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The Taxation of E-Commerce: The Inapplicability of Physical Presence Necessitates an Economic Presence Standard

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I. INTRODUCTION

{1}The explosive growth of electronic commerce has served as a catalyst for immense economic growth.[1] Virtually every aspect of traditional commerce now has some presence on the Internet. As such, the way people shop for clothing, cars, airline tickets, and even groceries, has been changed forever. However, these developments may also have drawbacks. As more and more traditional brick-and-mortar stores transfer their operations to the Internet, there are many unintended consequences. The traditional infrastructure of retail stores may slowly begin to erode. Similarly, jobs in the retail industry may be eliminated in favor of more efficient, more cost-effective Internet technology.

{2}Electronic commerce will also directly impact state and local governments as their tax laws are not universally applicable to all Internet sales. Under *Quill Corp. v. North Dakota*, [2] an out-of-state vendor must have a physical presence in a state before the state may require it to collect sales taxes from its customers.[3] Examples of when physical presence has been found include the presence of sales personnel, [4] the maintenance of local retail stores, [5] and the solicitation of business by independent contractors in the state.[6] Given the inherent nature of the Internet, this physical presence requirement essentially enables Internet vendors to escape collection requirements in most states where they have customers. At present, the only acceptable means by which an Internet vendor can establish physical presence is through the existence of a warehouse, office, or employees in a given state. Operating a web site[7] or shipping goods[8] into a state does not render an Internet vendor physically present in a state. Courts disagree as to whether advertising is sufficient to create a physical presence within a state.[9]

{3} Since states cannot require vendors without a physical presence to collect sales tax, [10] as electronic commerce continues to grow, state and local governments will lose an increasing percentage of their sales tax base each year. [11] In 1999 alone, states lost \$525 million in foregone sales taxes due to an inability to collect these taxes on Internet purchases. [12] In other contexts where states cannot collect sales taxes for the purchase of goods from out-of-state vendors, states instead seek to collect a use tax. [13] Use taxes are "imposed upon the storage, use, or consumption of tangible personal property within the state, [with] property upon which sales tax has been paid being exempt." [14] Such taxes "put local retailers subject to the sales tax on a competitive parity with out-of-state retailers exempt from the sales tax." [15]

{4} While the Constitution prohibits sales taxes from being assessed on purchases made outside the state's borders, [16] use taxes may in fact be constitutionally applied to such purchases, which are then brought into the taxing state for use or consumption. These use taxes will become increasingly more important as electronic commerce continues to grow and fewer Internet transactions are subject to sales taxes as compared to traditional commerce. [17] Unlike sales taxes, which are constitutionally restricted in their *assessment* upon purchases, [18] the constitutional limitation upon use taxes primarily arises in their *collection*. An out-of-state vendor must have a taxable nexus with the state before it can be required to collect the use tax from the consumer and remit it to the state. [19] As in the sales tax context, that nexus only exists if the vendor has a physical presence in the state. [20] For example, if a consumer purchases goods from either a mail-order or an Internet company, neither of whom have a physical presence within the consumer's state of residence, a state cannot assess a sales tax or require a vendor to collect a use tax on the state's behalf for that purchase.

{5} Because the Constitution limits a state's ability to require vendors to *collect* a use tax on the state's behalf, and not the state's authority to *assess* the use tax on purchases used within the state, states will increasingly assess use taxes in circumstances when a vendor lacks the physical presence sufficient for the state to require the vendor to collect the sales or use tax. Unless the vendor voluntarily collects the use tax, [21] however, it must be collected directly from purchasers, thus posing severe collection problems for state and local governments. Most states do not have an effective system in place to monitor use tax obligations, [22] and thus, the majority of Americans are not aware of their duties to pay such use taxes. [23] States would prefer requiring out-of-state vendors to collect these use taxes from customers and then remit the revenues to the states; since Internet vendors will rarely satisfy the physical presence standard in more than a few states, the inherent nature of the Internet makes an already difficult collection problem virtually impossible. It is estimated that in 2000, state and local governments may have lost as much as \$9.1 billion in lost *use* tax revenues, one-third of which is attributable to use taxes owed on Internet purchases. [24] By 2003, state and local governments will lose an estimated \$12.5 billion annually from lost *sales* taxes [25] and an additional \$20 billion annually in uncollected *use* taxes on Internet purchases. [26]

{6} It quickly becomes apparent that the existing tax scheme is inherently unequal in its tax treatment of traditional commerce versus e-commerce. Taxes on traditional commerce are currently assessed and collected more effectively than on electronic commerce, thus customers will be increasingly inclined to make their purchases through the Internet because of the favorable tax treatment afforded to electronic commerce. This result is inconsistent with the principle of tax neutrality, that the taxes assessed on goods not impact a consumer's decision to purchase goods from a particular vendor through a given medium. [27] The current system must be modified to create tax neutrality across all forms of commerce, thus treating traditional brick-and-mortar, mail-order, and Internet vendors equally. "Ideally, tax rules would not affect economic choices about the structure of markets and commercial activity." [28]

{7} This paper argues that the physical presence standard cannot accommodate the intricacies of electronic commerce. Under the current legal framework, it will be impossible to achieve tax neutrality, because Internet vendors will be able to avoid creating the physical presence that triggers tax obligations in most states. Courts should abandon the physical presence standard in favor of the economic presence standard

adopted in other contexts.[29] Such a standard is easily applicable to e-commerce transactions and enables states to require vendors to collect sales and use tax revenues. Alternatively, if the courts do not resolve this issue, Congress is empowered under the Commerce Clause to legislatively overrule the physical presence requirement and adopt a standard that restores tax neutrality to all forms of commerce.

{8}Part II discusses the Supreme Court cases addressing the constitutionality of the states' application of sales and use tax requirements to out-of-state vendors. The Supreme Court has essentially required that a vendor have a "substantial nexus" to the taxing state, and has determined that only a physical presence satisfies that requirement in the sales and use tax contexts. However, the emergence of the Internet has created logistical problems in applying this physical presence standard to electronic commerce, and these issues are discussed in Part III. Finally, the efficacy of an economic presence is analyzed, and ultimately, economic presence is suggested as an alternative to the ineffective physical presence requirement.

II. CONSTITUTIONAL ANALYSIS

{9}Two provisions of the Constitution limit states' ability to require out-of-state vendors to collect sales taxes: the Due Process Clause of the Fourteenth Amendment[30] and the Commerce Clause in Article I, section 8.[31] The Constitutional tests for satisfying these provisions were established well before the Internet became commonplace. The two most pertinent cases regarding sales and use tax collection by out-of-state vendors, *National Bellas Hess v. Department of Revenue*[32] and *Quill Corp. v. North Dakota*[33], both involved mail-order catalog companies. The Commerce Clause, particularly the negative aspects of this clause that limit state regulation, imposes the most significant limitations on states' ability to require out-of-state vendors to collect sales and use taxes. This Part addresses these Due Process and Commerce Clause concerns respectively.

A. The Due Process Clause

{10}The Fourteenth Amendment to the United States Constitution requires that no state shall "deprive any person of life, liberty, or property, without due process of law . . ."[34] The Due Process Clause "centrally concerns the fundamental fairness of governmental activity." [35] When the government action at issue is a court's exercise of personal jurisdiction over an individual, the key question is whether the defendant had adequate notice that his "conduct and connection with the forum State are such that he should reasonably anticipate being haled into court there." [36] Courts apply this due process analysis used in ascertaining personal jurisdiction to determine the constitutionality of a state's taxing scheme under the Due Process Clause.

1. Due Process and Personal Jurisdiction

{11}To establish personal jurisdiction, a party must have minimum contacts with a state "such that the maintenance of a suit does not offend `traditional notions of fair play and substantial justice.'" [37] Due process may be satisfied by an out-of-state vendor who "purposefully avails itself of the benefits of an economic market in the forum State." [38] The Court has recognized:

it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are `purposefully directed' towards residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.[39]

{12} There have been an increasing number of personal jurisdiction cases involving the Internet. In *Zippo Manufacturing Co. v. Zippo Dot Com*,^[40] the court found that "the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet."^[41] Additionally, in *Inset Systems, Inc. v. Instruction Set, Inc.*,^[42] the court held that a company with no physical contacts in the state was subject to personal jurisdiction because its advertising activities on the Internet and its toll-free telephone number constituted "purposeful availment."^[43] Similarly, in *Compuserve, Inc. v. Patterson*,^[44] the Sixth Circuit found personal jurisdiction was established exclusively through Internet contacts.^[45] The court "recognized the ability of the Internet to greatly expand a company's potential market far beyond a single state's border."^[46] Accordingly, the court found the parties' Internet transactions were substantial enough to satisfy due process requirements and assert personal jurisdiction.^[47] These cases exemplify how readily courts apply existing due process jurisprudence to the Internet, thus enabling parties to assert personal jurisdiction.

2. Due Process and Taxation

{13} Courts have easily adapted the due process analysis for personal jurisdiction to the state taxation context. The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax."^[48] Although the Supreme Court initially applied a physical presence analysis in assessing the constitutionality of a state's tax machine,^[49] it later moved to the more flexible standard that now predominates in the personal jurisdiction context.

{14} In *Bellas Hess*, the Supreme Court found that since the Missouri mail-order company did not maintain a place of business or have any agents in Illinois, and its sole contact with the State was via the mail or common carrier, any law requiring it to collect Illinois taxes violated the Due Process Clause.^[50]

The Court has upheld the power of a State to impose liability upon an out-of-state seller to collect a local use tax in a variety of circumstances. . . . [However,] the Court has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail.^[51]

The *Bellas Hess* Court recognized the strong distinction it has made over the years between the physical presence of retail outlets within a state and companies that only communicate with customers via mail or common carrier; it found this distinction "a valid one, and we decline to obliterate it."^[52] Thus, the Court essentially required that an out-of-state vendor have a physical presence in a state before it is required to collect taxes; the absence of such a presence would render the state's actions a violation of the Due Process Clause.^[53] As discussed below, the Court in *Bellas Hess* applied a similar analysis to the question of whether the state's taxing scheme was consistent with the negative implications of the Commerce Clause.^[54]

{15} Twenty-five years later in *Quill*, however, the Supreme Court overruled the portion of the *Bellas Hess* decision that required a physical presence for due process purposes.^[55] The Court recognized the evolution of due process jurisprudence and

[i]n that spirit, we have abandoned more formalistic tests that focused on a defendant's `presence' within a State in favor of a more flexible inquiry into whether a defendant's contacts with the forum made it *reasonable*, in the context of our federal system of Government, to require it to defend the suit in that State.^[56]

Thus, under *Quill*, if an out-of-state vendor purposely avails itself of the economic benefits of the state, physical presence is not necessary under the Due Process Clause for the vendor to be subject to the state's use tax collection requirements.^[57]

{16} Since the due process requirements were considerably weakened in *Quill*, primarily through the abandonment of the bright-line physical presence requirement, due process does not pose a significant obstacle to states implementing collection duties upon out-of-state Internet vendors.^[58] The Commerce Clause remains the primary hurdle for such state interests.

B. The Commerce Clause

{17} Once the requirements of the Due Process Clause are deemed satisfied, courts must consider the constitutionality of state tax laws under the Commerce Clause.^[59] The underlying concerns of the Commerce Clause are distinct from those of the Due Process Clause. While the Due Process Clause is concerned with the government treating persons fairly, the dormant Commerce Clause instead focuses on whether a state regulation places an undue burden upon interstate commerce.^[60]

{18} The Commerce Clause provides that "Congress shall have power . . . [t]o regulate commerce with foreign Nations, and among the several States. . . ." ^[61] Courts have "consistently held this language to contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even where Congress has failed to legislate on the subject." ^[62] The Supreme Court has determined it would "jeopardiz[e] the welfare of the Nation as a whole . . . if [states] were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear." ^[63] Thus, while the dormant Commerce Clause permits a court to strike down unduly burdensome regulation, the Commerce Clause itself empowers Congress to either limit^[64] or expand^[65] states' ability to pass laws regulating interstate commerce. As a result, Congress can pass federal legislation enabling states to impose taxes upon electronic commerce that would otherwise be unconstitutional under the dormant Commerce Clause.^[66]

{19} In *Bellas Hess*, in addition to finding that the state tax regulation violated the Due Process Clause, the Court held that the state violated the Commerce Clause by requiring a vendor to collect use taxes from customers when the vendor's only contacts with the state were by mail or common carrier.^[67] In the twenty-five years between the Supreme Court decisions in *Bellas Hess* and *Quill*, the Court established a four-prong test to help determine whether the dormant Commerce Clause prohibited a state's imposition of a tax upon an out-of-state vendor. In *Complete Auto Transit, Inc. v. Brady*,^[68] the Court established that a tax does not violate the dormant Commerce Clause so long as the tax: "is applied to an *activity* with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by the State." ^[69] Satisfying the first prong of this test has been the primary impediment to states' efforts to tax e-commerce.

{20} In *Quill*, the major issue before the Court was whether a mail-order company with no offices or representatives in North Dakota had a "sufficient nexus" with the state to be required to collect use taxes from its North Dakota customers.^[70] The Court recognized that, "it was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing business." ^[71] Yet, the Court held that since *Quill* had no stores or representatives in North Dakota, it did not have a physical presence within the state, and thus could not be required to collect use taxes from North Dakota residents.^[72] Despite *Quill*'s minimum contacts with North Dakota which satisfied due process requirements, the tax failed to satisfy the dormant Commerce Clause requirements.^[73] The Supreme Court agreed with the North Dakota Supreme Court's assessment of dormant Commerce Clause jurisprudence as indicating a "retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible substantive approach." ^[74] Nonetheless, the United States Supreme Court declined to depart from the *Bellas Hess* Court's analysis of the dormant Commerce Clause issue.^[75] The Court went on to say that, "although our Commerce Clause jurisprudence now favors more flexible balancing analyses, we have never intimated a desire to reject all established 'bright line' tests." ^[76] Accordingly, in *Quill* the Court retained *Bellas Hess*'s requirement that an out-of-state vendor must have a physical presence before it is

required to collect state use taxes; if that physical presence is lacking, the vendor will not have the requisite "substantial nexus" with the state.

{21} Courts consider numerous factors in ascertaining whether a vendor is physically present within a state to justify imposition of sales and use tax collection requirements. The *Bellas Hess* Court cited the following as indicative of a *lack* of physical presence: no place of business, agents or representatives, tangible property, telephone listing, or advertising within the state.[77] In *Quill*, the mail-order company licensed software to its customers in the taxing state; however, this alone did not satisfy the requisite "substantial nexus." [78] In both *Bellas Hess* and *Quill*, the out-of-state vendor's only significant contact with the taxing state was via the United States mail or common carrier, thus the vendors in both cases failed to establish the physical presence necessary to constitute "substantial nexus." [79]

{22} By separating the constitutional analyses of the Due Process and Commerce Clauses, the *Quill* Court invited Congress to intervene using its authority under the Commerce Clause. The Court explicitly stated that, "while Congress has plenary power to regulate commerce among the states and thus may authorize state actions that burden interstate commerce, it does not similarly have the power to regulate violations of the Due Process Clause." [80] Thus since the two analyses were combined in *Bellas Hess*, any legislation Congress would enact would be unconstitutional and violate the Due Process Clause. [81] The Court recognized that such a decision not to enact legislation may

have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes. [82]

The dormant Commerce Clause requirements remain the principal issues of concern to states seeking to require out-of-state vendors to collect sales and use taxes.

III. THE INAPPLICABILITY OF EXISTING TAX LAWS TO THE INTERNET AND E-COMMERCE

A. Existing Law

{23} The requirements of the Due Process and Commerce Clauses remain the primary limitations placed upon states in their efforts to assess and collect sales and use taxes on purchases made through interstate commerce. *Quill* established that the requirements of the Due Process Clause may be satisfied "irrespective of a corporation's lack of physical presence in the taxing State." [83] A state may reasonably impose a use tax collection duty, consistent with the Due Process Clause, upon any out-of-state vendor that has "minimum contacts" with the taxing State. These "minimum contacts" may be achieved by a vendor who has "purposefully directed its activities" at the State [84] or has "engaged in continuous and widespread solicitation of business within a State." [85]

{24} In contrast to the due process requirements redefined in *Quill*, Commerce Clause jurisprudence continues to require out-of-state vendors to have a physical presence within the taxing state before the state may constitutionally impose use tax collection duties upon the vendor. [86] The requisite physical presence has been identified by courts as constituting sales personnel, retail stores, and solicitation of business by agents within the state. [87]

B. The Inapplicability of Physical Presence to Internet Vendors

{25} The current definition of physical presence makes it extremely difficult for states to require vendors to

collect sales and use taxes on Internet purchases. Internet companies may generate sales without the presence of employees or agents within a state. Similarly, their website displays their products and thus, they do not need stores to market their products. Yet Internet purchases are analogous to mail-order sales in that tangible purchases are delivered via the mail or common carrier, thus invoking the application of *Bellas Hess* and *Quill*. However, it may be more difficult to ascertain the location of the point of sale in the Internet context. Presumably the point of sale is the state to which the goods are shipped, and thus, the consumer owes sales taxes to this state. If the Internet company has a "substantial nexus" with that state, the sales tax will be collected at the point of sale. Otherwise, the customer will owe a use tax to the state in which the product is consumed. This inevitably leads to questions as to how an Internet company establishes physical presence in a state. To date, the same general standards apply to Internet companies as apply to traditional businesses. The result is Internet vendors are virtually immune from sales and use tax collection requirements. This physical presence requirement seems to encourage both mail-order and Internet companies alike to establish corporate offices, warehouses, and distribution centers in the five states that do not impose sale taxes.^[88]

{26}Internet purchases will become increasingly appealing to customers as many businesses will lack the requisite tax situs in most states, and thus the sales tax will not be collected at the point of sale. States' inability to effectively collect use taxes will enable consumers to avoid payment of such use taxes. In fairness, while most consumers may not be aware of their use tax obligations, the resulting effect upon states is the same--the loss of significant amounts of revenue each year.

{27}Courts have successfully applied existing laws to the world of Cyberspace in numerous non-tax contexts, including personal jurisdiction, criminal law, and intellectual property.^[89] Jack Goldsmith, a professor at the University of Chicago Law School and scholar in the field of cyberlaw, believes existing laws can be successfully applied to Cyberspace, although they may require some tweaking and slight adaptations.^[90] Goldsmith argues it is legitimate to apply a state's laws to those actions having an effect within that state.^[91] "The medium by which the harm is transmitted into the regulating jurisdiction be it economic interdependence, postal mail, wind currents, or the Internet is not relevant to the justification for regulating it."^[92] Applying Goldsmith's theory in the context of e-commerce suggests that transactions should not be immune from taxation solely because the sale is conducted through a medium distinct from that of a traditional brick-and-mortar retailer. *Bellas Hess* and its progeny requiring a physical presence to satisfy the dormant Commerce Clause are outdated and not easily applicable to mail-order and Internet sales. Furthermore, they negate any tax neutrality between traditional, mail-order, and Internet purchases. If tax neutrality were restored between traditional purchases and mail-order sales, it would logically follow that Internet sales should continue to be treated the same as mail-order.

1. No Longer the Bright-Line Test the Court Envisioned

{28}In *Quill*, the Supreme Court seemed to retain the physical presence requirement because it perceived that it would serve as a bright-line test. As discussed below, however, the Supreme Court's requirement of a physical presence within a state to constitute a substantial nexus is no longer the instructive bright-line test it was at the time of its introduction. In deciding *Quill*, the Court explicitly stated that "the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause."^[93] In so ruling, the Court acknowledged that:

[I]ike other bright-line tests, the *Bellas Hess* rule appears artificial at its edges. . . . This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.^[94]

However, in his dissenting opinion, Justice White questioned the clarity of this bright-line test, and asserted that "[r]easonable minds surely can, and will, differ over what showing is required to make out a `physical

presence' adequate to justify imposing responsibilities for use tax collection." [95] He suggested that "[t]he majority clings to the physical presence rule not because of any logical relation to fairness or any economic rationale related to principles underlying the Commerce Clause, but simply out of the supposed convenience of having a bright-line rule." [96]

{29} There are many characteristics of the Internet and electronic commerce that distinguish it from more traditional forms of commerce and may diminish the effectiveness of this bright-line test. These differences, such as a lack of dependence on physical location, the irrelevance of geographic borders, the absence of any central governing entity, the ability of users to maintain anonymity, and the low cost of entry, have particular importance in the taxation of electronic commerce. [97] These factors contribute to states' difficulty in imposing sales and use tax collection duties upon Internet vendors as a literal physical presence can often be avoided. Given the "dimness" of this bright-line test in its application to the Internet and e-commerce, the Supreme Court can no longer cite the benefits of a bright-line test as a justification for upholding *Quill*.

{30} The Court has frequently distinguished Commerce Clause cases on their facts from existing precedent. [98] However, it insists that, "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." [99] Furthermore, the Court acknowledged that, "while contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today," it insisted that "*Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases." [100] The Court honored established precedent in upholding *Bellas Hess*' physical presence requirement to satisfy the dormant Commerce Clause, despite significant technological advances that may render such adherence inappropriate.

{31} Courts may continue to limit *Quill*'s application to sales and use taxes, or they may distinguish Internet and e-commerce cases involving intangible property from *Quill* which involved tangible property. [101] However, the end result of many lower courts distinguishing cases on the facts is that Commerce Clause jurisprudence no longer connotes a clear answer to state taxation issues. Rather, there is divisiveness amongst cases and scattered precedent that is often confusing and difficult to follow. As more and more states attempt to force out-of-state Internet vendors to collect sales taxes, courts may be forced to draw additional lines of demarcation and distinguish cases on the facts. As a result, it is becoming increasingly difficult for individuals and businesses alike to ascertain what taxes they may owe.

2. Undue Burden Concerns Should Not Be a Determining Factor

{32} The policy behind the Commerce Clause, that of preventing undue burden upon interstate commerce, continues to guide courts in determining the constitutionality of state taxing schemes. In deciding that both the Due Process and Commerce Clauses were violated in *Bellas Hess*, the Court specifically mentioned the 2,300 taxing jurisdictions to which an out-of-state vendor may be subject. [102] Yet in the lower court's decision in *Quill*, the North Dakota Supreme Court identified technological advances in the computer industry as a modern means of easing the burden of compliance with various state and local taxing jurisdictions. [103] The court declined to follow *Bellas Hess* because "the tremendous social, economic, commercial, and legal innovations' of the past quarter-century have rendered its holding `obsolete.'" [104] However, the United States Supreme Court rejected these technological advancements as insufficient to overcome any threatened undue burden. The Supreme Court again in *Quill*, as in *Bellas Hess*, specifically addressed the number of taxing jurisdictions an out-of-state vendor may ultimately be subject to--over 6,000 in 1992, up from 2,300 in 1967. [105]

{33} Today, the combination of sophisticated software and the promise of states' simplifying their tax laws ensures that state laws requiring businesses to collect sales and use taxes will not unduly burden interstate commerce. These developments suggest that it may be appropriate for courts to move away from the bright-

line physical presence test. Previous notions of undue burden are no longer determinative as "[t]he Internet along with developments of software gives the taxman a set of tools that is much more powerful in obtaining information than anything that's been used in the past." [106]

{34} Additionally, simplification of the numerous existing tax laws would help appease the courts' fears of burdening businesses, and hence interstate commerce, with the responsibilities of collecting and paying taxes to numerous jurisdictions. Computer software can be modified to enable both states and businesses to comply with existing laws. Proponents of simplification argue that "[s]implification of the structure of the existing `system' is a sine qua non of any solution to the problem," [107] and that the real debate is whether such simplification should be mandatory or voluntary. However, states' voluntary participation in a simplification plan does seem to provide the kind of long-term, nationwide solution that is necessary.

{35} Not surprisingly, the major opponents of Internet taxation are technology companies who have undergone rapid growth and fear additional taxes will hinder future growth. "The biggest obstacle to achieving simplification today is the belief by many Internet businesses that Congress will save them from taxation. Ironically, technology makes simplification much more achievable, yet businesses that owe their existence to technology deny its capabilities when it comes to taxes." [108]

{36} Despite the objections of the technology industry, states are leading the initiative towards simplification. From their standpoint, expending resources now to create a manageable system is in their own long-term best interests. They anticipate it will lead to Congressional action permitting states to collect sales and use taxes on Internet purchases. However, even among proponents of simplification, different factions are forming, each with their own view of what form this simplification should take. [109] Thus, simplification of existing tax laws may be too idealistic an undertaking that will not produce immediate results.

{37} Two of the reasons for *Quill's* retention of a physical presence standard, the ease of a bright-line test and the prevention of an undue burden on interstate commerce, appear to be diminished by an increasingly diverse e-commerce business and the evolution of modern technology. [110] These advances both complicate the application of a physical presence standard to the Internet, and simultaneously, through the imposition of software, ease concerns that existing tax laws are unduly burdensome on interstate commerce.

C. Change is Necessary to Achieve Tax Neutrality

{38} Given the increasing dominance of electronic commerce, and the states' great dependence upon their sales and use taxes as a major source of revenue, [111] imminent change in existing laws is necessary to ensure these two competing worlds can successfully coexist. [112] The states' difficulty in imposing tax collection duties upon out-of-state vendors is a major obstacle to creating tax neutrality. In addition, the non-physical, intangible nature of the Internet and electronic commerce renders a physical presence standard inapplicable to such transactions as it is difficult to identify a physical presence from most Internet companies' operations. It is inappropriate for the infrastructure of the Internet itself to constitute physical presence in a state. For servers may be easily rerouted through other servers, which would presumably pass through different states, thus negating any physical presence in the original state. [113] Rendering this physical presence would create an enormous incentive to route servers through the states which do not assess sales or use taxes. [114] The current definition of a literal physical presence of property within the state perpetuates existing inequalities in traditional commerce between retail and mail-order sales, and extends these inequalities into the Internet context. Thus, courts should abandon this physical presence requirement and adopt an economic presence standard which will enable states to collect sales and use taxes from mail order and Internet purchasers. If the courts do not address this issue, Congress should act by legislatively overruling this physical presence standard. Presumably Congress could restore tax neutrality to all forms of commerce by establishing an economic presence standard that applies to brick-and mortar, mail-order, and Internet purchases.

1. Courts Should Abandon Physical Presence Test in Favor of Economic Presence

{39} Economic presence, defined wholly independently of any physical presence, is easily applicable to the Internet and e-commerce.[115] An out-of-state seller's actual delivery of goods into a state would satisfy an economic presence requirement.[116] To protect small businesses, a de minimis standard must be satisfied before one is subject to tax collection responsibilities.[117] Factors relevant to an economic presence analysis include the number of customers in a state, advertising in the state, and total revenues generated from the state's residents.[118] The addition of these factors to any dormant Commerce Clause analysis appears logical since a vendor's ability to collect and pay taxes within a state is related to its *sales* within the state.[119] "[A] state's *ability* to collect use tax does not turn solely upon whether the remote seller maintained a physical presence in that state." [120] Furthermore, "in today's economy, physical presence frequently has very little to do with a transaction a State might seek to tax." [121]

i. Financial Institutions Analogy

{40} The tax treatment states assert on financial institutions may be a useful analogy in applying an economic presence standard to e-commerce. States may tax financial institutions that have a taxable nexus within the state, so long as such taxation does not violate the Constitution.[122] States have determined that *Quill's* application is limited to sales and use taxes, and thus not applicable to financial institutions.[123] As such, states have declined to apply a physical presence standard, instead opting for an economic presence standard.[124] Such an economic presence focuses on all contacts with a state, particularly any "economic exploitation" of the state's markets.[125] Economic presence is premised on the belief that the state's infrastructure "creates and maintains the consumer market and economic climate that fosters demand for the seller's goods and services." [126] Thus, this same standard could be successfully applied to e-commerce.

ii. Geoffrey Decision

{41} Less than a year after the United States Supreme Court decided *Quill*, the Supreme Court of South Carolina heard a similar case, *Geoffrey, Inc. v. South Carolina Tax Comm'n.*[127] The distinguishing feature between the two cases was the type of tax at issue. While *Quill* was concerned with use taxes, *Geoffrey* involved state income taxes. This difference proved sufficient for the Supreme Court of South Carolina to distinguish *Geoffrey* on its facts from *Quill*, and decline to apply *Quill*. [128]

{42} *Geoffrey, Inc.*, a wholly-owned subsidiary of Toys R Us, Inc., had no employees or offices within South Carolina.[129] Nonetheless, South Carolina asserted income tax liabilities on *Geoffrey* based upon its intangible property within the state, specifically its trademarks, trade names, and account receivables.[130] The court held that *Geoffrey's* presence satisfied due process requirements "by licensing intangibles for use in South Carolina and receiving income in exchange for their use" [131] In its dormant Commerce Clause analysis, the Court stated, "[i]t is well settled that the taxpayer need not have a tangible, physical presence in a state for *income* to be taxable there. The presence of intangible property alone is sufficient to establish nexus." [132]

{43} States have had varying responses to the *Geoffrey* decision. Some have legislatively adopted the *Geoffrey* Doctrine,[133] others have applied the Doctrine without any enabling legislation,[134] and still other states have rejected the Doctrine altogether.[135] This lack of uniformity erodes the predictability for businesses engaging in interstate commerce and threatens to undermine the very purpose of the Commerce Clause. Nonetheless, states are taking the initiative and applying an economic presence standard precisely because existing case law is limited to sales and use taxes, and economic presence accounts for the intangible, transient nature of electronic commerce. This discrepancy between sales and use taxes versus income and excise taxes needs to be resolved. Presumably, the same standard should apply to each. An

economic presence standard will bring this uniformity to existing tax schemes and simultaneously, will easily apply to the emerging electronic commerce industry.

2. If Courts Do Not Address this Issue, Congress Should Act

{44}Congress's concern about Internet taxation culminated in the enactment of the Internet Tax Freedom Act (ITFA) in October 1998.[136] The ITFA imposed a three-year moratorium on state and local taxes on Internet access and on any multiple or discriminatory taxes on electronic commerce.[137] Since very few states impose taxes on Internet access, a permanent moratorium on such taxes is not particularly controversial. However, what is more problematic to most states is the provision regarding discriminatory taxes. The ITFA defines a discriminatory tax as: "any tax imposed by a State or a political subdivision thereof on electronic commerce that is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means"[138] Additionally, the ITFA provides that using an Internet access provider to create nexus for a remote vendor constitutes a discriminatory tax.[139] Congress introduced a wide variety of bills in recent months in efforts to find a permanent solution prior to the moratorium's expiration on October 21, 2001.[140] The bills varied from seeking to permanently extend various aspects of the ITFA to simplifying states' tax laws to banning the taxation of e-commerce.[141] However, no clear consensus emerged and the ITFA expired without the enactment of any new legislation. On November 15, 2001, the Senate passed the Internet Tax Nondiscrimination Act that extends the moratorium on Internet access taxes, and multiple discriminatory taxes on Internet commerce, for two years.[142] The Act noticeably excludes discussion of remote sellers collecting sales taxes on Internet purchases; this remains a critical, and contentious, issue which Congress must address.

{45}Once courts establish precedent that explicitly involves electronic commerce, Congress may be more likely to adopt the judicially created requirements and require their universal application on a national level. The largest obstacle Congress faces in this pursuit is the various competing interests, all of whom will be affected by the enactment of any legislation. Congress itself has little, if anything, to gain from enacting legislation that permits states to effectively tax a greater percentage of transactions. Thus, one must doubt the likelihood that Congress will pass the necessary legislation. However, a perpetuation of the status quo will encourage states to try to expand the definition of physical presence to areas of electronic commerce, without violating the Commerce Clause.[143]

IV. CONCLUSION

{46}"Electronic commerce holds the potential to drastically increase the penetration of markets by out-of-state vendors with little or no physical presence in market states." [144] Internet vendors will be free to operate and generate revenue without incurring obligations to collect sales or use taxes from their customers. As a result, states will lose an increasing percentage of their tax base as more business is conducted over the Internet. The dissent in *Bellas Hess* notably recognized that "the volume [of sales] which . . . will be placed in a favored position and exempted from bearing its fair burden of the collection of state taxes certainly will be substantial, and as state sales taxes increase, this haven of immunity may well increase in size and importance." [145] Thus, changes must be made to existing tax laws to accommodate the complexities introduced by the emerging e-commerce industry. In the electronic commerce context, it is easier for both states and businesses to determine an economic presence within a state than a physical one. Such an economic presence standard would place traditional brick-and-mortar stores on a level playing field with both their mail-order and Internet competitors, thus creating tax neutrality.[146]

{47}In *Quill*, Justice White questioned "the rationality of perpetuating a rule that creates an interstate tax shelter for one form of business mail-order sellers but no countervailing advantage for its competitors. If the

Commerce Clause was intended to put businesses on an even playing field, the majority's rule is hardly a way to achieve that goal." [147] Justice White's comments show significant foresight and his concerns have more than materialized with the introduction of the Internet and electronic commerce. A physical presence test first adopted in 1967 and reaffirmed in 1992 is inapplicable to an age in which transactions may be conducted through an intangible, transient medium. Courts should reconsider this physical presence requirement and adopt an economic presence standard that is more readily applicable to both mail-order and Internet sales. If the courts do not act, it is within Congress's authority under the Commerce Clause to accept the Supreme Court's invitation in *Quill* and legislatively overrule the physical presence standard. [148] It is now up to either the courts or Congress to establish tax neutrality between traditional and electronic commerce and enable states to collect the sales and use taxes to which they are entitled.

ENDNOTES

[*]. J.D., Notre Dame Law School, 2001; Thomas J. White Scholar, 1999-2001; A.B., College of the Holy Cross, 1998. I am grateful to my mom, Maureen Lundy, for her unceasing love, support, and inspiration. I would like to thank Professor Patricia L. Bellia for her invaluable comments and suggestions on previous drafts of this Note.

[1]. U.S. electronic commerce sales will reach an estimated \$108 billion by 2003, comprising 6% of all U.S. retail spending. See R. Todd Ervin, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 523 n. 30 (2000) (citing Katherine Goncharoff, *News Flash*, BUS. WK ONLINE, Dec. 7, 1999, at <http://www.businessweek.com/bwdaily/dnflash/dec1999>) (article only available to paid website subscribers; copy on file with author).

[2]. 504 U.S. 298 (1992).

[3]. See *id.* at 311. While *Quill* actually involved "use" taxes (discussed *infra* notes 13-15 and accompanying text), *Quill* has also been applied to sales taxes. Cf. *infra* note 10 and accompanying text. The *Quill* Court adhered to the Commerce Clause requirements established in *Nat'l Bellas, Inc. v. Dep't of Revenue* regarding the collection of sales and use taxes by out-of-state vendors. 386 U.S. 753 (1967).

[4]. See *Quill Corp.*, 504 U.S. at 306 (citing *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939)).

[5]. See *id.* (citing *Nelson v. Sears Roebuck & Co.*, 312 U.S. 359 (1941)); John F. Due & John L. Mikesell, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 250-54 (2d ed. 1994).

[6]. See *Quill Corp.*, 504 U.S. at 306 (citing *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)).

[7]. See VIRGINIA DEPT. OF TAXATION RULING, P.D. 00-53 (Apr. 14, 2000) (determining that a taxpayer does not have sufficient taxable nexus in a state if using computers to host web sites serves as its only presence). See also *Millennium Enter. v. Millennium Music*, 33 F. Supp. 2d 907 (D. Or. 1999) (holding that a web presence in a state would not bring a company within the state's jurisdiction under the Due Process Clause). See generally, Annette Nellen, *Overview to E-Commerce Taxation Guide to Understanding the Current Discussions and Debates* at http://www.cob.sjsu.edu/facstaff/nellen_a/ (Dec. 2000).

[8]. See *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 758 (1967); see also *Miller Bros. v. Maryland*, 347 U.S. 340 (1954) (holding that delivery alone is insufficient to require an out-of-state vendor to collect taxes). However, since *Miller Bros.* was decided in 1954, three state supreme courts have held that the

delivery of goods into a state, when combined with some form of economic presence, is sufficient for a state to impose collection duties upon the vendor. *See* Due, *supra* note 5, at 250-54. *See also* Rowe-Genereux, Inc., v. Vt. Dep't of Taxes, 411 A.2d 1345 (1980) (holding that delivering goods, advertising, and retaining security interests in the state qualified the out-of-state vendor for collection duties); *In re* Webber Furniture, 290 N.W.2d 865 (S.D. 1980) (holding that this case was distinguishable from *Miller Bros.* due to the much greater volume of business conducted in the state compared to *Miller Bros.*); Goods Furniture House, Inc., v. Iowa State Bd. of Tax Review, 382 N.W.2d 145 (Iowa 1986) (holding that the combination of delivery of goods and extensive television advertising in the taxing state qualified the vendor for collection duties). The United States Supreme Court has never ruled on whether an out-of-state vendor's delivery of goods into a state in which the vendor has some other form of economic presence may qualify the vendor for collection responsibilities. If this issue were decided today, the Supreme Court might find that these additional factors sufficiently distinguish modern cases from the 1954 *Miller Bros.* decision. Such a ruling would help restore tax neutrality between traditional brick-and-mortar, mail-order, and Internet vendors.

[9]. *See* LETTER RULING 99-1 OF THE MASSACHUSETTS DEPT. OF REVENUE (Jan. 6, 1999) (providing that a vendor's relationship with a television station, for advertising purposes, created a physical presence within the state for the vendor). *See also* Nellen, *supra* note 7, at 39. In contrast, *Bensusan Restaurant Corp. v. King*, 937 F. Supp 295, 301 (S.D.N.Y. 1996), *aff'd*, 126 F.3d 25 (2d Cir. 1997) involved a restaurant which was merely placing information about the restaurant on the website with no opportunity to purchase any goods. The court held that placing an advertisement on a website did not establish jurisdiction in the courts of a state where the advertisement is seen. The court pointed out that, "creating a site, like placing a product into the stream of commerce, may be felt nationwide or even worldwide but without more, it is not an act purposefully directed toward the forum state." *Id.* at 301.

[10]. *Cf. supra* note 3 and accompanying text.

[11]. Sales taxes are assessed on "retail sales of tangible personal property for use or consumption." Megan E. Groves, *Tolling the Information Superhighway: State Sales and Use Taxation of Electronic Commerce*, 13 HARV. J. LAW & TECH. 619, 622 (2000) (quoting PRENTICE HALL, INC., PRENTICE HALL'S GUIDE TO SALES AND USE TAXES 57 (1988)). Currently, forty-five states and the District of Columbia assess sales taxes on items sold within the states' borders and use taxes on items purchased outside the state by its residents. *See* Matthew G. McLaughlin, *Comment, The Internet Tax Freedom Act: Congress Takes a Byte Out of the Net*, 48 CATH. U.L. REV. 209, 210 (1998) (citing David C. Blum, *Comment, State and Local Taxing Authorities: Taking More Than Their Fair Share of the Electronic Information Age*, 14 J. MARSHALL J. COMPUTER & INFO. L. 493, 494 n.6 (1996)). Electronic commerce and emerging technologies may force states to redefine the types of goods subject to sales taxes. At present, nineteen states impose sales taxes on the sale of intangible goods over the Internet, while another sixteen states completely exempt intangible goods from sales tax. An additional eight states do not tax the downloading of information from the Internet, but do tax the downloads of software. *See* Jeremy Holmes, *Taxing Electronic Commerce: Adapting to a New Age*, at <http://internetlaw.pf.com/subscribers/html/NewOverview.asp> (last visited Nov. 5, 2001)(article only available to paid website subscribers; copy on file with author).

[12]. *See* Groves, *supra* note 11, at 619 (citing National Governors' Association Online, *Overview of Sales and Use Taxes and Electronic Commerce*, at http://www.nga.org/nga/legislativeUpdate/1,1169,C_ISSUE_BRIEF^D_1248,00.html (Feb. 23, 2001)). These estimated figures are the amount of tax revenues state and local governments lost due to Internet purchases. In 2000, retail e-commerce sales were estimated at \$25.8 billion, comprising almost 1% of total retail sales. Fourth quarter sales alone were \$8.7 billion, up 67.1% from the fourth quarter of 1999. These figures exclude financial brokers, travel services, and concert and other ticket sales, as these are not considered retail. Given the large presence these three excluded areas have on the Internet, an assessment of online sales would be

considerably higher if these industries were included in the calculations. *See* U.S. CENSUS BUREAU, UNITED STATES DEPT. OF COMMERCE NEWS, at <http://www.census.gov/mrts/www/current.html> (reporting retail e-commerce sales in the fourth quarter of 2000 were \$8.7 billion, up 67.1 percent from the fourth quarter of 1999)(last modified Aug. 30, 2001).

[13]. Use taxes were first enacted in the 1930's to accommodate for sales tax revenues lost through out-of-state purchases. *See* Due, *supra* note 5, at 245. Since the 1960's, every state imposing sales taxes also imposed use taxes. *See id.*

[14]. Steven J. Forte, *Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?*, 15 J. MARSHALL J. COMPUTER & INFO. L. 203, 206 (1997) (quoting John F. Due & John L. Mikesell, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 246 (1981)). *See also* Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 322 (1999) (citing John F. Due & John L. Mikesell, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 1-4 (2d ed. 1994)). The United States Supreme Court has long since established the constitutionality of use taxes as a tax upon the privilege of using a product within the state. *See* Henneford v. Silas Mason Co., 300 U.S. 577 (1937). "Equal treatment for in-state and out-of-state taxpayers similarly situated is the condition precedent for a valid use tax on goods imported from out-of-state." *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987). *See* D.H. Holmes Co. v. McNamara, 486 U.S. 24, 32 (1988) (holding that a use tax was validly imposed upon products shipped into the state since the company had its principal place of business within the state).

[15]. *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 555 (1977) (citing H.R. Rep. No. 565, 89th Cong., 1st Sess., 614 (1965)).

[16]. *See* Groves, *supra* note 11, at 622 (citing *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944)).

[17]. This disparity is considerably attributable to the fact that the Internet provides consumers with immediate access to vendors located in all 50 states, unlike traditional commerce, in which customers are generally limited to shopping in their own and surrounding states for most purchases.

[18]. Every state that assesses a sales tax upon retail sales also requires the vendor to collect the tax and remit it to the state. *See* Due, *supra* note 5, at 29.

[19]. A good must be used or consumed within the state before the state may *assess* the use tax. *See* Due, *supra* note 5, at 247. However, while this is a rather straight-forward requirement, the limitation on a state's imposition of use tax *collection* duties upon out-of-state vendors is the state's primary obstacle to effective collection.

[20]. *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992).

[21]. McLure, *supra* note 14, at 322. It is notable that out-of-state vendors who are under no legal obligation to collect use taxes may voluntarily register to collect these taxes from their customers in order to relieve customers of their payment obligations. *See* Due, *supra* note 5, at 250. However, few vendors have opted to voluntarily provide this service.

[22]. The most notable exceptions to this include: required registration of a good before it can be used within the state, a business taxpayer who may be audited, and a seller with taxable nexus in the state. *See* McLure, *supra* note 14, at 322-23. All fifty states require taxpayers to pay their use tax obligations upon the registration of automobiles. The General Accounting Office estimated that in 2000, immediate use tax

compliance by individuals was less than 5% on automobile purchases. However, since the cars must then be registered, the use tax is collected upon registration, and as a result, use tax compliance is virtually 100%. *See* Nellen, *supra* note 7, at 53. Not surprisingly, the threat of being audited compelled 65-80% of businesses to pay the required use taxes. *See id.* at 53 (citing GENERAL ACCOUNTING OFFICE, ELECTRONIC COMMERCE GROWTH PRESENTS CHALLENGES; REVENUE LOSSES ARE UNCERTAIN, GAO/GGD/OCE-00-165, June 2000, at 17). Individual consumers remain the most unlikely to pay use taxes. An increasing number of states, including Connecticut, Idaho, Indiana, Kentucky, Maine, and Wisconsin, have added a line to their individual income tax forms for reporting use tax on mail-order and Internet purchases. However, the efficacy of such a system is doubtful since there does not appear to be an effective method for states to fully determine the use tax owed. *See id.* at 51 n.108.

[23]. The extent of this confusion is best exemplified by former House Majority Leader, Dick Armey. "Anybody who seriously tries to push a 'tax the Internet' proposal in this Congress is going to get run out of town. The American people won't stand for it." Peter Cobb, Transcript: *Taxing E-Commerce: The Landscape of Internet Taxation*, 21 U. PA. J. INT'L ECON. L. 659, 659 (2000) (quoting Dick Armey, *Press Release, Commission Rejects Net Taxes* (Mar. 21, 2000) available at <http://freedom.house.gov/library/technology/pr000321.asp>). This exemplifies the myths surrounding an "Internet tax." Many people believe such a tax would be a "new" tax. State and federal governments should advance public awareness campaigns to inform people that an Internet tax actually eases residents' use tax burdens by having vendors collect the taxes on their behalf. "If there were an efficient way of collecting the use tax, a lot of the issues that are being hotly debated [regarding an 'Internet tax'] would not arise." *Id.* at 662.

[24]. *See* Nellen, *supra* note 7, at 53 (citing GENERAL ACCOUNTING OFFICE, ELECTRONIC COMMERCE GROWTH PRESENTS CHALLENGES; REVENUE LOSSES ARE UNCERTAIN, GAO/GGD/OCE-00-165, June 2000, at 19).

[25]. *See* Robert MacMillan, *Sen. Graham Stresses Need for Net Sales Tax*, Newsbytes, at <http://newsbytes.com/news/01/163092.html> (Mar. 13, 2001).

[26]. *See* Groves, *supra* note 11, at 619 (citing National Governor's Association Online: *Overview of Sales and Use Taxes and Electronic Commerce*).

[27]. *See* DEPT. OF THE TREASURY OFF. OF TAX POL'Y, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE, available at <http://www.treas.gov/taxpolicy/internet.html> (Nov. 1996). A report issued by the White House in 1996 suggested that "no tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or locations of transactions." Brian S. Masterson, *Collecting Sales and Use Tax on Electronic Commerce: E-Confusion or E-Collection*, 79 N.C. L. REV. 203, 220 (2000) (quoting President William J. Clinton & Vice President Albert Gore, Jr., *A Framework for Global Electronic Commerce*, available at http://www.iitf.nist.gov/electronic_commerce.htm (July 1, 1997)). "Neutrality is especially important in the taxation of electronic commerce, because of the ease with which transactions can be diverted in response to differential taxation." McLure, *supra* note 14, at 374.

[28]. McLure, *supra* note 14, at 374 n.390 (quoting DEPT. OF THE TREASURY OFF. OF TAX POL'Y, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE (1996) at L-17).

[29]. *See* discussion *infra* Part II.C.1 a-b.

[30]. U.S. CONST. amend. XIV.

[31]. U.S. CONST. art. I, § 8.

[32]. 386 U.S. 753 (1967).

[33]. 504 U.S. 298 (1992).

[34]. U.S. CONST. amend. XIV, § 1.

[35]. *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992).

[36]. *Groves*, *supra* note 11, at 624 (quoting *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980)).

[37]. *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (citing *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)).

[38]. *Quill Corp.*, 504 U.S. at 307.

[39]. *Id.* at 308 (quoting *Burger King v. Rudzewicz*, 471 U.S. 462, 476 (1985)).

[40]. 952 F. Supp. 1119 (W.D. Pa. 1997).

[41]. *Groves*, *supra* note 11, at 626 (quoting *Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, 952 F. Supp. 1119, 1124 (W.D. Pa. 1997)).

[42]. 937 F. Supp. 161 (D. Conn. 1996).

[43]. *Id.* at 162-63.

[44]. 89 F.3d 1257 (6th Cir. 1996).

[45]. The defendant entered a shareware agreement with CompuServe to advertise his software, and his only contacts with Ohio, where CompuServe was headquartered, were via the Internet. *See id.*

[46]. Gregory A. Ichel, *Internet Sounds Death Knell for Use Taxes: States Continue to Scream over Lost Revenues*, 27 SETON HALL L. REV. 643, 650 (1997) (citing *CompuServe, Inc. v. Patterson*, 89 F.3d 1257, 1262 (6th Cir. 1996)).

[47]. *See id.* (citing *CompuServe, Inc.*, 89 F.3d at 1263).

[48]. *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)).

[49]. *See Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 758 (1967).

[50]. *Id.*

[51]. *Id.* Out-of-state vendors may be required to collect sales and use taxes when they have agents or stores located in the taxing State. *See id.* at 757 (citing *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939); *Nelson v. Sears Roebuck & Co.*, 312 U.S. 359 (1941)). *See also supra* notes 4-6 and accompanying text.

Bellas Hess "created a safe harbor for vendors whose only connection with customers in the [taxing] State is by common carrier or the United States mail." *Quill Corp.*, 504 U.S. at 315.

[52]. *Nat'l Bellas Hess, Inc.*, 386 U.S. at 758.

[53]. *See id.*

[54]. The Court found that "the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a State's compliance with the requirements of due process in this area are *similar*." *Id.* at 756 (citing *Central R. Co. v. Pennsylvania*, 370 U.S. 607, 621-22 (Black, J., concurring)) (emphasis added).

[55]. *See Quill Corp.*, 504 U.S. at 308. "[T]o the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of a duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process." *Id.*

[56]. *Id.* at 307 (emphasis added).

[57]. *See id.* at 307-08.

[58]. *See generally* McLure, *supra* note 14.

[59]. "If there is a want of due process to sustain a tax, by that fact alone any burden the tax imposes on the commerce among states becomes 'undue' and thus violates the Commerce Clause." *Quill Corp.*, 504 U.S. at 305.

[60]. *See* McLaughlin, *supra* note 11, at 217 (citing *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-84 (1995)). *See also Quill Corp.*, 504 U.S. at 312 (citing *Kassel v. Consol. Freightways Corp. of Del.*, 450 U.S. 662 (1981)).

[61]. U.S. CONST. art. I, § 8, cl. 3.

[62]. *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179 (1995) (citing *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)).

[63]. *Id.* at 180.

[64]. *See Groves, supra* note 11, at 628 (citing *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 71-72 (1997)).

[65]. *See* Walter Hellerstein, *Deconstructing the Debate Over State Taxation of Electronic Commerce*, 13 HARV. J. LAW & TECH. 549, 555 (2000) (citing *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408 (1946)).

[66]. *See id.* at 555-556. "Congress has plenary power. . . [to] authorize state actions that burden interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992) (quoting *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 315 (1945)).

[67]. *See Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 758 (1967).

[68]. 430 U.S. 274 (1977).

[69]. *Id.* at 279.

[70]. *See Quill Corp.*, 504 U.S. at 302-03.

[71]. *Id.* at 310 n.5 (quoting *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623-24 (1981)).

[72]. *See id.* at 311.

[73]. *Quill* established that "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause." *Id.* at 313. Thus, "a tax may be consistent with due process and yet unduly burden interstate commerce." *Id.* at 313 n.7 (citing *Tyler Pipe Indus., Inc. v. Washington*, 483 U.S. 232 (1987)).

[74]. *Id.* at 314 (quoting *North Dakota v. Quill*, 470 N.W.2d 203, 214 (1991)).

[75]. *See id.*

[76]. *Id.* *See infra* Part II.B.1 (discussing the extent to which this may no longer be the "bright-line" test the Court once envisioned).

[77]. *See Nat'l Bellas Hess, Inc.*, 386 U.S. 753, 754 (1967).

[78]. *See Quill Corp.*, 504 U.S. at 302 n.1.

[79]. *See Nat'l Bellas Hess, Inc.*, 386 U.S. at 754; *Quill Corp.*, 504 U.S. at 302.

[80]. *Quill Corp.*, 504 U.S. at 305.

[81]. *See McClure, supra* note 14, at 324.

[82]. *Quill Corp.*, 504 U.S. at 318.

[83]. *Id.* at 308.

[84]. *Id.*

[85]. *Id.*

[86]. *See* discussion *supra* Part I.B.

[87]. *See supra* notes 4-6.

[88]. Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose sales or use taxes. *See* McLaughlin, *supra* note 11, at 210 (citing David C. Blum, *State and Local Taxing Authorities: Taking More Than Their Fair Share of the Electronic Information Age*, 14 J. MARSHALL J. COMPUTER & INFO. L. 493, 494 n.6 (1996)).

[89]. *See, e.g.*, *Zippo Mfg. Co. v. Zippo Dot Com*, 952 F. Supp. 1119, (W.D. Pa. 1997); *United States v. Morris*, 928 F.2d 504 (2d Cir. 1991); *Panavision Int'l, L.P. v. Toeppen*, 141 F.3d 1316 (9th Cir. 1998).

[90]. See Jack L. Goldsmith, *The Internet and the Abiding Significance of Territorial Sovereignty*, 5 IND. J. GLOBAL LEG. STUD. 475, 475 (1998).

[91]. See *id.* at 476-77.

[92]. *Id.* at 479.

[93]. *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

[94]. *Id.* at 315.

[95]. *Id.* at 330-31 (White, J., dissenting). An example of how Justice White's concern has materialized is evidenced by an Administrative Ruling in New Mexico, *In re Kmart Properties, Inc.* (Jan. 2000). The judge held that "use of a subsidiary's trademark by the parent corporation was found to establish nexus and tax obligations in New Mexico" for the subsidiary. Nellen, *supra* note 7, at 34. The contractual relationship enables the parties to solicit customers in the state, thus creating the subsequent revenues New Mexico sought to tax.

[96]. *Quill Corp.*, 504 U.S. at 329 (White, J., dissenting).

[97]. See Groves, *supra* note 11, at 919 (citing Jeffrey Owens, *The Tax Man Cometh to Cyberspace*, 14 TAX NOTES INT'L 1833, 1835-36 (1997)).

[98]. See *Quill Corp.*, 504 U.S. at 320 (citing *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 33 (1988)). See also *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 559 (1977)). Additionally, in a 1998 Texas ruling by an Administrative Law Judge, the mere licensing of software to customers in Texas was sufficient to constitute physical presence for Commerce Clause purposes. (Hearing 36,237, July 21, 1998) (cited in Nellen, *supra* note 7, at 29). The Judge distinguished this case from *Quill* on the facts, since "Quill sold property to customers while taxpayer [here] licenses tangible personal property to customers. Thus, the nature of the transaction is not the same." *Id.*

[99]. *Quill Corp.*, 504 U.S. at 314. The Court reiterated this fact in saying that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.* at 317.

[100]. *Id.* at 311.

[101]. See McLure, *supra* note 14, at 328.

[102]. See *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 760 n.12 (1967). The Court concluded that,

if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. . . . The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions.

Id. at 759-60.

[103]. *See Quill Corp.*, 504 U.S. at 303 (citing *North Dakota v. Quill*, 470 N.W.2d 203, 215 (1991)).

[104]. *Id.* at 301 (quoting 470 N.W. 2d at 208). The court also found that "'wholesale changes' in both the economy and the law made it inappropriate to follow *Bellas Hess* today." *Id.* at 303 (quoting 470 N.W. 2d at 213).

[105]. *See id.* at 313 n.6 (citing *Nat'l Bellas Hess, Inc.*, 386 U.S. 753). Currently, there are over 7,500 state and local taxing jurisdictions. *See* Brian Krebs, *Internet Sales Tax Is Nail in Coffin for Dot Coms McCain*, NEWSBYTES, at <http://www.newsbytes.com/news/01/163152.html> (Mar. 14, 2001).

[106]. Cobb, *supra* note 23, at 666.

[107]. Hellerstein, *supra* note 65, at 554.

[108]. Stanley R. Arnold, *The Internet Tax Debate: Asking the Correct Questions*, 13 HARV. J. LAW & TECH. 653, 656 (2000).

[109]. At present, the two major groups leading this effort for simplification are: the National Conference of Comm'ners on Uniform State Laws (NCCUSL) and the Streamlined Sales Tax Project (SSTP). *See* Nonna A. Noto, *Report for Congress: RL30667: Internet Tax Legislation: Distinguishing Issues*, CONGRESSIONAL RESEARCH SERVICE (Nov. 24, 2000). NCCUSL is a non-profit organization that developed the Uniform Commercial Code (UCC). NCCUSL takes a more methodical approach by analyzing existing statutes and codes and seeking to find areas where nationwide uniformity may be feasible. The SSTP has two major concerns. The first is to simplify state and local sales and use taxes amongst the states. Second, they are researching computer software that may be used to implement the collection of use taxes on out-of-state vendors. *Id.* Currently, forty-one states are participating in the SSTP. *See generally*, the Streamlined Sales Tax website, at <http://www.streamlinedsalestax.org> (last modified Aug. 2001).

[110]. *See infra* Part II.B.1-2.

[111]. The amount of sales tax revenue as a percentage of total tax revenues varies greatly by state. For states such as Connecticut, South Dakota, Tennessee, and Texas, the sales tax accounts for over half of all tax revenues collected. *See* Due, *supra* note 5, at 18.

[112]. *See generally* Hellerstein, *supra* note 65. Over 170 tax economists and professors of law signed an "Appeal for Fair and Equal Taxation of Electronic Commerce" which contains four basic principles:

1. Electronic commerce should not permanently be treated differently from other commerce. . . . Electronic commerce should be taxed neither more nor less heavily than other commerce.
2. Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, *regardless of whether the vendor has a physical presence in the state*. . . .
3. There must be enough simplification of sales and use taxes to make destination-based taxation of sales feasible. . . .
4. A means must be found to eliminate burdens of compliance on sellers making only small amounts of sales in a state. . . .

Id. at 550 (citing *Federalism in the Information Age: Internet Tax Issues: Hearing Before the Senate Comm. on the Budget*, 106th Cong. (2000)).

[113]. See Masterson, *supra* note 27, at 213.

[114]. See *supra* note 88 and accompanying text.

[115]. See Masterson, *supra* note 27, at 214 (citing Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 Tax L. Rev. 269, 295 (1999)).

[116]. See *supra* note 8 and accompanying text. A decision addressing delivery of goods into a state where the vendor has an economic presence would enable the Court to act in this area without overruling *Bellas Hess* or *Quill*, and simultaneously, restoring the tax neutrality that has been absent from both mail-order and e-commerce since their inception. See Due, *supra* note 5, at 254.

[117]. Such a de minimus standard could be established based upon an actual dollar amount of sales in the state or as a percentage of a company's total sales. See McLure, *supra* note 14, at 400-401. For example, sales in excess of \$1 million may subject a vendor to collection responsibilities within a state. Or, a de minimus threshold may be satisfied by 5% or more of a business's total sales being generated in a given state.

[118]. See Masterson, *supra* note 27, at 215.

[119]. The North Dakota Supreme Court found that "Quill's `economic presence' in North Dakota depended on services and benefits provided by the State and therefore generated a `constitutionally sufficient nexus to justify imposition of the purely administrative duty of collecting and remitting the use tax.'" *Quill Corp. v. North Dakota*, 504 U.S. 298, 304 (1992) (quoting *North Dakota v. Quill Corp.*, 470 N.W. 2d. 203, 219 (1991)).

[120]. Masterson, *supra* note 27, at 215 (emphasis added).

[121]. *Quill Corp.*, 504 U.S. at 328 (White, J., dissenting).

[122]. See Ervin, *supra* note 1, at 525.

[123]. See *id.* at 534. States have adopted an economic nexus standard for the imposition of state income and franchise taxes upon non-resident financial institutions.

[124]. See *id.* at 525-26. Connecticut, Indiana, Kentucky, Massachusetts, Minnesota, Tennessee, and West Virginia have enacted such tax legislation. In Massachusetts, for example, a financial institution has economic presence when and if it satisfies *one* of the following three criteria: has 100 customers in the state, has assets of \$100 million attributed to the state, or has gross receipts of at least \$500,000 attributed to the state. See Craig J. Langstraat and Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 AKRON TAX J. 1, 10 (1999).

[125]. See Ervin, *supra* note 1, at 526.

[126]. *Id.* at 532 (quoting *North Dakota v. Quill Corp.*, 470 N.W. 2d 203, 218 (1991)).

[127]. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

[128]. See *id.* at 18. "Geoffrey's reliance on the physical presence requirement of *Bellas Hess* is misplaced." *Id.*

[129]. *See id.* at 15.

[130]. *See id.* at 17.

[131]. *Id.* at 16. The court added that, "[b]y providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income . . ." *Id.* at 18.

[132]. *Id.* (citing *Am. Dairy Queen, Corp. v. Taxation and Revenue Dep't*, 605 P.2d 251, 255 (1979)) (emphasis added).

[133]. A total of ten states, including Arkansas, Florida, Iowa, Massachusetts, New Jersey and North Carolina, have enacted legislation codifying *Geoffrey's* economic nexus standard. *See Langstraat, supra* note 124, at 15-16.

[134]. Nine states have pursued an economic presence standard without legislative action. Such states include: Colorado, Georgia, Maryland, Mississippi, Missouri, New Hampshire, and Tennessee. *See id.* at 16-17.

[135]. Seven states, including Alabama, Michigan, Ohio, and Texas, have been hesitant to apply this doctrine. *See id.* at 17-18.

[136]. H.R. 4328, P.L. 105-277, 112 Stat. 2681 (The Internet Tax Freedom Act is part of Titles XI and XII of Division C of the Omnibus Consolidated and Emergency Appropriations Act of 1999).

[137]. *See id.* *See also generally* Annette Nellen, *Federal Internet Tax Freedom Act The Myths and The Realities*, at http://www.cob.sjsu.edu/facstaff/nellen_a/ITFA.html (Feb. 1999). The ITFA contains a grandfather clause that protects states who had already implemented a tax on Internet access and allows them to continue to do so under this moratorium.

[138]. Internet Tax Freedom Act § 1104 (2)(A)(i).

[139]. *See id.* § 1104(2)(iv). *See generally* Nellen, *supra* note 137.

[140]. *See, e.g.*, Internet Tax Moratorium and Equity Act, S. 512, 107th Cong. (2001) (introduced by Sen. Dorgan, the bill enables states more freedom in their simplification process in exchange for their right to collect taxes from out-of state vendors); Internet Tax Nondiscrimination Act, S.288-IS, 107th Cong. (2001) (introduced by Senators Wyden and Cox, it permits states to collect from out-of-state vendors if they simplify their tax systems); The Internet Nondiscrimination Act of 2000, H.R. 3709, 106th Cong. (2000) (amended version was passed by a House vote of 352 to 75); H.R. 3252, 106th Cong. (2000). *See generally* Noto, *supra* note 109.

[141]. *See, e.g.*, The Internet Nondiscrimination Act of 2000, H.R. 3709, 106th Cong. (2000); Internet Tax Moratorium and Equity Act, S. 512, 107th Cong. (2001) (introduced by Sen. Dorgan); S. 1611, 106th Cong. (2000) (introduced by Sen. McCain).

[142]. H.R. 1552, 107th Cong. (2001). This Act extends the Internet Tax Freedom Act through November 1, 2003. In November 2001, the Senate rejected an amendment to this Act, introduced by Sens. Mike Enzi, R-Wyo., and Byron Dorgan, D-ND, that "would have required Congress to either grant or deny states the Brain Krebs, *Senate Passes Two-Year Internet Tax Ban Update*, Newsbytes, at <http://www.newsbytes.com/news/01/172220.html> (Nov. 15, 2001).

[143]. See *Ichel*, *supra* note 46, at 647.

[144]. Langstraat, *supra* note 124, at 12 (quoting Karl A. Frieden and Michael E. Porter, *The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce*, STATE TAX NOTES (Nov. 11, 1996)).

[145]. *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 764 (1967) (Fortas, J., dissenting).

[146]. "The preferred solution is to find ways to keep Internet commerce in the state consumption tax and federal income tax bases, and to bring mail-order commerce into both tax bases at the same time." J. Clifton Fleming, Jr., *Electronic Commerce and the State and Federal Tax Bases*, 2000 B.Y.U. L. REV. 1, 7 (2000).

[147]. *Quill Corp. v. North Dakota*, 504 U.S. 298, 329 (1992) (White, J., dissenting). He added, "we should not adhere to a decision [*Bellas Hess*], however right at the time [1967], that by reason of later cases and economic reality can no longer be rationally justified." *Id.* at 333 (White, J., dissenting).

[148]. The *Quill* Court recognized that this issue is one which "Congress may [not only] be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *Id.* at 318. The Court added that, "Congress remains free to disagree with our conclusions." *Id.* (citing *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408 (1946)).

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<http://www.ecommercecommission.org> The site of the Advisory Commission on Electronic Commerce provides a compilation of reports on e-commerce issues including taxation and other policy concerns.

<http://www.ntanet.org> The National Tax Associations's webpage that outlines their Communications and Electronic Commerce Tax Project.

<http://www.cbpp.org/512webtax.htm> The Center on Budget and Policy Priorities website provides a paper discussing the effect of a federal moratorium on Internet commerce taxes.