), *aff'd* 430 U.S. 551 (1977).

101. *See National Geographic*, 430 U.S. at 562 (holding that National Geographic's "continuous" presence satisfied constitutional nexus requirements).

102. *See id.* at 556.

103. *See id.* The Court held that the amount of advertising revenue collected by the two California offices constituted a nexus with the taxing state that belied the slightest presence standard. *See id.*

C. *Splitting Due Process and Commerce Clause Analysis: Quill Corp. v. North Dakota*

Twenty-five years after *Bellas Hess*, the Court revisited the physical presence requirement of the Due Process and Commerce Clauses in *Quill Corp. v. North Dakota*.¹⁰⁴ In that case, the Supreme Court upheld a North Dakota statute that imposed a tax-collection burden on an interstate seller in a situation very similar to that in *Bellas Hess*.¹⁰⁵

Quill was a mail-order company that had facilities in Illinois, California, and Georgia.¹⁰⁶ It had no personnel in North Dakota and did not operate any warehouses in that state.¹⁰⁷ North Dakota imposed a collection and remittance requirement on vendors selling out-of-state merchandise.¹⁰⁸ In much the same manner as *Bellas Hess*,¹⁰⁹ the North Dakota statute allowed the state to impose a use tax on vendors who solicited sales within its borders, regardless of whether the vendor had an actual location in the state.¹¹⁰

The Court in *Quill* departed drastically from its holding in *Bellas Hess*, where it had found that the requirements under the Due Process and Commerce Clauses were essentially similar.¹¹¹ Recognizing a fundamental difference in the concerns each clause addressed, the Court bifurcated its analysis to determine the validity of the North Dakota statute; first analyzing the due process concerns, then turning to a Commerce Clause analysis.¹¹²

1. *Due Process Protection After Quill: Is Any Contact Really Necessary?*

In *Bellas Hess*, the Supreme Court had interpreted the Due Process Clause to require some minimum connection between the business and the taxing state.¹¹³ Although that connection may have become a bit attenuated¹¹⁴ by the time *Bellas Hess* was decided, its necessity to satisfy

104. 504 U.S. 298 (1992).

105. *See id.* at 301-02 (describing the procedural background and factual similarities between *Quill* and *Bellas Hess*).

106. *See id.* at 302.

107. *See id.*

108. *See id.*

109. *See id.* at 301.

110. *See id.* at 302-03.

111. *See id.* at 305.

112. *See id.*

113. *See National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 758 (1967).

114. *See Scripto, Inc. v. Carson*, 362 U.S. 207, 210-12 (1960) (upholding a use tax not-

due process concerns was firmly ensconced in the Court's jurisprudence.¹¹⁵ As the *Quill* Court noted however, Due Process Clause jurisprudence had evolved significantly in the twenty-five years since the *Bellas Hess* decision.¹¹⁶ It noted further that the focus of due process analysis had shifted to a more flexible inquiry into whether the seller had contacts with the taxing state such that it could anticipate being brought into court there.¹¹⁷ This focus, the Court posited, was a departure from the more traditional emphasis placed on the seller's physical presence in the taxing state.¹¹⁸ As a result, the Court held that a foreign corporation could fall within the taxing state's jurisdiction if it took advantage of the benefits of the forum state, regardless of whether the corporation had any actual physical presence there.¹¹⁹

The Court determined that a mail-order vendor, by the very nature of the business involved, has fair warning that its activities may subject it to the jurisdiction of the taxing state.¹²⁰ Accordingly, the Court modified the due process requirements in this area to reflect its holding that a physical presence was no longer necessary.¹²¹ To the extent that the Court had based earlier decisions on the necessity of a physical presence, those decisions were overruled.¹²²

That did not end the *Quill* Court's analysis. Because it had bifurcated its consideration of Due Process and Commerce Clause requirements, it was possible for the North Dakota statute to survive due process scrutiny yet fail under a Commerce Clause analysis.¹²³

2. *Gotcha! Physical Presence Is Still Required by the Commerce Clause*

Highlighting its separate treatment of the Due Process and Commerce Clauses in its analysis, the *Quill* Court rejected the argument that if it found that *Quill* satisfied the Due Process Clause's minimum contacts test, it must necessarily find that *Quill* satisfied the Commerce Clause's

withstanding that all of the seller's in-state solicitation was done by independent contractors).

115. See *Quill*, 504 U.S. at 307 (“[T]he Court suggested that such presence was not only sufficient for jurisdiction under the Due Process Clause, but also necessary.”).

116. See *id.*

117. See *id.*; see also *Shaffer v. Heitner*, 433 U.S. 186, 207 (1977) (applying to in rem proceedings the “traditional notions of fair play and substantial justice” standard found in *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

118. See *Quill*, 504 U.S. at 307.

119. See *id.*

120. See *id.* at 308.

121. See *id.*

122. See *id.*

123. See *id.* at 305.

substantial nexus requirement.¹²⁴ The Court noted that where a due process analysis concerns the notice and fair warning given to a seller that his activities may subject him to the jurisdiction of the taxing state, a Commerce Clause analysis has a different emphasis.¹²⁵ The Commerce Clause analysis, the Court explained, concerns the impact of individual state regulations on the interstate economy as a whole rather than the rights of the individual.¹²⁶ Adopting the bright-line test put forth in *Bellas Hess*—exempting from state-imposed collection and remittance duties vendors whose sole contact with the taxing state was by mail or common carrier¹²⁷—the Court held that North Dakota's statute violated the Commerce Clause and could not stand because *Quill* lacked a “substantial nexus” with the state.¹²⁸

In the wake of the Supreme Court's decision in *Quill*, the precise definition of sufficient nexus remains unclear.¹²⁹ Although *Complete Auto*'s four-part test stands firm, the courts have wavered in establishing a predictable benchmark of connection sufficient to subject an out-of-state actor to a state sales or use tax.¹³⁰ In industries such as the mail-order business, where the vendor's contact with the taxing state is remote, *Quill*'s application is obvious: a vendor whose only contact with the taxing state is via the mail or common carrier lacks the substantial nexus required by the Commerce Clause to establish jurisdiction.¹³¹

D. Challenging In Personam or Personal Jurisdiction in Internet Cases

Although the extent of jurisprudence regarding the Internet does not

124. *See id.* at 312.

125. *See id.*

126. *See id.*

127. *See National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 758 (1967).

128. *See Quill*, 504 U.S. at 315 n.8.

129. *See Adam L. Schwartz, Note, Nexus or Not? Orvis v. New York, SFA Folio v. Tracy and the Persistent Confusion over Quill*, 29 CONN. L. REV. 485, 485-86 (1996) (discussing how the Court's failure to provide a precise definition in *Quill* has encouraged the states to litigate the nexus issue in an effort to collect revenues).

130. *Compare Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954, 961 (N.Y. 1995) (interpreting *Quill*'s nexus requirements to allow New York to tax a mail-order company whose salesmen made approximately a dozen visits to the State), *with SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693, 697 (Ohio 1995) (refusing to allow Ohio to tax a mail-order company whose parent sold its merchandise and accepted returned goods at retail outlets in-state); *see also Schwartz, supra* note 129, at 506-14 (discussing *Orvis* and *SFA Folio*).

131. *See Quill*, 504 U.S. at 311, 317 (refusing to overrule *Bellas Hess* and finding that a company whose only contact with the forum state is through the mail lacks sufficient nexus).

approach that of the mail-order industry, several cases addressing jurisdictional problems on the Internet have been decided.¹³² For example, in *Inset Systems, Inc. v. Instruction Set, Inc.*,¹³³ the United States District Court for the District of Connecticut heard Instruction Set's motion to dismiss Inset's trademark infringement claim for lack of personal jurisdiction.¹³⁴ Despite Instruction Set's lack of physical presence in Connecticut, Inset's home state,¹³⁵ the court found that it had jurisdiction to hear the case under Connecticut's long-arm statute.¹³⁶ That law provided that a Connecticut resident could sue any foreign corporation on a cause of action arising out of the repeated solicitation of business within its borders.¹³⁷ Although Instruction Set's only solicitation in Connecticut occurred in an advertisement posted on the Internet,¹³⁸ the court found that it was sufficiently repetitive to satisfy the long-arm statute.¹³⁹

Instruction Set, conceding the long-arm statute's application, further argued that it lacked sufficient minimum contacts with the state to survive a constitutional challenge on due process grounds.¹⁴⁰ The court rejected this argument and held that Instruction Set's actions on the Internet, including the establishment of a toll-free number available to residents of all states, were such that it could reasonably anticipate being brought into court in Connecticut.¹⁴¹

132. See, e.g., *Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414, 419-20 (9th Cir. 1997) (requiring, in a trademark infringement suit, something more than the mere presence of a Web-page to subject the individual corporation to jurisdiction); *CompuServe, Inc. v. Patterson*, 89 F.3d 1257, 1264 (6th Cir. 1996) (holding that the defendant purposefully availed himself of the forum state's benefits and protections when he sent electronic information over the Internet to in-state residents); *Digital Equip. Corp. v. Altavista Tech., Inc.*, 960 F. Supp. 456, 472 (D. Mass. 1997) (concluding that a company can be subjected to personal jurisdiction by virtue of the fact that it maintains a Web-site accessible to residents of the forum state); *Inset Sys., Inc. v. Instruction Set, Inc.*, 937 F. Supp. 161, 164-65 (D. Conn. 1996) (same); see also Christian M. Rieder & Stacy P. Pappas, *Personal Jurisdiction for Copyright Infringement on the Internet*, 38 SANTA CLARA L. REV. 367, 367 (1998) (discussing the problems the Internet poses to asserting personal jurisdiction over actors in commerce).

133. 937 F. Supp. 161 (D. Conn. 1996).

134. See *id.* at 162.

135. See *id.* at 162-63 (finding that Instruction Set had no employees or offices in Connecticut and conducted no business there).

136. See *id.* at 166.

137. See *id.* at 164 (citing CONN. GEN. STAT. § 33-41(c)(2) (repealed 1997)).

138. See *id.*

139. See *id.*

140. See *id.*

141. See *id.* at 165; cf. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980) (holding that due process requires minimum contacts such that a defendant could anticipate "being haled into court" in the forum state).

Similarly, in *CompuServe, Inc. v. Patterson*,¹⁴² the United States Court of Appeals for the Sixth Circuit considered whether a vendor, whose contacts with the state were almost entirely electronic in nature, could be subjected to the court's jurisdiction.¹⁴³ Patterson developed software and entered into an agreement with CompuServe to make his software available on its network for a fee.¹⁴⁴ The court concluded that Patterson purposefully had availed himself of the benefits and protections of Ohio and, as such, was subject to in personam jurisdiction.¹⁴⁵ Importantly, the court found that CompuServe's central location in Ohio acted as a distribution center for Patterson's software, albeit merely as an electrical conduit; therefore, he had received a benefit from his contact with the State.¹⁴⁶ Moreover, the court noted that Patterson had benefited from Ohio's commercial protections when he knowingly entered into a contract with CompuServe and put his software in the stream of commerce.¹⁴⁷

Inset and *Patterson* make clear that courts will apply traditional notions of minimum contacts and nexus sufficiency to cases involving the Internet.¹⁴⁸ Taken together, these cases stand for the proposition that a vendor who uses the Internet may subject himself unwittingly to a state's taxing jurisdiction.¹⁴⁹

Notwithstanding the courts' ability in *Inset* and *Patterson* to assert personal jurisdiction, it is difficult to reconcile traditional bases of jurisdiction with the taxation of intangible goods and services.¹⁵⁰ To address this, one commentator has called for a paradigmatic shift in establishing a nexus between the vendor and the taxing state, "situs-ing" the sale and

142. 89 F.3d 1257 (6th Cir. 1996).

143. *See id.* at 1262.

144. *See id.* at 1263.

145. *See id.*

146. *See id.*

147. *See id.* at 1265.

148. *See id.* at 1263 ("As always in this context, the crucial federal constitutional inquiry is whether . . . the nonresident defendant has sufficient contacts with the forum state that the district court's exercise of jurisdiction would comport with 'traditional notions of fair play and substantial justice.'") (quoting *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)); *Inset Sys., Inc. v. Instruction Set, Inc.*, 937 F. Supp. 161, 164-65 (D. Conn. 1996) (applying *World-Wide Volkswagen's* "reasonable anticipation" test and *International Shoe's* minimum contacts test).

149. *See supra* note 132 and accompanying text (discussing caselaw treatment of personal jurisdiction on the Internet).

150. *See* R. Scot Grierson, *State Taxation of the Information Superhighway: A Proposal for Taxation of Information Services*, 16 LOY. L.A. ENT. L.J. 603, 664-65 (1996) (suggesting that the existing case law is of little help in solving the Internet's nexus problem).

establishing a nexus in the state in which services are billed.¹⁵¹ Another has called for a standard altogether different from one based on physical presence; this new nexus would be based on the vendor's "economic presence" or "virtual presence" in the taxing state.¹⁵²

II. THE INTERNET TAX FREEDOM ACT: THE GREAT SOLUTION?

A. Framing the Problem

1. Intangible Property: The Taxation of Information Services

While the traditional notion of nexus is easily applied to situations in which there is a transfer of tangible property, a nexus analysis is problematic when considering the taxation of intangible information services.¹⁵³ Generally, intangible property is not subject to sales tax.¹⁵⁴ Re-

151. See *id.* at 631-644. Grierson proposes a model statute that addresses the taxation of information services. See *id.* at 633. He suggests an "unbundling" of services into separate content-based and transmission-based components. See *id.* at 632. With this distinction in mind, services with a high informational component would be subject to tax whereas "ordinary" telecommunications services would not be taxed. See *id.* at 636-37.

152. See Forte, *supra* note 70, at 225-26.

153. See Blum, *supra* note 7, at 509. States that are hesitant to impose new taxes on vendors often refrain from making definitive assertions as to the tangibility of a certain item, and instead defer to the courts or administrative bodies. See Edward A. Morse, *State Taxation of Internet Commerce: Something New Under the Sun?*, 30 CREIGHTON L. REV. 1113, 1132-33 (1997). This hesitancy to reform taxing structures has led to inconsistency. For example, mailing lists used by direct-mail vendors have received different tax treatment depending on the format in which they are delivered. Compare *Fingerhut Prods. Co. v. Commissioner of Revenue*, 258 N.W.2d 606, 610 (Minn. 1977) (holding that vendors who received typed mailing lists were not subject to tax on the transfer of that information, but finding that vendors who received those same lists on gummed labels or computer tapes were liable for the state's use tax), with *Spencer Gifts, Inc. v. Director, Div. of Taxation*, 440 A.2d 104, 118 (N.J. Tax Ct. 1981) (holding that mailing lists sold on magnetic tape were not taxable because the true object of the transaction was the names on the list, and not the magnetic tape itself). The court in *Fingerhut* reasoned that the tapes and labels were a tangible representation of the lists, whereas the typed lists were used for the information contained therein. See *Fingerhut*, 258 N.W.2d at 610. Notwithstanding the decision of the New Jersey Tax Court in *Spencer Gifts*, the Appellate Division of the New Jersey Superior Court held that mailing labels provided by a direct mailer were taxable. See *Hoffmann-LaRoche Inc. v. Director, Div. of Taxation*, 471 A.2d 786, 787 (N.J. Super. Ct. App. Div. 1983). These cases demonstrate that the distinction between tangible and intangible goods is controversial and carries substantial tax ramifications with its characterization.

154. See Walter Hellerstein, *State and Local Taxation of Intangibles Generates Increasing Controversy*, 80 J. TAX'N 296, 300 (1994). Despite this fact, approximately one-half of the states currently apply a sales tax to information services. See Grierson, *supra* note 150, at 620. Some currently available, or soon to be available, services on the Internet include videos, cable television, recorded music, books, newspapers, magazines, information databases, education, banking and brokerage services, electronic bill payment,

cently, however, courts have come to view packaged software as tangible personal property subject to tax, rather than intangible property transferred via an incidental, tangible medium.¹⁵⁵ Present technology has made it possible to convert otherwise tangible property to digital, intangible information.¹⁵⁶ In this electronic form, information can be transferred via a host of media, including direct broadcast satellite, integrated services digital network ("ISDN"), or the Internet.¹⁵⁷ As a result, com-

bulletin boards and chat rooms, electronic mail, and software that can be downloaded. See Morse, *supra* note 153, at 1128-29. These services are in addition to the access provided by Internet Service Providers such as America Online, Prodigy, and CompuServe. See *id.* at 1127 n.97.

Computer software is yet another product that has received differing tax treatment based in part on its tangibility. In an early case treating software as intangible property, the United States Court of Appeals for the District of Columbia Circuit held that software transmitted on punched cards was nontaxable intangible property because the transaction was based on the information punched onto the cards, and not the cards themselves. See *District of Columbia v. Universal Computer Associates*, 465 F.2d 615, 617 (D.C. Cir. 1972); see also *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405, 408 (Tenn. 1976) (holding that information placed on punched cards is the product being purchased and, therefore, is to be regarded as intangible property not subject to tax).

155. See *South Cent. Bell Tel. Co. v. Barthelemy*, 643 So. 2d 1240, 1245 (La. 1984); see also *Comptroller of the Treasury v. Equitable Trust Co.*, 464 A.2d 248, 261 (Md. 1983) (analogizing software packaged on a disk to music sold on a record to find the former taxable); *Hasbro Indus., Inc. v. Norberg*, 487 A.2d 124, 126-27 (R.I. 1985) (holding that the service content of a prepackaged program was only part of the transaction and could be included in the sale price as part of the tangible property for tax purposes); *Citizens and S. Sys., Inc. v. South Carolina Tax Comm'n*, 311 S.E.2d 717, 719 (S.C. 1984) (holding that the program was transferred in a form that could be "seen, weighed, measured, felt, and touched was therefore tangible personal property" and subject to tax).

156. See Grierson, *supra* note 150, at 616-17. The case for applying a sales tax to services typically has included the following arguments: first, as the national economy continues to grow most in the service sector, such a tax would expand the state's tax base. See Morse, *supra* note 153, at 1131 (noting as an illustration a 15% percent decline—from 67% percent to 52% percent—in the gross domestic product derived from the sale of goods). The Internet's potential to deliver services would appear to further this shift. See Grierson, *supra* note 150, at 616 (stating that the "revenue-producing potential of an expanding information services industry is one of the primary reasons for supporting the [sales] tax [on services]").

Second, to buttress the argument that it is fallacious to tax the consumption of goods and not the consumption of services, some commentators point to a specific notion that the "sales tax is rooted in consumption." See Morse, *supra* note 153, at 1131. Obviously, taxing goods and not services presents a "highly arbitrary" bias, in which consumers of services are favored over consumers of goods by giving service consumers a lower tax burden in satisfying their needs and wants. See *id.* (quoting JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, II *STATE TAXATION* ¶ 12.05, at 12-17 (2d ed. 1992)). This discrimination is illogical, scholars argue, because "services are 'an integral part of any good' . . . and, in the case of consumers, 'both [goods and services] satisfy personal wants.'" *Id.*

157. See Grierson, *supra* note 150, at 609-12. ISDN technology permits a user to send and receive data while maintaining a conversation on the telephone. See *id.* at 612. All transmissions are digitized and are transferred over a normal telephone line. See *id.* As its

panies that have the technology to transfer data through these media will, absent legislative or administrative action, be able to avoid the nexus that taxing states can use to tax revenue.¹⁵⁸

Professors Due and Mikesell argue that taxing all tangible property while not taxing all intangible services is regressive, burdening lower income families disproportionately because of their spending patterns.¹⁵⁹ The regressivity lies in the notion that individuals and families bear the burden of a consumption-based tax because each group spends a large proportion of its income on consumable, tangible property, and not intangible services.¹⁶⁰ At the same time, people in higher income brackets spend proportionately more money on intangible services, thereby avoiding the sales tax.¹⁶¹

price drops, the use of such technology is becoming more widespread. *See id.*

Future technology also will enable a user to send and receive information by direct satellite. *See id.* The implication of such technology is that it will allow on-line merchants to avoid land-based telecommunications equipment entirely, thereby avoiding the physical presence requirement to create a nexus under the Commerce Clause. *See id.* at 612-13.

158. *See id.* at 617. *But see* *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C. 1993) (finding jurisdiction where a foreign corporation derived income from the use of intangible property in the taxing state, despite the total absence of a physical presence within the state).

In *Geoffrey*, Toys R Us had granted *Geoffrey, Inc.*, one of its wholly owned subsidiaries and ownership of several trademarks and trade names. *See id.* at 15. *Geoffrey* entered into a licensing agreement in which it allowed its parent, Toys R Us, to use the "Toys R Us" trade name in South Carolina and forty-four other states. *See id.* Toys R Us paid royalties to *Geoffrey* for the use of its trademarks in South Carolina. *See id.* The State charged *Geoffrey* with a responsibility to pay South Carolina income tax on the royalties received from Toys R Us. *See id.*

159. *See* JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 91 (2d ed. 1994); *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 156, ¶ 12.05, 12-16 (arguing that a tax on goods but not on services is unjustified and runs counter to economic theory).

160. *See* DUE & MIKESSELL, *supra* note 159, at 91; Grierson, *supra* note 150, at 619.

161. *See* DUE & MIKESSELL, *supra* note 159, at 91; Grierson, *supra* note 150, at 619. Although Due and Mikesell argue that including services in the tax base makes the sales tax less regressive, they note that this result may well depend on the scope of services being taxed. *See* DUE & MIKESSELL, *supra* note 159, at 91 (suggesting that failure to tax all services would not eliminate the regressivity, or even ameliorate it effectively). For instance, a recent survey suggests that Internet users tend to be individuals in higher income brackets; the survey "found that the average household income of on-line users was \$48,200 . . . [rather than] the general population's \$44,400 average." Thomas E. Weber, *Who Uses the Internet?*, WALL ST. J., Dec. 9, 1996, at R6 (citing a Cybercitizen survey by Yankelovich Partners). This figure, however, was significantly lower than the average income for on-line users a year earlier: \$58,100. *See id.* Combined with the increasing availability of personal computers and Internet access at low prices, the decline in on-line users' average incomes suggests the regressivity problem may abate somewhat as lower income families gain access to intangible services. *See* Morse, *supra* note 153, at 1131-32. As Professor Morse suggests, however, a degree of regressivity likely will continue; a difference in demographics between Internet users and Internet purchasers indicates a lack

As an alternative to the current paradigm, Professors Due and Mike-sell suggest the possibility of a comprehensive sales tax on services.¹⁶² Such a tax would reduce the regressivity of the current system and provide the states with much sought-after revenue.¹⁶³ In addition, it would eliminate the perceived discrimination in the treatment between sales of services and sales of goods.¹⁶⁴ Lastly, the tax would ameliorate existing complications associated with transactions involving both services and consumables, where the tangible property portions of the transaction currently are subject to tax and the intangible service portions are exempt.¹⁶⁵

Although not approaching such a comprehensive tax, and despite arguments advanced by those such as Due and Mikesell, several states currently tax information services to varying degrees.¹⁶⁶ For example, California taxes information services only in very limited circumstances.¹⁶⁷ Indeed, its implementing regulation does not even mention information services; however, the State levies a tax whenever information is converted into a tangible form, such as a computer tape or diskette.¹⁶⁸ California courts attempt to discern whether the "true object" of the transaction is to transfer tangible property, which is taxable, or to perform an intangible service, which is non-taxable.¹⁶⁹

of correlation between the number of people using the Internet as a tool of commerce and the number using it solely for information. *See id.* at 1132.

Finally, taxing services at the same level as goods would eliminate the need to distinguish between the two. *See DUE & MIKESELL, supra* note 159, at 91. As Professor Morse points out, services are involved in the production or sale of nearly any product; at the same time, products sold (such as a mailing list) frequently include a service component. *See Morse, supra* note 153, at 1132.

162. *See DUE & MIKESELL, supra* note 159, at 90-92.

163. *See Grierson, supra* note 150, at 618; *supra* note 161 (discussing the regressivity argument).

164. *See Grierson, supra* note 150, at 618; *supra* note 161 (discussing the regressivity argument).

165. *See Grierson, supra* note 150, at 618. The distinction between services and consumable property has been handled by the courts using a "true object test." *See id.* at 619. This test involves making inquiries into the minds of both seller and purchaser to discern whether they intended to conduct a transaction for a service or a commodity. *See id.*

166. *See id.* at 620; *infra* notes 167-171 and accompanying text (discussing California and Ohio's treatment of a tax on information services).

167. *See Grierson, supra* note 150, at 621.

168. *See id.* at 621-22. In California, a taxable event occurs when a vendor charges a customer for "producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property." *Id.* (citing CAL. CODE REGS. tit. 18, § 1502 (c)(2) (1995)).

169. *See id.* at 622. A sample application of the true object test is the production of a mailing list. *See id.* While there is no doubt that there is a service component in the production of the list, the primary object of the transaction is the list itself and it is this list

Ohio is one of a few states that includes "electronic information services" as a vehicle by which taxable sales can be consummated,¹⁷⁰ defining "[e]lectronic information services" to include services that "provid[e] access to computer equipment by means of telecommunications equipment."¹⁷¹ States, such as California and Ohio, that attempt to tax out-of-state providers of information services must comport with the Due Process and Commerce Clause requirements established in the *Quill* line of cases.¹⁷² The question for the states therefore, is how to satisfy those tests in the electronic realm.

2. Agency/Representational Nexus Theory

In *Quill*, the Supreme Court took the unprecedented step of splitting Due Process and Commerce Clause analysis into two distinct questions.¹⁷³ In so doing, the Court held that physical presence was no longer necessary to satisfy due process concerns, but remained a requirement under the Commerce Clause.¹⁷⁴ In the wake of *Quill*, courts are left with the task of establishing jurisdiction to tax vendors whose only contact with the taxing state is the Internet.¹⁷⁵

One method of obtaining jurisdiction is to find an agent or representative of the out-of-state vendor within the taxing state who makes the out-of-state vendor's sales possible.¹⁷⁶ In the context of Internet sales, the most obvious conduit to the out-of-state vendor would seem to be his Internet Service Provider ("ISP").¹⁷⁷ Indeed, the Sixth Circuit in *Patterson* found that an agency relationship may exist between a private vendor and an ISP.¹⁷⁸ This conclusion seems flawed however, because the

that is taxable as tangible personal property. *See id.*

170. *See id.* at 622-23. The other jurisdictions that have statutes specifically mentioning "information services" are the District of Columbia and Texas. *See id.* at 622 n.88.

171. OHIO REV. CODE ANN. § 5739.01(Y)(1)(c) (Anderson 1996 & Supp. 1997).

172. *See generally* Grierson, *supra* note 150, at 644-48 (analyzing the taxation of information services in light of the Supreme Court's jurisprudence in the Commerce Clause and Due Process Clause arenas, particularly the *Quill* line of cases).

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

174. *See id.* at 311, 313.

175. *See Saba Ashraf, Virtual Taxation: State Taxation of Internet and On-Line Sales*, 24 FLA. ST. U. L. REV. 605, 616 (1997).

176. *See id.* at 620.

177. *See id.* at 622. Electronic "storefronts" may be placed directly on the Internet or may be contracted through a commercial ISP such as CompuServe or America Online. *See id.* at 607. These ISPs then contract with local telecommunications companies to carry their signal; supporters of this theory argue that this contract establishes the necessary contact between the ISP and the taxing state. *See id.* at 622.

178. *See CompuServe, Inc. v. Patterson*, 89 F.3d 1257, 1263-66 (6th Cir. 1996). The Sixth Circuit concluded that

relationship between an ISP and a vendor is no different from the relationship between a mail-order vendor and the United States Postal Service.¹⁷⁹ Far from an agency relationship, the ISP acts merely as a common carrier who enters into agreements with vendors to carry their advertisements.¹⁸⁰

A second avenue for finding an agency relationship may be through the telecommunications provider.¹⁸¹ It is clear that an out-of-state Internet vendor's purpose would be frustrated without a telecommunications infrastructure through which to transmit his advertisement.¹⁸² Unfortunately, the same argument that defeats the attempt to find an agency relationship between an ISP and a vendor also applies in this context; the telecommunications provider is merely a common carrier.¹⁸³ Telecommunications providers, like ISPs, do nothing more than make it possible for an electrical impulse to travel along their wires.¹⁸⁴ An in-state telecommunications provider does nothing to actively solicit business for the vendor within the state; by acting as a conduit, it is merely pursuing its own business, almost in the role of an independent contractor, rather than acting as an agent of the out-of-state vendor.¹⁸⁵

As a third possibility, courts may look to the relationship between the vendor and the consumer's in-state credit card system to establish juris-

Patterson ha[d] knowingly made an effort—and, in fact, purposefully contracted—to market a product in other states, with Ohio-based CompuServe operating, in effect, as his distribution center. Thus, it [was] reasonable to subject Patterson to suit in Ohio, the state which is home to the computer network service he chose to employ.

Id. It should be noted that the case did not include a tax problem, but centered around an Ohio court's ability to assert in personam jurisdiction over Patterson. *See id.* at 1259-60.

179. *See Ashraf, supra* note 175, at 622-23.

180. *See id.*

181. *See Grierson, supra* note 150, at 651.

182. *See id.* at 652. Note, however, that when a vendor uses a direct broadcast satellite, the product is beamed directly into the consumer's home (via his own satellite dish) and does not come into contact with any telecommunications infrastructure. *See id.* at 655. Thus, the physical presence does not seem to exist in that instance and the theory loses some of its validity. *See id.*

183. *See Ashraf, supra* note 175, at 625 (classifying on-line service providers as common carriers).

184. *See Grierson, supra* note 150, at 652 (stating that the telecommunications provider acts as the in-state distributor of the out-of-state vendor).

185. *See id.*; *see also* Arthur Rosen & Alysse Grossman, *Coping With Electronic Commerce Today*, 14 STATE TAX NOTES 463, 470 (1998). In the context of finding an agency relationship between the ISP and the vendor, or the telecommunications provider and the vendor, it also should be noted that 1) the vendor does not exercise any control over the service provider; 2) the service provider neither holds itself out to be an agent of the vendor, nor can it bind the vendor in contract; and 3) there is no fiduciary relationship between the service provider and the vendor. *See id.*

diction.¹⁸⁶ This argument is flawed, however, and is susceptible to the same arguments that prevent telecommunications and ISP providers from serving as agents, because in-state credit card systems neither solicit customer sales, nor provide customer services;¹⁸⁷ and courts have held that both are indicative of an agency relationship.¹⁸⁸

3. *Changing the Nexus Standard*

As an alternative to the agency theory, some have argued for a change in the definition of physical presence.¹⁸⁹ One suggestion is that the physical presence requirement be replaced by an "economic presence" requirement.¹⁹⁰ Under that standard, a vendor who sells wares on the Internet has an intermediate "informational presence" when a consumer first accesses the vendor's Web-page; but this presence would not satisfy the Commerce Clause's nexus requirement.¹⁹¹ Once the first consumer purchases the vendor's product through the Internet however, the safe harbor of informational presence would be replaced with an economic presence that would survive constitutional scrutiny; at that point, the vendor is deemed to have voluntarily entered the state's taxing jurisdiction in an attempt to do business.¹⁹² The purchase by an in-state resident connects the out-of-state vendor to the taxing state.

A second alternative argues for the creation of a "virtual" presence.¹⁹³ Under this analysis, a vendor lacking a purely tangible, physical presence would have a virtual presence in any jurisdiction where a consumer had access to its Web-site.¹⁹⁴ If this argument was accepted, however, any vendor doing business on the Internet would have a virtual presence in any state where a computer with Internet capability existed.¹⁹⁵ The obvious parallel to the mail-order industry would be the creation of a presence in any state where a catalog came to rest on a coffee table; a sce-

186. See Ashraf, *supra* note 175, at 626.

187. See *id.*

188. Cf., e.g., *Tyler Pipe Indus., Inc., v. Washington State Dep't of Revenue*, 483 U.S. 232, 249-50 (1987) (analyzing in-state customer service as sufficient to satisfy nexus requirements).

189. See Mitch Betts, *Internet Renews Tax Battles: Murky On-Line Tax Jurisdictions Cause Trouble*, COMPUTERWORLD, June 19, 1995, at 64 (describing criticisms of the Supreme Court's continued adherence to the physical presence requirement in an age of commerce that occurs via "mail, fax, and modem").

190. See Forte, *supra* note 70, at 225.

191. See *id.*

192. See *id.*

193. See Ashraf, *supra* note 175, at 628.

194. See *id.*

195. See *id.*

nario already ruled unconstitutional in both *Bellas Hess* and *Quill*, where the Court held that the Commerce Clause required more than such an innocuous presence.¹⁹⁶

B. Hold Up! Wait a Minute! The Congressional Response

If, as it appears, courts will continue to allow states like California and Ohio to tax Internet transactions, some have suggested that the Federal Government should intercede, not only to ameliorate the vendor's newly created administrative burden, but also to grant express state authority in this area.¹⁹⁷ Congress has explicit authority to regulate interstate commerce under Article I of the Constitution, and because it is impractical to legislate changes to the notion of due process, any congressional movement to overcome the constitutional hurdles to states taxing out-of-state vendors most likely will be through an exercise of its Commerce Clause power.¹⁹⁸

Congress could, therefore, authorize states to impose tax collection responsibilities on out-of-state vendors.¹⁹⁹ Congress has attempted to take such action in the past with respect to mail-order vendors, but with little success.²⁰⁰ In the 105th Congress, Senator Ron Wyden (D-OR) and Rep-

196. See *id.*; see also *Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (1992) (refusing to overrule *Bellas Hess's* bright-line rule); *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 758 (1967) (“declin[ing] to obliterate” the distinction between those mail-order sellers who hold property in the state, and those whose only contact with the taxing state is through the mail).

197. See Forte, *supra* note 70, at 214-16.

198. See *id.* at 215.

199. See *id.*

200. See *id.*; see also, e.g., H.R. 2230, 101st Cong. (1989) (granting states the power to require collection of sales taxes by out-of-state vendors if the vendor engages in regular or systematic solicitation of business in the state and has annual sales exceeding either \$12.5 million in the United States or \$500,000 in the taxing state).

Congress has enacted legislation determining, albeit in very limited circumstances, when states can impose a tax on a nonresident corporate entity. See 15 U.S.C. § 381 (1994) (originally enacted as Pub. L. No. 86-272, §101(a)(1), 73 Stat. 555 (1959)). In fact, under the legislation, states are prohibited only from imposing an *income* tax on an entity that solicits orders for tangible goods to be approved and shipped from outside the taxing state. See *id.* Importantly, it should be noted that Public Law 86-272 does not protect a corporation from state imposition of a sales or use tax; a state can tax a vendor so long as it can assert jurisdiction without offending Due Process Clause or Commerce Clause protections. See Rosen & Grossman, *supra* note 185, at 467. Congress's general failure to pass adequate legislation has been attributed to the power of the mail-order lobby. See Pamela M. Krill, Note, *Quill Corp. v. North Dakota: Tax Nexus Under the Due Process and Commerce Clauses No Longer the Same*, 1993 WIS. L. REV. 1405, 1429 & n.152 (1993) (discussing the national campaign to prevent federal legislation waged by the Direct Marketing Association, the industry's largest trade association). The absence of such an element in the nascent group of Internet vendors could make passage of Internet-specific legisla-

representative Christopher Cox (R-CA) introduced companion bills, the Internet Tax Freedom Act ("ITFA"), addressing state taxation of Internet transactions.²⁰¹ The primary purpose of the legislation is to provide for a period of careful study in an atmosphere free from distracting legislative movement by the states.²⁰²

As enacted, House Bill 4328 (formerly House Bill 4105) imposes a three-year moratorium, retroactive to October 1, 1998, that prevents states and localities from assessing or collecting taxes on "Internet access."²⁰³ Importantly, the bill does not prohibit states from taxing the sale of goods so long as those taxes are applied similarly to mail-order and retail transactions.²⁰⁴ In addition, states that have enacted taxes on Internet access prior to October 1, 1998 will be exempt from the moratorium if the tax was authorized by statute and either (1) an Internet access provider had reason to know that the existing tax statute was interpreted so as to include Internet access; or (2) the state or locality "generally collected such tax on charges for Internet access."²⁰⁵

Section 1102 of House Bill 4328 establishes an entity known as the Advisory Commission on Electronic Commerce ("Commission").²⁰⁶ The Commission is designed to bring together a mix of federal, state, and local government officials, as well as representatives from taxpayer and business groups, to devise a framework for taxing Internet commerce.²⁰⁷

tion easier. See Ashraf, *supra* note 175, at 619.

201. See S. 442, 105th Cong. (1997); H.R. 1054, 105th Cong. (1997). H.R. 4105 passed the House of Representatives by voice vote on June 23, 1998. See 144 CONG. REC. H5037 (daily ed. June 23, 1998). The Senate passed its version of the ITFA, Senate Bill 442 by a 96-2 vote on October 8, 1998. See 144 CONG. REC. S11858 (daily ed. Oct. 8, 1998). President Clinton signed the ITFA into law on October 21, 1998. See *supra* note 21.

202. See 143 CONG. REC. S2282-83 (daily ed. Mar. 13, 1997) (statement of Sen. Wyden). As Senator Wyden stated: "The purpose of the bill I am introducing today . . . is to allow everyone to step back and take a deep breath. It says let's suspend this crazy tax quilting bee so that everyone can come together in a rational way to figure out what policy makes the most sense." *Id.* at S2283.

203. Internet Tax Freedom Act, H.R. 4328, 105th Cong. § 1101(a) (1998). "Internet access" is defined in the bill as a "service that enables users to access content, information, electronic mail, or other services offered over the Internet . . ." *Id.* § 1101(e)(3)(D). In addition, the bill expressly prohibits states from imposing taxes that discriminate based on the mode of transfer used; that is, electronic commerce versus a more traditional means of commerce. See *id.* §§ 1101(a)(2); 1104(2) (defining "discriminatory tax").

204. See *supra* note 203 (describing the bill's moratorium as extending only to those taxes that are applied unequally to business conducted over the Internet versus more traditional means).

205. H.R. 4328, §§ 1101(b), (d)(1)-(2). Unlike the House passed version, see H.R. 4105, 105th Cong., § 151(b)(1) (1998), House Bill 4328 extends the grandfather clause to local taxing authorities. See H.R. 4328, § 1101(b).

206. See H.R. 4328, § 1102(a).

207. See *id.* § 1102(b) (listing membership guidelines for Commission).

As currently written, the bill imparts fairly specific goals and guidelines under which the Commission is to operate.²⁰⁸ In addition, according to the provisions of House Bill 4328, the work of the Commission is to culminate in a series of legislative recommendations to Congress.²⁰⁹ The stated duties of the Commission are, *inter alia*, to examine model legislation that would propose a uniform definition of electronic commerce and to simplify interstate administration of sales and use taxes.²¹⁰ The Commission also is directed to move toward defining and proposing a new nexus standard for electronic commerce.²¹¹

Except for these vague recommendations, the ITFA as enacted does not contain many valuable provisions that were part of the bill as it passed the House as House Bill 4105.²¹² For example, House Bill 4105 directed the Commission to propose legislation establishing a method of interstate dispute resolution regarding multiple taxation and make permanent the ITFA's moratorium on the taxation of Internet access services.²¹³ In addition, it directed the Commission to craft legislation providing that any state not adopting a single sales and use tax rate, and not putting into place simplified procedures within four years after the ITFA's enactment, would be deemed to have an effective sales and use tax rate of zero percent.²¹⁴ Finally, House Bill 4105 required an expedited review of Commission recommendations by the President and Congress.²¹⁵

208. *See id.* § 1102(g). The bill directs the Commission to work in conjunction with the National Tax Association's Communications and Electronic Commerce Tax Project. *See id.* § 1102(h) (declaring that in no way should the work of the Commission interfere with the work of the Tax Project); *see also infra* notes 219, 235, 248, 250 (describing in detail the work of the Tax Project).

209. *See H.R. 4328* § 1103. These proposals are to be made within eighteen months after the ITFA is enacted. *See id.*

210. *See id.* § 1102(g)(2)(D)(i), (g)(2)(F).

211. *Cf. id.* § 1102(g)(2)(E). House Bill 4105, the ITFA passed by the House, contained language that was more specific to the issue of nexus; such language was not included in the final version of the bill. *See H.R. 4105*, 105th Cong. §§ 152(g)(10), 153(b)(1) (1998).

212. Among the legislative recommendations by the Commission directed by House Bill 4105 was a proposal that conditioned the future ability of states to impose sales and use taxes on electronic commerce on the adoption of a statewide single tax rate, and simple administrative procedures. *See H.R. 4105*, § 153(b)(2).

213. *See id.* § 153(b)(5)-(6).

214. *See id.* § 153(b)(3).

215. *See id.* §§ 153(c), 154(a). These provisions mandated that the President forward to Congress, within forty-five days of receipt, those Commission recommendations he found "necessary or expedient." *Id.* § 153(c). In addition, those congressional committees with jurisdiction must consider those forwarded recommendations within ninety days of receipt. *See id.* § 154(a). None of these provisions are in the ITFA as enacted.

C. Executive Response: Neutrality Theory

As Congress places a moratorium on new state Internet taxes, the Treasury Department also has announced a policy of neutrality toward Internet commerce.²¹⁶ Under this policy, no *new* taxes on Internet commerce would be imposed; instead, the income earned through electronic means would be taxed in the same manner as that derived from more conventional means.²¹⁷ After the release of its report in November 1996, however, officials from the Treasury Department joined forces with the Tax Project—an initiative of industry and government leaders designed to forge a compromise²¹⁸ and “operating under the auspices of the National Tax Association (NTA)”²¹⁹—to “develop[] a national approach . . . to questions regarding state taxation of electronic commerce.”²¹⁹

216. See Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* at iii (visited Nov. 3, 1998) <ftp://ftp.fedworld.gov/pub/tel/internet.txt>. The reported purpose of this report was to provide an introduction to federal tax policy and administration issues presented by the growth in Internet commerce, and to foment discussion. See *id.* at i.

217. See *id.* at iii.

218. See Amy Hamilton, *Internet Tax Talks Come Home to Treasury*, 13 STATE TAX NOTES 1406, 1406 (1997) (stating that the Treasury Department was the first federal member to join the NTA in its efforts). The Federal Government became involved with the Tax Project in the summer of 1997 after Ira Magaziner, President Clinton's senior policy adviser, concluded that the United States would lead the global economy in its approach to the subject of electronic commerce. See *id.*

219. *Id.* Bruce Cohen, an attorney with the Treasury Department, recently participated in discussions with the Tax Project concerning preliminary proposals to address taxation of electronic commerce. See *id.* Cohen suggested that initiatives such as the Tax Project demonstrate precisely the national dialogue the Department called for in its 1996 report. See *id.*

As an arm of the Federal Government, the Treasury Department cannot concern itself merely with subnational taxation of electronic commerce; the global nature of electronic commerce commands the Treasury Department's attention both at home and abroad. See *id.* at 1407 (relating the statement of Bruce Cohen, the Treasury Department's representative to the Tax Project, that “the international tax issues are not going to be resolved [easily]”). European ministers, industry leaders, and consumers recently met in Bonn, Germany to begin development of solutions to existing problems of electronic commerce. See *id.* Although members of the European Community have not commented directly on what is perhaps the most controversial idea put forth in Treasury's 1996 report—a move away from source-based taxation toward a residence-based system—Australia has not been similarly silent. See *id.*

Australia's status as a net importer of capital distinguishes it from other, more export-oriented nations in the discussion of global taxation of Internet commerce. See *id.* An Australian international tax policy statement expressed concern regarding the United States position to move to a residence-based regime. See *id.* The Australian report concluded that

‘[S]ource and residency principles are equally at risk’ because they often turn on matters of form that ‘may prove difficult to establish or test or may be readily manipulated in an electronic commerce environment where business activity is

III. THE FUTURE OF INTERNET TAXATION: RECOMMENDATIONS TO BRING STATE TAXATION INTO THE 21ST CENTURY

Under the ITFA, the Commission is charged with the responsibility of recommending legislative proposals to Congress.²²⁰ Although the ITFA as enacted lacks the specific House language that would have required that the Commission address issues of nexus and the possibility of a streamlined, uniform sales and use tax structure,²²¹ it is useful to examine those issues and possible solutions in some detail.

A. Adoption of a New Standard for Internet Taxation

Under the Supreme Court's bifurcated analysis in *Quill*, a state tax must satisfy separate Commerce Clause and due process requirements.²²² With the emergence of Internet technology however, the nexus issue poses a difficult problem for state policy makers.²²³ Although at least one commentator advocates dissolution of the *Bellas Hess* physical presence requirement,²²⁴ the physical presence requirement set forth in *Bellas Hess* and affirmed, so far as the Commerce Clause is concerned, in *Quill*,²²⁵

highly flexible.' . . . [N]either source nor residence alone is satisfactory as a basis of income tax liability for Internet transactions.

Id.

220. See H.R. 4328, 105th Cong. § 1103 (1998).

221. See H.R. 4105, 105th Cong. §§ 153(b)(1)-(2), (b)(4) (1998).

222. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992). In adopting a bifurcated analysis the Court noted

'Due Process' and '[C]ommerce [C]ause' conceptions are not always sharply separable in dealing with these problems To some extent they overlap. If there is a want of due process to sustain the tax, by that fact alone any burden the tax imposes on the commerce among the states becomes 'undue.' But, though overlapping, the two conceptions are not identical. There may be more than sufficient factual connections, with economic and legal effects, between the transaction and the taxing state to sustain the tax as against due process objections. Yet it may fall because of its burdening effect upon the commerce. And, although the two notions cannot always be separated, clarity of consideration and of decision would be promoted if the two issues are approached, where they are presented, at least tentatively as if they were separate and distinct, not intermingled ones

Id. at 305-06 (internal citations omitted).

223. See Forte, *supra* note 70, at 226 (concluding that the "physical presence requirement is outdated and inequitable" and must "be updated to reflect the realities of modern commerce").

224. See Paul J. Hartman, *Collection of the Use Tax on Out-of-State Mail-Order Sales*, 39 VAND. L. REV. 993, 1008 (1986). Hartman characterizes the Court's decision in *Bellas Hess* as a "roadblock to use tax collection[]" and argues that the "Court "could—and should—relegate the *Bellas Hess* decision to the dustbin of unconstitutional oblivion." *Id.*

225. See *Quill*, 504 U.S. at 318-19. Justice Stevens, writing for the majority, stated that although in our cases subsequent to *Bellas Hess* and concerning other types of

remains a constitutional requirement for state taxation of out-of-state vendors.²²⁶ To satisfy the nexus requirement, as modified by the Court in *Quill*, the out-of-state vendor must purposefully direct activities at in-state residents and there must be some rational connection between the vendor's activity and the benefit provided by the taxing state.²²⁷

The question then, is what the nature of that nexus should be. The "economic presence" theory provides the best characterization of the current substantial nexus standard.²²⁸ Under a due process analysis, the "economic presence" standard follows much of the *Quill* Court's reasoning; a vendor would be required to collect taxes if his activities were purposefully directed toward the state's market and were such that he could reasonably anticipate being taxed there.²²⁹ The economic presence standard also takes into consideration that, although a business may not have a physical presence in the taxing state, it nonetheless may benefit from state services that provide its consumers with social and economic stability—in essence, state preservation of the vendor's market.²³⁰

With respect to Commerce Clause analysis, a modified "economic presence" standard keeps pace with emerging cyber-commerce.²³¹ The *Quill* Court made clear that the Commerce Clause requires more than a "sufficient connection" between the vendor and the taxing state; it requires the vendor to have some physical presence within the taxing state before that state may subject it to jurisdiction.²³² Due to the nature of the Internet industry, however, it is impractical to require a physical presence in the taxing state to satisfy Commerce Clause restrictions.²³³ Al-

taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of stare decisis indicate that the *Bellas Hess* rule remains good law.

Id. at 317.

226. *See id.* at 317-19.

227. *See Edson, supra* note 12, at 922.

228. *See id.* at 947 (arguing that the nature of the changing electronic marketplace demands a standard based less on the physical presence within the taxing state and more on the nature of the vendor's activities in that state).

229. *See id.* at 940.

230. *See id.*

231. *See id.* at 947.

232. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (1992) (adopting the bright-line physical presence requirement put forth in *Bellas Hess*); *see also Edson, supra* note 12, at 942.

233. *See Ashraf, supra* note 175, at 628 (stating that the Supreme Court that decided both *Bellas Hess* and *Quill* probably did not foresee the possibility, or, if it did, the scope of future on-line sales). Ashraf suggests that one apparently simple solution would be to impose a "virtual presence" standard in which a vendor would have a physical presence in

though the *Quill* Court suggested that a “substantial nexus” was the appropriate constitutional standard, it again failed to elucidate what would constitute such a nexus, beyond physical presence.²³⁴ A “substantial economic presence” standard would require an examination of the frequency, quality, and systematic nature of the vendor’s contact with the taxing state and, in so doing, would ensure that only those vendors whose contact with the forum state approached that of a traditional out-of-state retailer would be subject to tax.²³⁵

B. Proposals for Substantive Federal Action

If states are able to impose the duty to collect taxes on Internet ven-

any state in which a consumer accessed the site. *See id.* Ashraf points out the problem inherent in such a solution, however, is that “[b]y 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.” *Id.*

234. *See Edson, supra* note 12, at 942.

235. *See id.* at 943-46 (describing the requirements of a would-be “substantial economic presence” standard). The Tax Project recently reported its “tentative and preliminary thinking on the direction that a statute addressed to taxation of electronic commerce might take.” *NTA Report, supra* note 2, at 1255. Perhaps the greatest departure the Tax Project takes from the established physical presence paradigm is in establishing nexus. *See id.* at 1258. Under the proposal, nexus is established in the state of the consumer’s billing address. *See id.* The vendor must make a good faith effort to determine the correct billing address and, if it can be determined, to collect and remit a sales or use tax to that state. *See id.* at 1259. As long as the vendor makes a good faith attempt at determining the proper billing address, he could not be held liable if the consumer was deliberately falsifying information. *See id.* The Tax Project asserts that such a novel approach is necessary because many Internet vendors may not know the location of the person to whom they are selling goods or services. *See id.* at 1258. The Tax Project realizes that Congress might have to remove any existing impediment the Dormant Commerce Clause presents to the approach, and also notes that the Due Process Clause may ultimately bar such a standard. *See id.*

The most controversial aspect of the nexus standard supported by the Tax Project occurs in the event the vendor cannot accurately determine the consumer’s proper billing address. *See id.* at 1259-60. One alternative, termed the “Throwback Rule,” obligates the vendor to assess the appropriate sales tax and remit it to his own state. *See id.* at 1259. In another alternative, termed the “Throwaround Rule,” the vendor would not send sales taxes back to the state in which his principal place of business is located, but rather, would “assign[] it to all of the states in which the vendor makes taxable sales of electronically transmitted information or services, in the same proportion as the taxpayer’s sales receipts from electronic commerce were distributed among the states during the preceding calendar year.” *Id.* at 1260. The Tax Project acknowledges the novelty of the “Throwaround Rule,” which could be criticized on the ground that it assumes that all sales are taxed, rather than taxable, but argues that it results in a more equitable distribution of revenue than the throwback rule, which only sends the revenue to one state. *See id.* The proposal also calls for enhanced enforcement of existing use tax laws by the creation of a clearinghouse to which vendors who make sales to states in which they do not have a physical presence would be required to report sales. *See id.* at 1261.

dors, particularly use taxes, the administrative burden placed on those vendors would be considerable.²³⁶ The vendor would have to comply with the differing tax codes in each state where it conducts business.²³⁷ After determining whether it is subject to the responsibility, the vendor would have to administer, collect, and then remit the appropriate amount of tax to the state.²³⁸

The *Quill* Court considered the role of Congress in fashioning an answer to the questions left by *Bellas Hess*'s bright-line test.²³⁹ In deciding that it was not proper to overrule *Bellas Hess*, the Court found that the "ultimate power to resolve" the dispute over due process concerns laid with the Congress.²⁴⁰ Calling upon its power to regulate interstate commerce granted by the Constitution, Congress can fashion a solution if it so chooses.²⁴¹ The moratorium recently enacted may not be the right answer; by grandfathering those states that already have Internet taxes on their books, the moratorium discriminates against states without such laws by preventing them from realizing the potential revenue from Internet taxes.²⁴² Enacting a moratorium provides Congress with an opportunity and a vehicle by which to declare its desire to address the problem and to satisfy its concomitant need for time to figure out the best way to do so.²⁴³ By definition, the moratorium will not in and of itself provide an

236. See Blum, *supra* note 7, at 496 (describing the adverse effects on a company that had to comply with tax laws in a state where it did not have a physical presence).

237. See *id.* at 495-96 & n.8; see also *Quill*, 504 U.S. at 313 n.6 (noting that there are over 6,000 state and local taxing jurisdictions).

238. See Blum, *supra* note 7, at 496.

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

240. See *id.* The Court noted that Congress had considered, but not enacted, legislation to overrule *Bellas Hess*. See *id.* Positing that Congress's failure to act on this legislation was perhaps based on its respect for the Court's holding in *Bellas Hess*—that states were prohibited from imposing such taxes—the Court definitively removed that notion from Congress's consideration. See *id.* In the words of Justice Stevens, writing for the court, "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." *Id.* In fact, Justice Stevens wrote, even if the Court had decided that *Bellas Hess* was inconsistent with Commerce Clause jurisprudence, it might not overrule it, but instead, would allow Congress to exercise its Commerce Clause power. See *id.*

241. See *id.* at 318-19. Justice Stevens noted that Congress has the power to protect interstate commerce from undue burden. See *id.* Rather than legislate judicially in this situation, Stevens supposed it would be "the better part of both wisdom and valor . . . to respect the judgment" of Congress and the Executive branch. See *id.* at 319.

242. Cf. Internet Tax Freedom Act, H.R. 4328, 105th Cong. § 1101(b) (1998).

243. See 143 CONG. REC. S2283 (daily ed. Mar. 13, 1997) (statement of Sen. Wyden) (describing the moratorium and requiring submission of policy recommendations to Congress).

answer; it merely will buy Congress time.²⁴⁴

Legislation introduced in years past to address the nexus problem in the mail-order industry failed in part because of a powerful, industry sponsored lobby.²⁴⁵ Conditions now may be favorable for the enactment of similar language with respect to Internet commerce before a powerful lobby can organize itself and quash congressional effort.²⁴⁶ Certainly Congress is faced with a policy decision: to remain on the sidelines and allow the states to work the matter out,²⁴⁷ through the ITFA, to initiate a

244. See *id.* Industry and state officials have been quick to fault the ITFA for undermining a state tax base in an era of scarce state revenue resources. See Doug Sheppard, *Proposed Internet Act a Natural for Debate at Electronic Commerce Seminar*, 14 STATE TAX NOTES 455, 455 (1998). A conference held recently by the National Tax Association concluded with a debate over the Act's ramifications. See *id.* In one session, three out of four presenters spoke out against the Act, alleging that Congress would be prohibiting the states from taxing Internet commerce indefinitely. See *id.* Retailers argue that allowing states to tax them while exempting Internet vendors is harmful to their business; state and local governments, meanwhile, argue that Congress is taking away a necessary power in this era of shrinking tax bases. See *id.*; see also Tannenwald, *supra* note 17, at 357 (discussing the decline in tax base for state and local governments due to a decline in consumption and states' general unwillingness to increase taxes on corporations located within their individual borders).

Ronald Snell, Director of the Economic and Fiscal Division of the National Conference of State Legislatures noted that sales taxes, which are used mainly by the states to fund public education, are "shrinking as a portion of the gross national product." Sheppard, *supra*, at 455. Snell asserted that the Internet Tax Freedom Act would further erode already fragile tax bases. See *id.* Moreover, Snell refuted industry assertions that states are enacting new taxes on the Internet. See *id.* Instead, he said states merely are trying to enforce existing laws. See *id.*

245. See *supra* note 200 and accompanying text (describing the massive lobbying campaign on behalf of direct mailers to defeat similar legislation with respect to mail-order sales).

246. Cf. *supra* note 200 and accompanying text (describing the impact of the direct mail industry on congressional efforts to pass legislation); see also Harriet Hanlon, *MTC Examines Making (Tax) Money on the Internet*, 9 STATE TAX NOTES 408, 408 (1995) ("Because electronic sales are not an established industry as catalog sales are, the money and power are not yet behind the industry, forestalling change."). The similarity of sales and use tax issues among Internet vendors and mail-order merchants, however, may present an opportunity for the direct mailers to shepherd Internet vendors' efforts to defeat any legislation that would impose a new tax. See Forte, *supra* note 70, at 215-16.

247. See Carol Douglas, *State Taxes in '97: The Once and Future Internet*, 14 STATE TAX NOTES 25, 25 (1998) (evidencing a belief that state and industry officials can work together to fashion a solution that would not involve the Federal Government); Doug Sheppard, *National League of Cities Airs Concerns About Proposed Internet Act*, 14 STATE TAX NOTES 271, 272 (1998) [hereinafter Sheppard II] (quoting National League of Cities spokesman Randy Arndt, who stated that the efforts by state and local governments and industry leaders are being "sabotaged by preemptive legislation" such as the Internet Tax Freedom Act").

At the very least, industry and government officials are establishing the parameters of the ensuing debate, irrespective of Federal Government intrusion. See Sheppard, *supra* note 244, at 455-56 (reporting on a seminar where business and government officials dis-

“cooling off” period and require a commission to study the problem; or, having acknowledged the states’ right to tax the Internet, to get involved to develop a proper taxing regime.²⁴⁸

As an alternative to enacting a moratorium, Congress could have enacted legislation overruling *Bellas Hess* and requiring an out-of-state Internet vendor to collect a state’s use tax on sales delivered into the taxing state.²⁴⁹ In so doing, Congress would stop short of jeopardizing state sovereignty—states would be able to tax the Internet if they so chose—yet would still provide assurances to Internet vendors as to their legal obligations by establishing a de minimis exemption, or by mandating a uniform rate for all states.²⁵⁰

cussed the ITFA). Charles E. McLure, Jr., of Stanford University’s Hoover Institution, has suggested that the solution to Internet taxation lies in three basic principles: uniform definitions of what is to be taxed, establishment of an “economic presence” nexus standard, and elimination of sales and use tax liability on sales to businesses. *See id.* at 456. Matthew N. Murray, of the University of Tennessee, has outlined eight points to consider in approaching the problem: (a) “attentiveness in tax policy to the economic structure of the industry”; (b) “consumer response to taxes”; (c) “tax base and revenue stability”; (d) “changes on the ‘sources’ side of the budget (tax capacity and tax effort)”; (e) “changes on the ‘uses’ side of the budget”; (f) “uneven burdens borne by providers of similar services”; (g) “administration and compliance costs”; and (h) “incidence and efficiency efforts.” *Id.*

248. *See Douglas, supra* note 247, at 25. Indeed, in an attempt to solve the problem before the Federal Government intrudes, some states have been working with the direct marketing industry to reach a mutual agreement. *See id.* Douglas suggests that public outcry by direct-mail shoppers may have prevented such an agreement. *See id.*

The Tax Project has been working towards a resolution as well. *See id.* Despite the labors of these groups, Professor Richard D. Pomp, of the University of Connecticut Law school, suggests that there is little possibility that any agreement will defuse the legislation moving through Congress. *See id.* Pomp has stated, “[i]f such a bill passes, the states may be limited to damage-control efforts.” *Id.*

249. *See Hartman, supra* note 224, at 1015 (discussing similar legislation addressing taxation of mail-order sales). Professor Hartman recognizes the problem of attendant compliance costs associated with a law that places a collection and remittance burden on the out-of-state vendor. *See id.* Hartman, however, suggests several methods by which these compliance costs could be ameliorated. *See id.* at 1016. Congress could formulate a de minimis rule which would exempt vendors whose sales did not meet a certain threshold from tax collection responsibilities. *See id.* In the mail-order industry, Professor Hartman found, small firms constitute the greatest number of businesses, but large firms sell the most product; therefore, an exemption for small firms would have little effect on the amount of revenue collected. *See id.* The analogy may not be easily transferrable to the Internet industry, because the numbers Professor Hartman used were for mail-order firms—a de minimis exemption level of five million dollars would exempt 96% of mail-order firms, but the remaining 4% would account for 76% of mail-order revenue—and Internet vendors may not be similarly distributed. *See id.* In the alternative, Congress could address compliance burdens either by creating “a uniform combined state and local tax rate for each state,” or by permitting only the states to collect use taxes (thereby disallowing local use tax assessment). *Id.*

250. *See supra* note 249 and accompanying text. Focusing its efforts on the retail sales

As a second alternative, Congress could refrain from overruling *Bellas Hess*; instead, it could use its commerce power to impose a direct federal tax on interstate Internet sales at a uniform rate and then distribute the resulting revenues among the states.²⁵¹ An obvious advantage to this approach is its relative simplicity, because Internet vendors would not need to comply with the law of multiple state jurisdictions, but instead would need only to know the federal rate.²⁵² A federal tax, however, is the ultimate intrusion into what is perceived by antitax legislators to be a state and local problem, and its feasibility in the current political climate is suspect at best.²⁵³

A third and final alternative, and one that has little intrusive effect, would be a legislative attempt by Congress to permit the states to tax the Internet upon satisfaction of due process requirements; physical presence would not be required.²⁵⁴ With the addition of a de minimis exemption similar to that in the first alternative, such legislation would condition the ability to tax on the occurrence of the sale within the taxing state and the

tax, the Tax Project states that its intention was to follow generally accepted policy objectives in fashioning its proposal. *See NTA Report, supra* note 2, at 1256. The first such commonly-held objective is "competitive equality"; that is, actors in Internet commerce should be taxed the same as their counterparts in the traditional market. *See id.* Second, the Tax Project submits that there is general agreement that state taxes should be uniform; definitions of goods to be taxed and standards for establishing a nexus should be the same in every state. *See id.* Third, it is generally accepted that any regime of Internet taxation must be administratively feasible; if the tax is overly complex, or its compliance or administrative costs are unreasonable, "the tax 'will fail to serve its basic function as an effective raiser of revenue.'" *Id.* More than merely enumerating guiding principles of Internet taxation, the Tax Project has proposed model legislation on which federal action could be based. *See id.* at 1257-69.

From the outset, the proposal attempts to deal with the ambiguous nature of Internet commerce by defining the term "sales tax," to include sales not only of tangible goods, but intangible goods and services as well. *See id.* at 1257. The proposal offers alternatives in determining a vendor's principal place of business: the place from which the business is managed or directed, or the state in which it does most of its electronic commerce. *See id.* at 1257-58. The proposal defines "billing address" as the place to which bills are sent, but suggests an additional requirement that a portion of the goods sold over the Internet must be used in the state where bills are sent. *See id.* at 1258. The Tax Project hopes that this requirement will prevent businesses that buy over the Internet from establishing billing addresses in tax-free states but using the product elsewhere. *See id.*

251. *See Hartman, supra* note 224, at 1017. Congress could set the tax rate and distribute the collected revenue among the states according to a formula for Internet sales that could consider population, personal income, or in-state retail sales. *See id.*

252. *See id.* For this reason, the proposal to tax vendors on sales delivered into the state generally is viewed as more feasible. *See id.*

253. *See id.*

254. *See Gregory A. Ichel, Comment, Internet Sounds Death Knell for Use Taxes: States Continue to Scream Over Lost Revenues*, 27 SETON HALL L. REV. 643, 660 (1997).

purposeful and continuous actions of the vendor.²⁵⁵

At present, a moratorium might be preferable to adding to the number of administrative problems that an out-of-state vendor might face if Congress is unsure of the role it wants to assume and cannot find a politically feasible or palatable option.²⁵⁶ The issue demands careful study across all levels of government and, to the extent that the ITFA foments that discussion,²⁵⁷ it should be supported.

IV. CONCLUSION

Internet commerce is an industry of almost limitless potential. As is their constitutional right, states have moved to take advantage of this new source of revenue. The nature of Internet commerce, however, does not allow for an easy application of traditional Due Process and Commerce Clause analyses. However attenuated the connection between the seller's actions and presence in the taxing state has become, requirements of foreseeability, purposeful availment, and some degree of physical or

255. *See id.* During the 104th Congress, the Senate directed its efforts toward the mail-order industry through the proposal of Senate Bill 480. *See id.* With little modification however, Congress could use similar language to address Internet nexus issues. *See id.* Senate Bill 480 suggested that the following jurisdictional requirements be met:

A State shall have power to require a person to collect a State sales [and/or use] tax imposed with respect to the sale of tangible personal property if-

(1) the destination of sale is *in* such State, *and*

(2) such person [or corporation]-

engages in *regular* or systematic soliciting of sales in such State, *and*

during the *1-year period* ending September 30 of the calendar year preceding the calendar year in which the sale occurs, has gross receipts from the sale of such tangible personal property-

(i) in the United States exceeding \$12,500,000, *or*

(ii) in such State exceeding \$500,000.

Id. at 661 n.88 (alteration in original). Ichel suggests that this legislation could be tailored easily to encompass the Internet. *See id.* at 661. Thus, the legislation would cover the sale of tangible personal property "commenced by utilizing a web site and Internet to advertise and market their respective products in states other than that where they are domiciled and/or incorporated." *Id.* at 661-62 n.89. Under Ichel's proposal, vendors would be liable to pay the tax if their domestic sales totaled one billion dollars, or if in-state sales totaled at least one million dollars. *See id.*

256. *Cf. Morse, supra* note 153, at 1132-33 (opining that legislative bodies generally are hesitant to impose new taxes, and defer instead to administrative bodies.) *But see Ashraf, supra* note 175, at 619 (noting that recent developments in software have made the administrative task of calculating the tax rates of differing jurisdictions less cumbersome). Software marketed under the name TAXWARE, "specifically designed for sales over the Internet, can track sales and use tax rates [nationwide] through zip code information [that may be] required of a customer before [the Internet] transaction" occurs. *Id.*

257. *See H.R. 4328, 105th Cong. § 1102(a) (1998)* (creating an advisory commission comprised of federal, state, and local government representatives and industry leaders to study Internet taxation).

economic presence remain.

The federal government has an important role to play. Legislation that definitively establishes jurisdiction and exempts businesses whose revenue falls short of a certain threshold is optimal in that it preserves state sovereignty while protecting Internet growth. If similar attempts to regulate the mail-order industry are any indication, however, enacting any legislation that imposes a burden on Internet vendors will be difficult indeed. In that event, the ITFA has merit. Despite its shortcomings, the period of careful study it offers can serve only to enhance national understanding of a global phenomenon—Internet commerce—that will continue to grow exponentially in the future.

