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Arthur Rosen
Moderator

Orson Swindle
Panelist

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THE TAXATION OF E-COMMERCE¹

Transcript from the 1999 Judge James R. Browning Symposium

MODERATOR: *Arthur Rosen*²

PANELISTS:³ *Orson Swindle*
Mark Nebergall
Judy Paynter
R. Bruce Johnson

MR. ROSEN:

My name is Art Rosen and I'm going to be moderating this next panel.

. . . .

Our first speaker is Orson Swindle. Orson is a Commissioner on the Federal Trade Commission. He's been there since 1997. Mr. Swindle has a very interesting and distinguished military career, which I'll get to in a second, as well as a career in government, having served in the Reagan Administration from 1981 to 1989.

He directed the Financial Assistance Program to help economically depressed rural areas. He was Assistant Secretary of Commerce For Development and he was a state director for the Farmers Home Administration, U.S. Department of Agriculture.

During the Vietnam War, Mr. Swindle was shot down and held as a prisoner of war for several years in . . . North Vietnam, taken to Hanoi. He retired from the U.S. Marine Corps at the rank of lieutenant colonel in 1979. When he retired, he had twenty military decorations for valor, including two Silver Stars,

1. All footnotes are attributable to the editors.

2. Partner in the New York City office of McDermott, Will and Emery; J.D. St. John's University School of Law.

3. For an introduction to the panel members, please see Mr. Rosen's description, *infra*.

two Bronze Stars and two Purple Hearts. He'll have a lot to offer us on what's going on in the real world and the economics involved with electronic commerce.

Our next speaker will be Mark Nebergall. He's sitting in the center over there. Mark received his B.S. in business administration from the University of Missouri, his J.D. from Pepperdine University, and his LL.M. in tax from NYU.

He began practicing law with the Tax Division of the U.S. Department of Justice upon graduation, and he completed his tour with the Justice Department in 1993.

Since the middle of 1993 until, I guess, Sunday at midnight of this past week, Mark was the public policy counsel with the Software Publishers Association, specializing in the areas of finance and taxation.

On Monday, but it was a holiday, so I'm not sure, Monday or Tuesday, Mark became president of the Software Finance and Tax Executives Council in Washington.

Mark was a founding member of the NTA Electronic Commerce Project you heard me refer to earlier and you will hear discussed in a little while.

Next to Mark is Judy Marie Paynter, and I guess you can figure out which one she is. She's not the guy on the end.

Judy is a CPA and she's the process lead for tax policy and research for the Montana Department of Revenue. She's held this position since 1989. Prior to joining the department, she taught at Weber State College, worked for a CPA firm, as well as for the Montana Legislature. In 1980, she assumed the position of Legislative Fiscal Analyst which she held [until] 1989.

The final member of the panel, Bruce Johnson, is a member of the Utah State Tax Commission. He was appointed by Governor Leavitt in October of 1998. Prior to his appointment to the Commission, Bruce was a partner in the law firm of Holme, Robert and Owens in Salt Lake City.

Bruce graduated from the University of Utah with a degree in accounting and he is a certified public accountant in addition to being an attorney. He currently serves as chairman of the American Bar Association's State and Local Tax Committee.

We'll start with Mr. Swindle.

MR. SWINDLE: It's nice to be with you. I see we have Baptists in the audience. I'm from South Georgia. I grew up a Methodist and occasionally would go over with my friends to the

Baptist churches.

And I found out that they always sit on the side because they don't want to be in direct view of the minister because, in the Baptist church, they ask you for money and so they all hide over in the wings. I noticed when the session started, most of the people were in the wings so I make the assumption that you are Baptists. That's okay, we'll accept you in the fold.

I'm not a lawyer. I come from the Federal Trade Commission and one of the very first things that we commissioners are required to do is to tell you that anything we say has nothing to do with the Federal Trade Commission.

We don't speak for the Commissioners nor the Commission. I speak totally independently. After my remarks, you will say that was probably the most ridiculous, unnecessary statement you ever heard anybody make because it will be quite apparent that I don't agree with a lot of the things the Commission does. But these are my comments and it's a pleasure to be out here with you, Dean Eck, the law students, Mr. Burke, Art, the Law Review, everyone who made this trip possible. I appreciate the opportunity to be here.

I am somewhat conservative in my beliefs, if not Libertarian. However, I do believe there is a calling for government, and I'm not one of those people who thinks we need to do away with it. That said, I will can not be neutral on this issue of taxing the internet, so I'll pass along some comments . . . similar to the ones I made several months ago. I hope they will add to the discussion today.

One of the first thoughts that I would share comes from a number of years of experience as an executive in the federal government. As was mentioned by Art, I was with the Reagan Administration for eight years and headed up the Economic Development Administration. If you want to see your tax dollars misused, go look at the Economic Development Administration. We tried desperately to do away with it under Reagan. Our efforts were unsuccessful because of a Congress dominated by Democrats. Now we have a Congress dominated by Republicans, and guess what they did? They reauthorized it for the first time since the Carter Administration and increased the funding. So, I guess the Reagan revolution is dead.

These thoughts and experiences lead me to the conclusion that our founding fathers pretty well had it right. They believed, I think fairly strongly, that government governs least, governs best. The least intrusive government is the best form of

government

In more modern-day times a philosopher of ours, Will Rogers from Oklahoma, once said that all government programs have three things in common: A beginning, a middle and no end.

I mention this because the promises of electronic commerce have created an incredible phenomena in Washington, D.C.— certainly, inside the beltway, and inside government circles: politicians see electronic commerce as a tremendous source of new revenues for new spending. Regulators, which I am one, being the Federal Trade Commission, see endless possibilities to do what we like to do best, and that's regulate.

I fear that in the emotion of all this, we in government will perhaps fail to remember some of the very principles that make the country we live in the remarkable journey that it has been, that we're a society built on private enterprise. Given the tremendous benefits that flow from private enterprise and private markets, governmental intervention in these markets should be undertaken only when clearly necessary.

We, in government, who are responsible for regulation, taxation and policy should always keep the Hippocratic oath in mind: First, do no harm.

I have a rule in my office with my staff, and it's served me well because I apply it to myself. And that is, every time I go through the decision-making process, when I come to the final conclusion, I sort of step back (and I ask my staff to do the same thing) and I ask, "Does this make sense?"

The issue of taxation is not the FTC's bailiwick, we're regulators, as I said, but because I feel so strongly about this, I have been invited to speak on several occasions on the subject.

Taxation, as you know, is a very tangible form of regulation, although we don't always think of it that way. The history of taxation seems to be that every time we come up with a new product, ("we" being the creative people that make the economic engine run— they are not in government, by the way; they are out in the private sector, in little towns and big cities, in big corporations and mom-and-pop operations) — but, every time we come up with a new product, a new industry, a new form of social organization or even a new economic concept of income and wealth, somebody in government comes up with a way to tax it.

President Reagan, who is one of my heroes, once said, "The government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it.

And if it stops moving, subsidize it.”⁴ I’ve been in a couple organizations where we’re dealing with the latter and I can tell you we do a lot of subsidizing of things that should have just been allowed to die. We all would have been better off.

Earlier this year the University of Texas, backed by Cisco Systems, did a rather comprehensive study of the current status of electronic commerce.⁵ I believe it’s one of the first efforts to try to measure this thing that we’re all on fire with, E-commerce. According to the study, which was released back in late May or early June as I recall, the Internet economy generated an estimated \$301 billion dollars in 1998 and was responsible for over 1.2 million jobs.⁶ These estimates are based on worldwide sales of Internet-related companies and products and services from U.S.-based companies.

The study divided the Internet economy into four categories, four layers: the infrastructure layer, which include companies like MCI WorldCom, AOL and Cisco; the applications layer, which includes companies like Netscape and Microsoft and Sun; the intermediary layer which included companies like Schwab.com, Yahoo and Travelweb.com; and, the commerce layer that includes companies like Amazon.com, IBM and the *Wall Street Journal*.⁷

It’s important to note that many companies are players in multiple levels of this structure. Each layer produced a range of revenues from \$66 to \$115 billion dollars, according to this study, and created anywhere from 230,000 to 482,000 jobs.⁸

Let me put those figures in perspective. The Internet economy today, 1998 . . . is already bigger than the energy industry. It is larger than the telecommunications industry, and it is almost as big as the automobile industry. In a sense, the Internet economy is becoming as essential to American life as the automobile.

As impressive as this is, we have got to keep things in perspective. Keep in mind that Netscape did not arrive on the scene until, I believe, 1993. And it was Netscape that gave us, the average person, as well as businesses, the capacity to

4. Ronald Reagan, Remarks to the White House Conference on Small Business (Aug. 15, 1986).

5. Anitesh Barua et al., *Measuring the Internet Economy: An Exploratory Study* (June 1999) (study sponsored by Cisco systems) <<http://cism.bus.utexas.edu/>>.

6. *Id.*

7. *Id.*

8. *Id.*

interrelate on the Internet. So we're really just in the early, early, very early stages of what the Internet economy is all about.

As you may know, I spoke before the inaugural meeting of the Advisory Commission on Electronic Commerce that Mr. Bucks mentioned earlier. I guess it was the first meeting back in June, I believe, down in Williamsburg, Virginia.

I posed a question that day, and I think it's worth repeating here today. I asked the question: Should policymakers apply a depression-era tax system to the economy of the 21st century?

The answer to that question will have an enormous impact on economic growth, the creation of jobs, the creation of wealth, and prosperity throughout our country and the world. The question of imposing new taxes on the Internet is more than just a philosophical or an ideological debate. The economic consequences of what the government might do in electronic commerce will be profound and serious. Any missteps will injure our country gravely and diminish our position as a leading world economy.

The Internet is a competitive advantage for the United States. More than one-third of all Internet users today are Americans.⁹ The Internet advances the cause of free trade and improvements of living standards by creating a comparative advantage for people who are creative, innovative and aggressive in pursuit of that engine that we have seen drive this country, and that is business.

Internet specific taxes and taxes on the Internet access threaten to choke the Internet economically at a critical, early stage of its development. Unwarranted taxes and regulation at a time when technology is still rapidly evolving threaten to lock in or limit the Internet to specific technologies and modes of services that probably fall very short of the potential.

Tomorrow's tax policy will have enormous impact in shaping the future of this burgeoning new industry of electronic commerce as supported by the Internet.

The issue of taxing the Internet is complicated by several factors. First, with approximately 30,000 taxing jurisdictions, compliance becomes a significant obstacle. Mr. Bucks mentioned 9,000. I'm sure we could probably reconcile both of those

9. According to a September, 1999 survey, there are 201 million internet users worldwide; 106.3 million users are Americans (53%) <http://www.nua.ie/surveys/how_many_online/index.html>.

numbers in some fashion; but the information I have, there are 30,000 taxing jurisdictions across this country. That obviously would be quite an obstacle to any kind of tax system that we might want to put in place.

The Internet is inherently susceptible to multiple or discriminatory taxation in a way that commerce conducted in more traditional ways is not. Double taxation would be inevitable because of the borderless nature of the Internet, which makes taxation very tricky.

If we simply require that merchants collect the relevant tax for the jurisdiction in which the product is being delivered, such legislation would produce a world that is anything but simple.

Can you imagine the confusion that would arise in a case where a small business owner from New Hampshire, a state without sales tax—or we could say Montana—is required to collect tax on a purchase made by a consumer living in the Dallas area, a metropolitan area with numerous suburbs, several of which have different local sales tax rates in addition to the Texas state sales tax, should there be one? Or, even more bizarre, consider the basic issue of selling shoes over the Internet, a product that is tax exempt in some states, but not others, depending on such factors as whether the footwear in question are tennis shoes, sneakers, or cleated athletic shoes.

Since the Internet's commerce is so new, we don't really know what the business model is. If we don't know what the business model is, how in the world are we going to logically, rationally tax it?

There are likely many adverse, unintended and unanticipated consequences lurking in the future. How would the taxes be collected? One of the main benefits of web-based businesses is that the ability to reach such a large potential universe of customers cheaply provides an opportunity for very small, one- or two-person companies (taking it to the extreme), to thrive without a tremendous amount of start-up capital.

The cost of compliance and tax collection alone for these small businesses could be enough of a deterrent to keep them from participating in the economy. Clearly, compelling retailers to collect tax under the current jurisdictional regime would place a significant burden on merchants and such a burden would likely not be uniformly felt across all retailers.

If a recent study by the Washington Department of Revenue is any indication of things to come, small businesses would be hit hardest (something new!) with respect to the cost of

compliance with multi-jurisdictional tax rates.¹⁰

More specifically, a recent study by one of the big five accounting firms, Ernst and Young, concluded that they estimate the cost of compliance for small businesses to be close to eighty-seven percent of the sales tax they collect.¹¹ In other words, of every dollar they collect, eighty-seven percent is a cost they have to incur. A far greater percentage than the fourteen percent of the tax collected that it would cost large businesses to comply. Now, we can all figure out why that might be the case, given staffs and the capacity of large firms versus small firms.

While it might be possible that these costs could be eased by employing various software packages, such software can cost well over \$20,000.¹² I was reading an article coming out here saying that some, not totally adequate, systems do exist, but they are far from being the efficient things that we would need for such a tax system, and they will be expensive.

In a time when technology finally makes it possible for virtually anyone to realize the American dream by starting out on their own, having a business and making money from scratch, do we really want to place one more barrier to their entry into the economic world with high or heavy compliance costs that they would be required to have due to collecting taxes for another jurisdiction?

Another major enforcement issue is identifying the state, county or countries that have tax jurisdiction over income generated by electronic transmissions.

Electronic commerce permits a foreign person to sell any number of products anywhere in the world. The Internet is nowhere and it's everywhere. That's something no tax system has really had to cope with.

Furthermore, do we want to enact a taxation scheme that, to be effectively implemented, systematically undermines our privacy by amassing a comprehensive database on our online purchases so that some centralized agency (state government perhaps) can be certain that we paid our relevant taxes?

What guarantees do we have, as consumers, that these state

10. Washington Department of Revenue, *Retailers' Cost of Collecting & Remitting Sales Tax* (Dec. 1998) <<http://www.dor.wa.gov>>.

11. Robert J. Cline & Thomas Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*, Ernst & Young Economics Consulting and Quantitative Analysis, Sept. 8, 1999.

12. Harry Tennant & Associates, *Sales Tax, Use Tax and Internet Transactions* (1997) <<http://www.htennant.com/hta/askus/salestax.htm>>.

governments would not take this information they have learned about our buying habits and sell the information or share it with someone else, which would undermine our personal privacy, not to mention our security.

Then, there is the lost revenue argument. Throughout this debate, the argument has often focused on those who claim that failing to create a suitable Internet commerce tax will lead to a steady decline of state revenues—perhaps as much, in one study I recently saw, twenty billion a year, significantly hindering the development of state infrastructure.¹³ While such arguments conjure up a frightening picture of what could occur, are the predictions really true?

Another recent study by Ernst and Young has shown that current estimates of sales and use tax not collected in 1998 due to Internet sales are less than \$170 million, only one-tenth of one percent of the total state and local tax revenues.¹⁴

This small effect is due to a number of factors, two of which should be noted. First, an estimated eighty percent of the current E-commerce is business-to-business sales that are not subject to sales and use taxes, generally.¹⁵

Second, an estimated sixty-three percent of current E-commerce business-to-consumer sales are services, such as travel and financial services, and are not subject to state and local tax in many cases.¹⁶

These estimates are similar to another study by scholars at the University of Chicago and Harvard who have estimated the loss to be close to one-quarter of one percent.¹⁷

Considering future growth of the electronic commerce, these scholars have predicted that even after five years, the average loss in sales tax revenue to the states will only amount to two percent of potential tax revenues,¹⁸ a mere fraction of the \$20 billion loss that had been predicted by proponents of Internet taxation. Is retaining this minor loss in tax revenue worth crippling the potential of entrepreneurs and this economic

13. *Governors Fear Tax Loss From Internet States' Surpluses Treated Cautiously*, BOSTON GLOBE, Dec. 31, 1998, at A22.

14. Robert J. Cline & Thomas S. Neubig, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*, Ernst & Young Economics Consulting and Quantitative Analysis, June 18, 1999.

15. *Id.*

16. *Id.*

17. *Id.*

18. Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, 52 NATIONAL TAX JOURNAL 413 (1999).

engine that could bring untold fortune to this country?

Those advocating taxation of the electronic marketplace are also operating on the basis of expectations. They are hungrily anticipating revenues to spend as a result of taxes collected on new products and services.

What they may lose sight of, however, is that inappropriate government intrusion in the form of regulation and taxation may, in fact, chill the development and marketing of new products and services.

I would offer a proposal that I certainly favor for your consideration. Senator John McCain has introduced a bill to permanently ban Internet sales taxes by specifically outlawing any future attempts to impose a sales tax structure on Internet sales.¹⁹ This is a follow-on to the Internet Tax Freedom Act²⁰ that Senator Wyden and Representative Cox, I believe, were the sponsors in 1998.

In addition, the senator's bill would call for the World Trade Organization's adoption of global moratorium on Internet taxes. As Senator McCain said on the Senate floor, "Simply, this bill would make permanent the moratorium on sales and use taxes for e-commerce and would encourage the Administration to urge our world trading partners to do the same."²¹ The Senator continued, "I think it is important to move forward on ensuring that the default position, absent a consensus proposal," commenting on the Advisory Committee, "is not to lift the moratorium, but to place the burden of proof on those advocating taxation of e-commerce."²² Commerce conducted through the Internet is experiencing tremendous growth. This growth helps our nation's economy by keeping it free from burdensome and anti-consumer taxation.

I could not agree with Senator McCain more.

While the Advisory Committee on Electronic Commerce seems more focused on how to tax rather than whether to tax the Internet, only Congress can authorize one state to compel sellers in another state to collect Internet taxes. With that in

19. S. 1611, 106th (1999).

20. Pub. L. 105-277, § 1100, 112 Stat. 2681-719 (signed by President Clinton on Oct. 21, 1998).

21. *Introduction of S. 1611 before the Senate*, 106th Cong. (Sept. 22, 1999) (statement of Sen. John McCain) < <http://thomas.loc.gov/cgi-bin/query/D?r106:4:/temp/~r106m4lbR9:e338:>>.

22. *Id.*

mind, I believe the proposal²³ offered by Senator McCain will be adopted by Congress.

I would go back to the question that I posed several months ago, and I'll mention it here again for this purpose of discussion here today. Should the policymakers apply a depression-era tax system to the economy of the 21st century?

We're talking about change, and I want to mention a true story — how many of you are baseball fans? Years ago there was a guy named Curt Flood, a magnificent baseball player.²⁴ I think he had a lifetime batting average over thirteen or fourteen years of .293. He played for the St. Louis Cardinals. He was such a great center fielder, fans had an expression about him: Two-thirds of the world is covered by the ocean and the other third is covered by Curt Flood.

And, if you don't understand baseball, you won't understand that, so I'll get on with the story. Curt Flood chose to go the free agency route, I believe, in 1969. He said, you don't own me. I'm a free person. I can negotiate my own deal with management for a contract. He took it into court. As I recall, it went to the Supreme Court and I believe he lost in the Supreme Court.²⁵

The arguments against him doing this by the owners was, my God, we will change baseball forever. It will never be the same. You know, the sky will fall. Attendance will go down. Parity will cease to exist.

Now, for those of you who are real aficionados of baseball, you know in the fifty years prior to that, New York City teams—there were the Yankees, the Giants and the Brooklyn Dodgers, and the Mets came along. At no time more than three teams, I guess. They won in fifty years something like twenty-six of the world championships. So the parity argument really didn't make much sense. As the argument went, we're going to lose attendance, baseball will die, it will never be the same, and we'll lose parity.

A couple of years after Curt Flood took this action, the courts decided he was right.²⁶ He didn't benefit by it. Curt

23. See *supra* note 19.

24. Story related by columnist, George Will.

25. *Flood v. Kuhn*, 407 U.S. 258 (1972) (holding that professional baseball's reserve system from federal antitrust laws is an established aberration in which Congress has acquiesced).

26. Andy Messersmith and Dave McNally filed grievances against the reserve clause in 1975. On December 23, 1975, an arbitration panel under the 1973 collective bargaining agreement between the baseball club owners and the Players Association held that players Andy Messersmith and Dave McNally were free agents, able to

Flood didn't get multi-million dollar contracts, but baseball has indeed changed forever. Instead of having a couple of dozen teams, we have—I don't know how many now—thirty two or thirty four, something like that. Attendance is bursting through the roof. Baseball is more fun than ever.

Parity? In the '80s, just a few years after the Court ruled to allow the dreaded "free-agent," in a ten-year time period, we had ten different teams win the world championship.

That's about freedom, folks; that's what this country is all about and that's what the Internet is about. Let's don't destroy it with over taxation, wrongful taxation, and certainly regulation that would stifle the innovative, creative spirit of what the American dream is all about. Thank you very much, and I look forward to the discussion.

MR. ROSEN: Thank you. Our next speaker, Mark Nebergall.

MR. NEBERGALL: I also would like to say it's an honor to come to Montana this morning to speak to you all about taxation of electronic commerce.

Before I start with that, I would like to just tell you a little bit about what it is that I do. I'm not going to sugarcoat it. I'm a lobbyist. I spend most of my time lobbying tax issues on behalf of the software industry. I do that at the state level, the federal level and the international level.

As Dan [Bucks] said, I've served on the National Tax Association's Communications and Electronic Commerce Tax Project which was primarily looking into ideas for simplifying state sales and use taxes. I wore out a lot of shoe leather on Capitol Hill lobbying for passage of the Internet Tax Freedom Act,²⁷ and I wore out my pants on plane seats flying to Europe to lobby places like the Organization for Economic Cooperation and Development, which is also studying international issues with regard to taxation of electronic commerce.

....

It's no great secret that the Internet holds out the promise

negotiate with other baseball clubs. The district court ordered the award of the arbitration panel to be enforced. See *Kansas City Royals Baseball Corp. v. Major League Baseball Players Ass'n*, 409 F.Supp. 233 (W.D.Mo. 1976). The Court of Appeals for the Eighth Circuit affirmed. See *Kansas City Royals Baseball Corp. v. Major League Baseball Players Ass'n*, 532 F.2d 615 (8th Cir. 1976).

27. See *supra* note 20.

of allowing . . . small, local businesses to expand their markets both beyond the reach of their state borders, but also internationally.

Small businesses can use the Internet to reach customers throughout the world and, hopefully, small businesses in Montana will find that they can increase their revenues.

But the one thing that your small business clients need to do is to come to you to say, how can I avoid being haled into court in some state where I've never been just because I happen to have some customers there that I'm shipping stuff to, either through the mail or, perhaps, I'm delivering digital products just by download.

I think, you know, you heard Dan Bucks mention it and Commissioner Swindle also indicate that the sales tax is a creature of the depression. Mississippi was the first state to enact a sales tax back in the 1930's in a response to declining income tax revenues because back in the depression, nobody was working, nobody was earning any income, so the income tax base, you know, took a fall and they were looking around for some way to replace it.²⁸

I think everybody understands that, at that point in time, most commerce was conducted in a fashion where the vendor saw his customer face-to-face over the counter. There was some remote commerce. Sears and Roebuck was around back then, Montgomery Ward and maybe some other large catalog retailers.

But, commerce has changed. More and more consumers are looking to catalogs, and now the Internet, which is sort of a migration of catalog commerce to Internet commerce as a way to buy things. The model that was developed back in the 1930's, I think, has been called into question as to whether it is viable in the 1990's and after the new millennium.

What is it that you need to tell . . . your clients? I think the first thing you need to do is you need to find out and have a good understanding of the nature and extent of your client's business. You need to know what your client is doing extraterritorially. Does your client own any property in another state? Does he have employees in another state? If he doesn't, things might be different. If he does, things will be entirely different.

You need to know the nature of the products that your client is delivering to his or her customers. Is the product a good, like

28. Mississippi was the first state to enact a sales tax in 1932.

a pair of boots or any other physical object that you have got to call either the Post Office, UPS or Federal Express to come pick up and deliver for you? Is the product a digital product which can be downloaded to the customer electronically? Is the product a service?

All of these things have important consequences to the determination as to whether and if the transaction will be taxable to the customer and whether or not your client will have an obligation to collect a sales tax.

You need to know the location of the customer. Is the customer in Montana? Is the customer in another state? Is the customer in another country?

You need to know what kind of tax might be imposed. Is there an income tax problem? Is there a sales tax; or, in the international context, a VAT²⁹ problem. Believe it or not, there is a difference in taxation if the product or the nature of the income that you are receiving is characterized as income from the sale of a good or if it's a royalty.

If your customer is overseas and the income is royalty income, chances are your customer is going to be withholding some of the payments that he's sending to your client and your client may have to file an income tax return in a foreign country to claim recovery of the income tax, assuming he's got no activities in the foreign country.

Is the customer a business or is the customer a consumer? All of these things have vast implications for whether or not, you know, there is going to be a tax responsibility, either income or transactions tax, whether there is a collection obligation.

I'm going to try to keep my remarks brief and I hope that you all will have some questions for us later on. Because I work in public policy, I do have at least a shadowy idea of what's coming down the road. Dan talked about the Advisory Commission on Electronic Commerce. It's meeting again in New York in a few months. It's unknown what, if any, recommendations the Advisory Commission will come out with.

I also do some work with the Organization for Economic Cooperation and Development which is a group of twenty nine developed countries. They are located in Paris and they also have an extensive project going on international taxation. We expect that they will come out with some recommendations in probably about a year from now.

29. Value Added Tax

I think some of the things you can expect are recommendations, at least domestically, for simplification. I'm going to ask Art to help me out here. Art, where are you?

To give you just a couple of examples as to how difficult it can be to determine whether a transaction is taxable or not, I'll ask Art over there to tell you about taxation of marshmallows and Chap Stick in New York.

MR. ROSEN: I guess one of my favorite examples of this, when we talk nationwide, is New York.

New York, as many states, has a sales tax imposed on candies and confectionery goods, but there is no sales tax on food products. So the question is: Marshmallow . . . is that a food product or is it a candy? Well, for many years, until about a year and a half ago, it was the rule of New York, very strictly enforced, was that big marshmallows were things you would eat and, therefore, they were candy subject to sales tax.

The small marshmallows, the little things, are things you put into cakes and to cookies and they are a baking supply; therefore, they are a food product, not subject to sales tax.

My favorite one is a motive issue, which is Chap Stick. The question the sales clerk is supposed to ask you, and obviously nobody really does this, but why are you buying it? If you are buying it to prevent getting chapped lips, you have to pay sales tax. That's not an exempt medicine or drug. However, if you already have chapped lips and you are buying it to cure the chapped lips, well, that's okay, that's a medicine or drug and that's exempt.

So that's one example. And to tie into another example that Commissioner Swindle talked about on the shoes, you not only have to know what kind of shoes in the jurisdiction and exactly where the person is located but also the time of year. New York now, for instance, has two weeks a year when there is an exemption for clothing, except for shoes in certain weeks. So it's just impossible to administer on a nationwide basis and that's why the business community is so concerned about this complexity. . . .

MR. NEBERGALL: I guess the point is that your client needs to know what his or her customer is going to do with whatever it is that your client may be selling. If your client has a customer in New York and your client is selling marshmallows or Chap Stick electronically for delivery, you need to know

what . . . the customer [is] going to do with the stuff and how big the marshmallows might be. These are just two examples, and only Art can describe them. Being from New York, he knows all the vigors of the New York law.

You need to understand just how complex this is. And we are hopeful that the debates that Dan [Bucks] and myself and Art and some of the others are involved in will lead to some uniformity, some simplification, so that you don't have to worry whether your client's customer is in New York City or maybe, perhaps, in the Borough of Queens, which may have a different tax than the Borough of Brooklyn or Staten Island.

The Supreme Court in the *Quill* case,³⁰ which Dan [Bucks] talked about, said very clearly that the reason the Commerce Clause prohibits states from extraterritorially imposing their tax collection obligations on vendors that have no physical presence is because of the complexity.

My personal view is that if the complexity can be eliminated, the Supreme Court is likely to rule that the burden has been eliminated and will permit expansion of the obligation on behalf of out-of-state vendors to collect the tax.

There has also been some talk of the availability of technology to simplify these issues. I was on the phone with the state and local tax guy at Microsoft the other day, and I said, "Bruce, what's out there?" He says, "You know, we use two products. A company called TaxWare has a product and a company called Vertex has some products that help automate the computation of the tax." "And," he said, "the only thing that those products do is compute the amount of the tax. It costs us between fifty and \$100,000 a year to license those software products, and those products do nothing about raking the tax off at the time of the transaction and sending it directly to the tax administrators."

The point that I'm making is that, for the time being, I believe that while technology may be available, it will be available only to large, well-capitalized companies. It's going to be a while before there is something in the nature of TurboTax that your clients can buy, install on their computers and use to reduce the cost of complying with state and local taxes.

30. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (holding that a mail-order business did not need to have physical presence in the state in order for the state to require the business to collect use tax from its in-state customers, but physical presence in the state was required in order for there to be "substantial nexus" required by Commerce Clause).

Dan Bucks talked about some alleged problems with reduction of the tax base and the increase of the tax rates, and he prophesied all this gloom and doom about how state and local jurisdictions are going to have to curtail police services, fire protection and education.

I hear that, and then I pick up my local newspaper and some of the other tax journals that I read and I see, astonishingly, that many states are having political problems trying to figure out what to do with the burgeoning tax surpluses that they are experiencing. Some states have decided to give them back to their citizens. Other states are looking into building, you know, a savings account for a rainy day. Others are looking into ways to spend it. But I don't see states and local jurisdictions hurting for revenue.

Mr. Swindle mentioned legislation introduced by Senator McCain that would call for a complete ban on sales taxation of goods and services that are ordered using the Internet.³¹

The members of my organization that I represent adhere to what we call the principle of neutrality. Do not treat, for tax purposes, the Internet any differently than you would treat any other form of commerce, either commerce conducted using the phone or using the mail or using the telefax machine. We believe that Senator McCain's legislation would violate that principle and treat the Internet specially.

We do not believe that the Internet ought to be treated specially, either from an overburdensome tax position or a more favorable tax position. We have taken no position one way or the other on Senator McCain's legislation.³²

One other thing I'll mention is that the McCain legislation calls for the World Trade Organization to, at least internationally, adopt things like the Internet Tax Freedom Act.³³ Our view is that the World Trade Organization is a group uniquely positioned to handle issues involving tariffs and it is not a forum for the discussion for international taxation issues.

We believe that the place where the international discussions on these issues should be carried out is the Organization for Economic Cooperation and Development.

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31. See *supra* note 19.

32. See *supra* note 19.

33. See *supra* note 20.

MR. ROSEN:

Our next speaker, Judy Paynter.

MS. PAYNTER: My talk today is going to be about some criteria for taxing electronic commerce. In this process of getting introduced to the other panelists this morning, one of their questions was: Well, why is Montana even interested in speaking because you don't have a sales tax?

But we have been very active in this area and the Governor, last session, introduced or proposed to the legislature a VAT tax and that had to do considerably with nexus issues.³⁴ The reason we went with a VAT tax is because a traditional sales tax is considered to be a dying tax and we need to be looking forward into the next centuries and how are we going to get our tax systems modernized. So, we've done quite a bit of work and have been following closely the E-commerce debate.

We think that not only just for E-commerce but for all activity, that the tax policy for electronic commerce should meet the criteria for being part of a "high quality tax system," and, also, that the medium of commerce should not be the criteria to tax one form of commerce differently than another. [T]he tax administration may need to be simplified and done in cooperation with other governments.

There is a foundation for developing revenue and tax policy. My group at the Department of Revenue has now been organized within the last two years to try to start to focus on a more state level and to be more involved in what's happening to us nationally and internationally as it comes back and it does affect the citizens of Montana.

Montana, itself, has been in a tax debate considerably in the last twenty years. It's been a lot of debate and very few solutions. But we now are working [on the principle] that sound tax policy should be driven by fundamental underlying principles of taxation. These principles provide a conceptual framework for policymakers and citizens to measure the performance and quality of the tax policy and to promote stability and consistency in tax laws.

If you are going to have a high quality tax structure, when you are debating your tax policy and what you are going to do to change the laws as you have now, you need to be looking at your system and say, is it stable?

34. S.B. 518, 56th Sess. (Mont. 1999).

We need a revenue system that produces revenue in a reliable manner, sufficient to fund government services without the constant up and down of starting or stopping programs. Revenue collected should be relatively constant and, also, you should keep the changes to your tax policy and the types of taxes that you have to a minimum. Otherwise, it causes considerable business disruption.

An equitable revenue system imposes similar tax burdens on people and businesses in similar circumstances. When you are looking at “equitable,” you should be discussing two things: there is the “benefits received” principle, and that’s those who enjoy the benefits of government services should be taxed in proportion to the amount of benefits received. And then there is the “ability to pay” principle that you must keep in mind; that the tax burden should be related to an individual’s ability to pay based upon their economic well-being.

An economically neutral revenue system does not unnecessarily or unintentionally interfere with private decisions in the marketplace. I think that you will find a lot of the E-commerce is concerned about this, but we don’t want the tax to be driving the business decisions.

A high quality tax structure should allow for competition, but your benefits have to be measured against the costs when your state revenue systems are used as a tool for economic development policy. Interstate tax competition can deplete state resources without significantly enhancing job creation. And concessions in the form of tax breaks can erode your tax bases. The tax system, however, must be competitive with those that are used in other states, but you have got to be careful and debate what your policies are going to be.

One of the issues of a high quality tax structure that’s coming into question with the E-commerce that’s bringing it up is simplicity. A revenue system should be simple. It should facilitate the taxpayer compliance. It should be easy to understand. It needs to minimize the compliance cost. It needs to promote fair, efficient and effective administration, and it needs to be applied uniformly.

It also needs to be complementary. And this is sometimes a difficult fundamental to understand, but you need to have a healthy relationship between different levels of government taxing authorities. You have some governmental units with greater authority. And, for example, in Montana, the State of Montana has greater taxing authority than our local taxing

jurisdictions.

In Montana, our local taxing jurisdictions are feeling that there is no partnership with them. It is more a parent-child relationship and that the child is giving the local governments a lot of responsibilities to carry out and to make things work and, at the same time, they are given no authority to raise the revenue or to have the capacity to fund the things that they have been given responsibility for.

And to be healthy, you have got to look at all levels of government. We're in a situation now, as a state, when you talk about E-commerce, the State of Montana is not driving that discussion. But that discussion is going to come back and affect us, so we're concerned that, there, we're not the highest authority on the taxing. We're getting into the national and international arena. We want them to be considered as this principle is going to exist to the State of Montana.

A revenue system needs to be balanced, and that means that it relies on a diverse and broad-based range of sources. A broad tax base helps to meet the goal of diversification and it spreads the tax burden amongst more players, and that's important because it keeps the tax rate low on everybody who is participating in the tax system. And, hopefully, everybody has to contribute somewhat to the tax system.

A tax system must be accountable to the citizens that it's designed to serve. Taxes and tax policy should be explicit. Taxes must be clearly visible and they should not be hidden from the taxpayers. Proposed policy should be highly publicized and it should be open to public debate, and there is certainly no lack of public debate on this one.

So when we come down, we say, well, why do you want to tax electronic commerce? From a tax policy perspective, electronic commerce is business activity in a different form than Main Street business. In the next century, there will be several evolutions of business interactions and should each new form of business activity be untaxed?

Electronic commerce is competing with other forms of business activity. Is it feasible or fair to tax one form of commerce differently than another? Why should I tax the CD that you buy on Main Street differently than the CD that you might buy through E-commerce? What does that do to the person who is in your town on Main Street trying to sell the product?

Electronic commerce is growing rapidly and some predict it

will account for up to seventy five percent of all sales. If this is so, would not taxing electronic commerce cause a major reduction in the revenue stream to fund government services?

Even though electronic commerce, and some of the figures you have been given today, say this is where it's at now or this is where it was in 1998, that's not where it's going to stay. And I have been in some meetings with the Governor when we have had some citizen groups come to see him about the dying communities that they have in some of our smaller towns, and the commerce in those towns is drying up and it does it through a number of things.

E-commerce is already having an impacts on those who are located remotely and can get a broader range of services if they use E-commerce to get their product, and the transportation systems have increased dramatically and people drive to a larger town. What it is doing is already, in Montana, we're seeing a number of factors come together to drive up the small retailer and the rural activity in Montana, and E-commerce will be a part of that.

Not imposing or collecting tax on electronic commerce will undermine the sales and use tax base and create inequities between sales of equivalent goods and services, and that's depending on the mode or form of delivery again. What is the difference on when you buy the product, depending on how I decide to creatively market it to you?

[T]ax administration for electronic commerce does need to be fair, simple, nondiscriminatory and equitable.

We do think that the old sales tax system has come up and grown up. When it first started, it didn't have the cross border implications and nearly the complexities in it that it does today, and we do concede that there needs to be a look at tax simplification.

But how do we achieve effective tax administration? I think we need to modernize the nexus rules in the court orders in order to require all sellers above a certain volume to collect taxes. . . .

I think nexus needs to be modernized not only for E-commerce but it needs to be modernized for other types of business. We spend a considerable amount of time in Montana trying to establish nexus for corporate license tax.

Our Montana corporations, if you take the top 100, they pay almost all the corporate license tax, and those are companies that are doing business not only in Montana but across our state

borders. When they start doing business in Montana, we get no tax unless we can establish nexus. So nexus rules need to be looked at not just for E-commerce but for all types of taxes. [W]hen you talk about it you need to be sure that we include both goods and services. The economy is changing from a goods base to a service base. And when you are not able to tax the services, that's the wave of a lot of the economic activity of the future. And so if you keep your sales tax, or . . . whatever tax you have, the same level as it was last year but your population continues to grow, you have to have new revenues to service new people and to keep up with inflation.

Also, we need to be cooperative and compromise to develop a tax collection system that's easy for both large and small businesses to comply with. It does not duplicate administrative compliance efforts among federal, state and local governments.

And those people who need to cooperate and compromise are not just state tax administration officials. Industry needs to get involved and roll up their shirt sleeves and work with state tax people. Because it needs to work not only for state tax administration, it needs to work for both small and large businesses.

And, what we're going to find is when you start cooperating between federal, state and local governments, somebody is going to be collecting the revenue trying not to duplicate, and when you do that, then you are going to have the question of the distribution system back. If the federal government, for example, should collect a national tax and then allocate it amongst the states and then the states allocate it amongst the local governments, you have a distribution question.

And there are a number of ways this tax collection can go. But once you decide how to collect the taxes, and that may satisfy industry, you have to find a way in order to get it back to the taxing jurisdictions that provide services.

Now, what do we have to lose . . . if a tax structure cannot be agreed upon, if certain economic activity cannot be taxed equitably, and if tax administration and compliance are not simplified? We have a lot to lose. States are going to have difficulty establishing nexus. We're going to have difficulty taxing the service sector of the economy. We're going to have the erosion of the traditional Main Street business tax revenue, and we're going to have no tax base for the fastest growing form of commerce.

So, today, you have heard kind of two sides. Is it the

beginning or is it the end? I think that this discussion on E-commerce is not just about E-commerce. I think it should be a broader discussion that says, we need to move our taxing systems which were based in the 1920s and 30s when you had manufacturing—you had hard physical assets there—and we need to take this opportunity to move the tax discussion and say, our existing tax laws are not in conformity with the new type of ways that we do business, with the new economy. And it's broader than E-commerce. We need to get in and provide . . . appropriate government services in the most efficient manner with tax revenue collected from a broad tax base with low tax rates. And that doesn't mean, if I'm going to do that, that I just continue to tax your physical assets that continue to be existing, like a Boeing, and I don't tax anything on Microsoft, that I consider that to be fair. It's not fair. It's because it is a new way of doing business, and we need to catch up with that new way of doing business so that everybody who is benefiting from economic activity contributes to the tax base revenue so that the tax base on all folks can be kept to a minimal level.

I think to have electronic commerce . . . [a] part of the tax base, and I firmly believe that it needs to be, [it] is going to take a lot of cooperation, compromise, and I strongly suggest that we need to use the principles of taxation and we need to simplify tax administration criteria.

I'm not going to make any additional comments because I talked to the next speaker and some of our comments, I think, were going to overlap each other. So, for the sake of time, I'm going to stop just with that presentation and let the next speaker make the other comments.

. . . .

MR. JOHNSON:

I will try to keep my comments fairly brief, but it's just been a year since I have been a tax commissioner and prior to that, like Art, I was paid by the hour, so it's very difficult for me to keep my comments brief.

You are to be congratulated. I know that law students and lawyers have a high tolerance for boredom, but tax lawyers are noted. My wife, she's astonished at my capacity for boredom and said that tax lawyers are people that are fairly good with numbers but don't have the personality to be actuaries. . . .

These really are interesting, to me, fascinating policy issues. I do have to confess, I am a tax collector as such. Many of you in

Montana, I assume, are familiar with the advice that's given to visitors to your national parks when they are approached by a bear, and I submit that the same advice would work well when you are approached by a tax commissioner.

First thing you do is raise your arms and try to look big. Speak loudly. If the bear or the tax collector continues to advance, back away slowly, but do not run. And if that doesn't work, drop to the ground, assume the fetal position and protect your vital organs.

That, I think, is maybe what the software industry, what the E-commerce people are feeling now. But let me repeat a lot of what's been said and put a slightly different spin on it. I do want to talk about what is good tax policy.

To me, good tax policy is having a broad base, having a low rate, something that's economical to administer, something that's relatively easy to comply with, economical for the businesses to comply with. Something that's fair, something that's not counter to other kinds of social policies. And something that is business neutral. Something where you don't have to spend millions of dollars having Art, or people like Art, or people like me in my former incarnation, tell you that there are lots of things you want to do for good business purposes. You want to go out and visit that client. You want to go out and examine their needs. You want to go out and make sure your product is properly installed and properly used, but don't do it. Because if you do it, you are going to be subjecting yourself to nexus and you are going to have sales tax obligations.

You don't want a tax system where your business decisions are being made by your tax lawyer and not by your salespeople. So, I think you want a system that's neutral as much as possible.

Now, in Utah I think we have a fairly balanced tax system. We have a property tax which taxes wealth. We've talked about intangible wealth, it doesn't get that, and that's certainly a problem. We have an income tax that taxes income; that does get some of your intangible wealth. And we have a sales tax that taxes consumption.

So, all of the three . . . elements of the economy: wealth, income, consumption, are all taxed. You can keep the rates relatively low when you do that. Those rates are a little bit higher in Utah because we happen to have more children per capita than any other state in the union and it costs a lot of money to educate all of those children.

But I would—and this is going to be an overgeneralization that is going to be unfair but I'm going to do it anyway—I'm going to contrast that to a mythical state that we might call Montana. In Montana we might say, you know, we've got a lot of extractive industries. We've got ASARCO, we've got, you know, Grace, we've got lots of coal and we've got lots of oil and we can tax them and not tax us, and that's great, and let's put all our eggs in that basket. And then what happens when those companies pick up their own baskets and go home?

I think good tax policy would say, keep the tax as broad as possible, spread the burden as fairly as possible, keep it as low as possible. Now, again, in the interest of trying to have more interaction, I'm going to try to keep my comments a little bit briefer here, but I want to put a different spin on some of the things the other panelists said.

I don't think anyone is arguing that Utah, my state, shouldn't have the right, if the voters want to do it, to impose a sales tax. Part of that is a complementary use tax. And I don't know if anyone has really argued—and I want to make it clear, here, is what I'm going to be talking about is just Internet taxation insofar as it relates to an Internet vendor's responsibility to collect sales tax, traditional sales tax. I'm not going to be talking about a byte tax or a bit tax or any tax on electronic commerce that doesn't apply to another vendor.

So what we're talking about is, should you have an Internet vendor be required to collect a sales tax, and at least two of the panelists would say no. I will admit that it violates my "easy to comply with." There is no doubt about that.

I will also note that the reason that you have got problems with marshmallows is not really because the New York Department of Revenue said we have got to have an exemption for marshmallows.

The reason that our sales tax is riddled with exemptions is because the business community has asked for those exemptions.

I'm not naive enough to believe that the business community is monolithic, or that we can expect it to be monolithic; but the fact of the matter is, when I was up at the legislature in Utah a few months ago arguing against a sales tax exemption for gun safes, it was not because there weren't any retailers with me saying, we don't know what a gun safe is; we don't know whether it's a locked briefcase; we don't know whether it's a strong box; we don't know whether it's a rifle

display case with a lock on it.

There isn't a person in this room, I suspect, even in Montana I don't think there is a person that doesn't say, regardless of your right to bear arms, that you ought to lock them up when you have got small children. There isn't anybody that would say it's not a good idea to lock up your firearms. Should we have a sales tax exemption for gun safes? Should we make the eighteen-year-old at the counter try to figure out what a gun safe is? Do you have chapped lips? Are you going to use this to lock up a gun? You might? Okay, it's tax exempt. I don't have a gun right now, but, you know, I might get one some day. So anything I've got with a lock on it is now tax exempt?

Well, you know, in fairness, it's not the tax administrators that are asking for those kind of exemptions. The complexity is not driven by the administrators. The complexity is driven by the people who want to get out of the tax.

What happens when you get some people who get out of the tax? Well, . . . one of two things. The government says—and these are our elected representatives, like it or not—the government says, well, we've got an exemption there. What are we going to cut in government spending? You know, I tend to agree with Will Rogers, that's not likely to happen. So what happens? The tax rate goes up on everybody else. I mean, if you are going to keep your revenues constant and you are not going to drop spending, you get an exemption, somebody else pays the tax.

Let's get back, then, to the use tax. Assuming we agree that Utah has the authority and the right, and the people of Utah have the right to say we're going to impose a tax, then we're going to say in the E-commerce area, if you are not going to require E-commerce to collect it, then you are going to require the individuals to pay it. And I don't think that's a controversial statement.

So let's talk about privacy in that context. Let's talk about the role of government. Let's talk about government intervention. I don't know how many of you have been through an income tax audit. I suspect—I've never been through one myself, but I know enough about the system to know it's not a pleasant experience. But you are talking about revenues, you are talking about income, you are talking about wages, you are talking about interest.

You have got a twenty-year-old kid fresh out of college who is there asking you questions about that. It's intrusive. You

don't like it.

All right, let's go to a use tax. Now you have got the same twenty-year-old kid there. Instead of asking you about your income and your interest and your bank statements, he's saying, tell me what books you bought, tell me what magazines you ordered, tell me what marital aids you bought over the Internet. You want to talk about an intrusive invasion into privacy, talk about administering a use tax on an individual basis. You don't want to go there. I don't want to go there. That is not good public policy.

Let me give you some quick numbers. In Utah—well, not in Utah. This is a hypothetical. Let's say you have got—let's say somebody really uses the Internet a lot. They buy \$1000 worth of stuff. And I can tell you there are probably a lot of people that are going to buy more than \$1000 over the Internet and ten years from now there are going to be a lot of people who are going to buy a lot more than \$1000 over the Internet.

Well, that works out to \$60 of sales tax at a six percent rate, which is what we have in Utah. You talk about tax administration. You say, well, let's have the use tax. Do you want to send an auditor out to collect \$60 worth of sales tax? I concede that the compliance burdens are heavy, and I concede that the states ought to work actively to reduce those burdens. But do you want a system where you have got to send an auditor out to collect \$60?

You have got two million people in the State of Utah. If two million people spend \$1000, that's \$2 billion worth of sales and it's \$120 million worth of sales tax, but you have got to do two million audits to get the money and to make sure you are getting the money. That's intrusive. That's bad tax policy. We can't go there.

Now, you can say, All right, let's get away—if you buy something over the Internet, there is no use tax, either. [It] might get you out of that problem. Well, let's talk about fairness, then.

I will concede that there are Davids in the E-commerce industry and that there are Goliaths in the traditional brick and mortar industry. But I would also submit that there are Davids in the brick and mortar industries and that there are Goliaths in the E-commerce industry.

A nice little bookstore in Utah, Waking Owl Bookstore, closed their doors; they couldn't compete anymore. Was it Amazon.com that drove them out of business? I mean, there is a

five percent, six percent differential in what you buy if you are not going to report your use tax. It probably wasn't Amazon.com. But it probably was Barnes and Noble. It was the big chains that were coming in, and Amazon.com was a part of it. [It] wasn't all of it.

If I'm going to buy twenty books a year, I might buy twenty five books a year because I'm browsing on Amazon.com. But if I'm going to buy a stereo system, I'm going to buy one. Do I go to my local retailer to buy it? Do I pay \$500 and \$30 worth of sales tax, or do I spend \$500 and not pay the sales tax? Well, that's one consideration. That's not the only consideration, but it's one consideration.

[D]o you have a lot of money sitting there that you are saying, you know, I'm not going to spend this money at Montana businesses, but, boy, because there is just nothing here that I want to buy. I've got all this extra money. So when the E-tailers start showing me all of this stuff, then I'm going to start spending a whole bunch of new money? There is a little bit of that, but most of the money that's going to be spent on E-commerce is going to come out of traditional commerce.

Now, I don't know where that is. I do think there is going to be some increased expenditure but some of that money is going to come from traditional retailers. Do you want to make that playing field uneven? It's hard, you know. . . . It's hard for my Aunt May, who sells five doilies at the state fair, to collect sales tax. She only has to do it on one rate but it's hard. It's something that she doesn't have the resources to spend a lot of time doing. It's hard for small businesses to withhold income tax on their employees. But if they get it wrong, we're going to hit them with a 100 percent penalty. That's hard, you know. If they withhold and don't pay it over, they are going to get nailed.

There are a lot of things about living in a civilized society that are hard. We ought to make it as easy as possible. Sales tax is a mess. The marshmallow thing is a mess. We have got analogous problems in Utah. It's a mess. But we have those analogous problems, in part, because we're a democracy and, in part, because our legislative representatives have been responding to the needs of their people. And we need to all work together to simplify that system.

But the way to do it is not to exempt and take out of the picture one of the most vibrant, most promising segments of our economy. We don't want to kill it, that's dumb. You don't want to kill the goose that's going to lay the golden egg but you do

want to treat it the same way you treat other people. Thank you.

MR. ROSEN: When Mark Nebergall started his presentation, he explained his role in life very honestly that he is a lobbyist. I'll do the same. I'm what's called a tax nerd, very much a technician getting lost in the details as opposed to the more important philosophical things we heard about today.

....

One thing I think is a problem when people start talking about taxation of electronic commerce is they don't do it very carefully. They muddle a lot of things together rather than thinking of the various issues that have to be analyzed on a separate basis.

What I think is very important for us to do today is, when we review everything that's been said, is we think about where it falls into.

There are several different things we want to talk about and I'll go through these pretty briefly.

....

A lot of people are concerned about the future, but I have clients who currently have problems today and we have to decide what they should do.

Now, when we talk about electronic commerce, one of the worst things you can hear people say, shall we tax electronic commerce? What does that mean, taxing electronic commerce? It doesn't really mean anything. We have to be a lot more specific. So one type of electronic commerce we have to consider is ordering tangible personal property electronically. Treat that separately than other issues. That is, you go to your home, you go on your computer, you order a shirt from a main retailer, they send you the shirt by UPS or by mail.

Another one is ordering and receiving a digitized product electronically. Now, "digitized product" is a term we've developed, those of us working in this area, to make sure we stay away from the problems associated with using words like software, canned software, tangibles, intangibles, a digitized product. For instance, you go to your home computer and you order some music and you download the music on your computer . . . that's a different type of transaction.

Next is ordering a service or executing a transaction, [a] very important area. You go home to your computer—this all assumes you are living in Southern California, you don't have

the snow you have out here—you go to your home in southern California and you order a stock transaction to take place. You buy a share of GE through your broker, through a New York server, let's say. That's an example of that type of transaction.

Next, suppose you subscribe to an on-line service provider, Internet service provider, subscribe to AT&T service or AOL service. Should that be taxed? Internet access is something totally different and being considered totally different than the sale of products, whether they be tangible products or digitized products, through the Internet. So think of that as a separate category also.

Now, what are the issues? There are four major issues we have heard talked about today and you will hear a lot about if you follow this issue. One is nexus or jurisdiction over the taxpayer. Does the state or locality have enough connection with the taxpayer to impose a tax jurisdiction on that company?

Second, is the transaction itself taxable under the tax laws that are in force? Three, where did the transaction take place? Fourth, how do you deal with the myriad of compliance problems people referred to a couple times today?

Well, first of all, the nexus issue. First, let's look at sales tax where most people have spoken earlier today. Sales tax. When should a remote seller, our main example of tangible property or music seller, when should the remote seller be required to collect a use tax? Under current law it's clear, most people believe, that if that entity, the corporate entity, let's say, that is selling that product has no physical presence in the state and has no agents in the state, then that company cannot be required to collect the state's use tax. But the question for the future is: Should those companies be required to collect the use tax?

For "business activity taxes," (and that's a term we use to encompass income taxes, corporate franchise taxes, the B & O tax³⁵ in Washington, for instance, the same questions)—under current law, you have sellers, out of state, selling to a customer . . . in California. When, under current law, can the state impose its income tax on that out-of-state seller just because it has a customer in the state? In the future, when should a state be able to impose tax in those situations?

Taxability of transactions. You know, what is really being purchased? Is that what really should drive the decision on

35. Business and Organization Tax.

what's taxable? We heard Judy Paynter [speak] of an example that a lot of people use—I knew that, I read your mind, I had a slide made while you were talking—is that if you go next door and you buy a CD from a record store—isn't that interesting, they still call it record stores, they don't sell records anymore—and you buy a CD from a record store, that's subject to sales tax in virtually every state. Every state that imposes sales tax, it is.

However, if you download music from a computer, well, should that be taxable? Well, the state tax administrators say, hey, you go next door and buy a CD, you pay tax on that, you should pay tax on that. A lot of companies say hey, wait a second: if I record music off a radio broadcast, there is no sales tax on that, and downloading off the Internet is the same as recording off a radio station's broadcast so there shouldn't be tax. So there are two sides to each of these issues, you can look at it either way.

Next question: Where is the transaction? Where did the transaction occur? In sales and use taxes the issue is, where does the sale take place, or where does the use take place? It's a very difficult decision, especially when you are looking at a sale of a digitized product. Does it take place at the vendor's server or the vendor's location . . . or the server where the customer is accessing the Internet or at the customer's location? Where is that sale taking place? You can make arguments along any of those points.

For business activity taxes, in most states that have corporate income taxes, and franchise taxes that are on capital even, there is apportionment to each state and one of the apportionment factors that is normally used is you compare your receipts in that state over your entire worldwide receipts or sales revenue.

Well, where does a sale that takes place in electronic commerce occur? Which jurisdiction's numerator, as we say, should that sale go into? Again, should it go at the business's server, the person's server, the person's location, the customer's location? [It is] another issue that you have to think about and resolve.

Compliance problems. We heard about these 30,000 tax jurisdictions, 9,000 of which currently impose sales and use taxes with different bases, different rates. The boundaries of these tax jurisdictions don't coincide with zip codes, so there is a very little way of anybody doing this accurately.

I had one matter in Southern California where a question

was in L.A. city but outside the county of L.A., or something like that. And for the one company, for one year, it was \$12 million in utility user tax. So these are major problems and they have to be simplified, and Dan Bucks earlier said the states do recognize that and they are working towards simplification.

Now, another problem with compliance is when you are selling a digitized product, where is the customer? You really don't know. You have an e-mail address but you don't know geographically where that customer is. So that's a real problem.

There is some possibility of using a surrogate for where the customer is located, such as the customer's billing address if the customer is paying by credit card, but that's not always accurate, not always available and it's difficult information to gather.

Now, the nexus issue... When you think about jurisdiction, you have to think about... four different areas in background. You have the Due Process Clause of the Constitution.³⁶ It's very important in this area; Commerce Clause,³⁷ which we're looking to most closely to protect businesses from overreaching tax administrators, if they were to exist. Three, we're looking at Public Law 86-272,³⁸ the federal statute that restricts when states or localities can impose taxes on income or taxes measured by income. Attributional nexus. When is the presence of one party in a state going to be attributed to an out-of-state party? When is an in-state party going to be the agent or the alter ego of the out-of-state company so as to give that out-of-state company enough nexus with the state so the state can impose its jurisdiction over the company?

Now, when I give this presentation to fellow tax nerds, we go through all these cases and, again, we don't have time to do this but I'll tell you there are a series of cases that say that under the Due Process Clause, a state has the right to impose its tax jurisdiction over a taxpayer if that entity purposefully directs its economic activities into the state.³⁹ There [are] the

36. U. S. Const., amend. 14, § 1 ("nor shall any State deprive any person of life, liberty, or property, without due process of law.")

37. U.S. Const., art. 1, § 8, cl. 3 ("[t]he Congress shall have the power . . . [t]o regulate commerce . . . among the several states").

38. 15 U.S.C. § 381 et seq.

39. See, e.g., *Asahi Metal Indus. Co., Ltd. v. Superior Ct. of Cal.*, 480 U.S. 102 (1987) (holding that California's claim to jurisdiction over Japanese manufacturer was unfair under the circumstances); *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985) (holding that purposeful availment requirement for long-arm jurisdiction insures that defendant will not be haled into a jurisdiction solely as the result of random contacts or

keywords, “purposeful direction of economic activities in a state.” If a company does that, under the Due Process Clause, . . . the state can impose tax.

But there are other cases that talk about the company that’s directing its activities must direct its own activities; a third party can’t bring that company’s activities into the state.⁴⁰ Merely placing something in the stream of commerce is not enough.

So . . . due process raises [the] question, for instance, if you have a web site in Missouri and people in Montana access that web site and see an advertisement for something in Missouri, does the State of Montana have nexus to tax that Missouri company?

The question is: is the Missouri company directing its activities into Montana because people from Montana are coming on the web site? So most of the cases in this area have concluded, under the Due Process Clause, no.⁴¹ The people in Montana are going out to the web site. The web site company is not directing its activities into the State of Montana.

Commerce Clause. Under the Commerce Clause, when we talk about the Commerce Clause today, we’re talking about negative or dormant Commerce Clause jurisprudence. We’re talking about when Congress has not said anything. And since the 1860s, the U.S. Supreme Court has said when Congress has said nothing in an area of the Commerce Clause, we’re going to say certain principles still apply.⁴²

And all we know so far, specific in the area of nexus, is there must be substantial nexus over a taxpayer. We know for sales tax that means the company must have physical presence; but for other activities, we don’t know what it means.

The government people say that you clearly need less . . . than a physical presence. Because they read the U.S. Supreme Court’s decision in *Quill*⁴³ saying, we really want to have a

unilateral activity).

40. See, e.g., *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980). (holding that where automobile wholesaler and retailer, who carried on no activity whatsoever in Oklahoma, a single automobile sold in New York to New York residents who happened to suffer an accident while passing through Oklahoma did not constitute “minimum contacts” with Oklahoma).

41. See, e.g., *Bensusan Restaurant Corp. v. King*, 937 F. Supp. 295 (S.D.N.Y. 1996) (holding that a person who merely activates a web site, without more, is not an act of purposeful direction toward the forum state).

42. See generally *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

43. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (holding that a mail-order

better standard but we're tied to what we said because of principle, *stare decisis* from what we said in the *National Bellas Hess*⁴⁴ case. So, you probably don't need physical presence to impose an income tax.

The business community says no. Imposing an income tax on a company is even a greater burden than just asking a company to collect tax from a customer and turn it over; that's really taking money out of the company's pocket. So it's a greater burden, so even a greater nexus is required than the mere physical presence that's okay in the sales tax area.

Public Law 86-272,⁴⁵ that's a federal statute that says the state cannot impose tax on a company's income if the company is just soliciting for sales of tangible personal property, in the state. Those orders are accepted out of state and the goods are shipped into the state. What does all that mean? Attributional nexus. We talked about agency, alter ego. Something you have to be careful of, your relationships with other entities that are in the state. . . .

Now we're to the heart of the presentation. What does all this mean in the context of E-commerce?

. . . .

The question is, if you advertise on a web site . . . is that enough to allow a state where you don't have a web site to impose tax? We talked about there are a number of cases under due process that have already been decided, about 30 cases so far, and most of those cases say if all you have is a web site that's being accessed by somebody out of the state, there is not enough nexus under the Due Process Clause.⁴⁶

Two, sending e-mails. Suppose you send a load of e-mails to somebody. To one person, you negotiate a transaction over e-mail. Are you directing your activities within that state? Nobody knows. The *Burger King* case,⁴⁷ read that case, you will

business did not need to have physical presence in the state in order for the state to require the business to collect use tax from its in-state customers, but physical presence in the state was required in order for there to be "substantial nexus" required by Commerce Cause).

44. *National Bellas Hess v. Department of Revenue of Illinois*, 386 U.S. 753 (1967) (holding that Illinois had no power to impose liability on out-of-state mail order firm to collect use taxes imposed by Illinois Use Tax Act, where mail order firm had not maintained an office, had no agents, owned no property, and had no telephone listing in Illinois).

45. *See supra* note 38.

46. *See supra* note 41.

47. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985) (holding that a contract between an individual and an out-of-state party cannot alone establish sufficient

see that might have some analogies you might want to consider.

What if you send spam . . . to people in the state? Is that enough for substantial nexus under the Commerce Clause? For due process, you are probably directing your activities in the state. Maybe that's clear. Even though you don't know the address, I can see states having a pretty good argument. But [under the] Commerce Clause, is that substantial nexus? I would doubt it.

The selling of digitized products, is that enough for a state to impose sales collection responsibility? Obviously not, there is no physical presence. But income tax, is that enough? Under P.L. 86-272,⁴⁸ clearly not, you are not in the state at all.

Now, one thing that's been said a few times, is if you have a remote seller selling into the state, that remote seller should have to pay some, say, corporate income tax to that state.

Why? Because that state is providing a market for that company. Well, a lot of us think that is just silly. The government is not providing fire and police and education for an out-of-state company. They are providing it for the businesses that are in that state. They are providing it for the people that are in that state. The fact that the state people say that, well, we're having an education system that allows our citizens to read, therefore, they can go to your web site and, therefore, order something . . . that is so indirect and de minimus. The real beneficiaries are people who live and work and businesses that are in that state.

And a lot of businesses, as an example, in Northern Virginia, big companies there talking about how important for their growth the infrastructure is. They want to pay more taxes. Right, because they are located there and that's who should pay the taxes.

. . . .

Another example . . . is a kiosk in the shopping center. Suppose a company puts a kiosk in a shopping center with a computer terminal and some signs. Can that state impose an income tax on that company? We think pretty clearly not because Public Law 86-272 says, if all you are doing in the state is soliciting for sales of intangible property, then the state cannot impose an income tax on you.⁴⁹

minimum contacts in the other party's home forum).

48. See *supra* note 38.

49. See *supra* note 38.

We know from the *Wrigley* case⁵⁰ . . . that having salespeople with cars and sample cases and order forms and computers is fine. That is okay and the states still cannot impose tax.

Is there any difference if you have a computer just on a stand? It's even less than having a person in a car driving around. So in that situation, the company is probably protected by 86-272.⁵¹

I got three calls in a period of four days from three different clients asking the same question. This happens all the time. If we create a separate subsidiary to sell over the Internet, will we have to collect the sales and use tax? [S]uppose the parent company is present in every state and has a taxable nexus with every state. Does the subsidiary, just located in Texas, have to collect the sales and use tax? We think it's absolutely clear, and I don't think anybody can seriously disagree, if the companies are separate, the parent is not the agent or the alter ego of the subsidiary, then no, subsidiary need not collect the sales and use tax.

And that case has been litigated in a little different context in Pennsylvania, in Connecticut, in Ohio, Bloomingsdale By Mail, and Saks Fifth Avenue, Sacks Folio, and in the current case in California also. And case after case, taxpayers win. After separate entities, there can't be an attribution of nexus from one to the other.

These are all the other issues we talked about. I brought the issues, you can see what they are in electronic commerce, where is the transaction. One example, a client called me. It's a software company selling high-end, . . . \$500,000 software for businesses. Client sends one hard disk to one location, and it gets so many thousands dollars for every user around the country, and it knows who those users are. Well, where is the sales tax due? Is it due where the hard disk is delivered? Is it due where all the users are?

The problem is, some states, the state where the disk is delivered, happen to say, we impose tax 100 percent on the disk. But in a number of states where the users are, they say having the right to use that is also subject to sales tax. So we end up in a multiple tax situation. We have had to do the best we can to

50. *Wisconsin Dep't of Rev. v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992) (holding that manufacturer's business activities were not sufficiently de minimus, therefore it had no statutory immunity from state income taxation).

51. See *supra* note 38.

do a reasonable approach to collecting and remitting the sales tax in that case.

We talked about the Internet Tax Freedom Act⁵² and what that's done. And [as for] the Advisory Commission on Electronic Commerce, a lot of us are working with them. Some of us have met with half the Commission members and we're working and we have high hopes, I think a lot of us, if the Commission's life is extended. There is some talk starting to go around now in Washington of extending the life of the Commission past the April due date of its report. And if that happens, based on some of the issues identified by the NTA project, there might be some resolution of some of these issues.

And there are a lot of things going on. There are a number of business coalitions. . . . There may be ten different coalitions formed by business to try to work on these issues and end up with a rational system not that will say no tax, but that will have businesses paying tax in a fair, administrable way that doesn't alter business decisions and recognizes that businesses should pay tax where they are getting the benefits from the government.

. . . .

AUDIENCE: You were referring to a Barnes and Noble-dot-com . . . ?

MR. ROSEN: As an example of a subsidiary? As an example that might qualify. That is not a client so I don't know exactly how they are structured.

The questions we get [are] how much separation does there have to be? I got a call last week, "We just want to have this new subsidiary do the selling, the marketing without taking title." We said no good. The sub must take title and must be the seller for accounting purposes, financial purposes, local wall purposes. The parent can do drop shipments, that's okay, but it must have title.

Should there be separate officers? A definite yes. We have two cases where it had in separate facilities in the city, the E-commerce sub and the parent. So as much separation as possible is what we tried to do. You can't just do it on paper because then there really are—one is really the alter ego of the other and you really can't support that they are separate

52. See *supra* note 20.

entities. Yes.

AUDIENCE: Why is the tax issue as far as like sales tax being looked at only from the location of where the purchaser is? Wouldn't it be much simpler if you were to simply say, the location of the transaction is where the merchandise is and is being shipped from, you know, the parent organization.

MR. ROSEN: There is somebody who has been promoting that and people have joined on and that's a real issue that's been raised.

There are three problems there that people focused on. Number one is if the sales tax is conceptually from an economist's view point, and you want to have a lot of different taxes (it's really consumption tax). You want to tax where the consumption takes place. So that's the conceptual underpinnings of the tax. So at origination would be a tax on production, not a tax on consumption, so that's one problem.

The second problem that people are concerned about is that just means that you are going to have everybody moving E-commerce sellers to tax havens in Montana.

Or Bermuda or Cayman Islands. We have a number of companies in the Cayman Islands now doing that. And so that's a problem with that from a compliance viewpoint. . . .

Maybe you are saying maybe we can get more revenues by increasing taxes on production, increasing state income taxes and if all we're concerned about is maintaining or increasing state revenue that's not a bad answer. But if you do want to continue the concept of having tax on consumption then that won't work for that reason.

MR. JOHNSON: Let me just add the political answer to that: there isn't a state in the union that wants to encourage its own citizens to go outside the state to do business. Why would you want to encourage your own citizens to go out and buy something from an out-of-state seller and give a disincentive from somebody outside your state to come in and use one of your businesses.

You know, the political answer is, gee, let's make it as easy as possible for people to come in and use our businesses from outside the state and let's make it as easy as possible and as painless as possible, or at least remove the incentive for our own people to go to Idaho. When we passed the Emergency Revenue

Act of 1933,⁵³ which later was renamed the sales tax, the first thing, you know, within a couple of years, we had to pass a complementary use tax because all of our citizens were going to Idaho to make purchases and there isn't a state in the world that wants to encourage that type of activity.

. . . .

MR. BUCKS: If I could I would like to comment on a couple of points and get the panel's reaction that come up in the discussion that were new.

One is, on the McCain bill⁵⁴ says simply that a sale made in electronic commerce through electronic commerce will not be subject to sales tax.

In most instances, except for the most primitive store context, it doesn't take very many changes to make that a de facto repeal of existing sales taxes, because all you need to do is convert the cash registers into an Internet connected kiosk, and turn the counter into the delivery place for the good and you have got even store sales taxes revenues repealed from taxation, and that's how most of us who have looked at that bill are looking at that.

. . . .

Secondly, I think there was a very good point made about privacy, and I just wanted to add that the systems that the states are beginning to look at create a new business model for sales tax collection are very dedicated to the notion that no data should be collected by government in the normal purchase situation that identifies either the individual or the address of the individual.

That's not necessary for tax purposes, unless a taxpayer is asserting an exemption by use, their use or their entity, the nature of their entity, and in that case, that information is already available and accessible under current legal principles so that you can monitor whether people are abusing that. But I think consumer privacy protection is very essential in the design of the system and there was a concern raised about that and I agree with that concern. And the states are very cognizant of that, and do not believe that there ought to be compromises on purchaser privacy

53. UTAH CODE ANN. § 59-15-1 et seq. (1985). The statute was renamed the "Sales and Use Tax Act" in 1987, and renumbered as § 59-12-101.

54. See *supra* note 19.

MR. ROSEN: Any response from anybody? I would just throw in the idea that E-commerce is destroying small businesses . . . [is] not totally true. A number of small businesses, the classic mom-and-pop operations, are also getting involved, a lot of them are getting involved to a large degree in electronic commerce. You see commercials all the time on television about the small shops that are now selling worldwide. So there is a displacement taking place, but it's not as, maybe, drastic as it may sound, because everybody is able to benefit, as Dan was saying, the local stores could also get involved [in] electronic commerce but in the McCain bill that would be no tax at all.⁵⁵

MR. SWINDLE: The Federal Trade Commission[']s . . . ultimate goal is consumer welfare and that means getting to consumers the best possible products at the most reasonable cost possible. In other words, the competitive environment where innovation creativity and price is all done for the benefit of the consumers.

The comment was made that the Internet is drying up small businesses and entrepreneurs that you just touched on. Wal-Mart (I'm from the deep south and I guess we have Wal-Marts out here, too), but, they are taking their toll in small rural communities. Is anybody doing anything to protect the small businesses there?

Consumers are making out like a bandit because they are getting an enormous variety of products at lower than typical prices, but small businesses are taking the hit. This is the evolution of business, folks, and we're not going to stop economics. It's going to work as creativity, new ideas come along, and it's going to be just one of those things that happened. And, I'm not saying I'm not sensitive to it because I come from a family involved in small businesses, and I know in grocery store businesses, we just went right down the tube. But, it would be hard for me to argue that consumers are not better off with Safeways and Food Giants and others.

The other thing, this concept of having access fees . . . what's the comparable condition for a consumer to go down here, downtown Missoula, and go to a store that sells something. What's the access fee they pay for that? The point is, and I am

55. See *supra* note 19.

not saying there should be no ultimate tax on Internet commerce. I am saying, folks, this is complicated, and we best look before we leap because the situation as it has been said by every presenter here, the current situation is replete with double taxation, multiple taxation, overlaps, and everybody is anxious to start taxing. And, I'll guarantee you we'll do it wrong and that will have extraordinary consequences.

