CYBERTAXATION:

CURRENT CONTROVERSY AND PERSPECTIVE ON THE FUTURE

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I. Introduction.

The explosion of e-commerce and the multitude of transactions presently taking place over the Internet raise a plethora of issues ranging from tax policy to public policy. The primary concern is to encourage use of the Internet, even now only in its embryonic stage. Taxing jurisdictions that depend heavily on sales and use as well as other transaction related taxes complain that their tax bases are shrinking as a result of the Internet. The solution is clear to these taxing jurisdictions: tax transactions of goods and services that occur on line in the same manner as non-Internet related goods and services. These jurisdictions argue that the explosion of e-commerce will result in a massive shift away from the traditional tax base to transactions not subject to taxation in any jurisdiction.

E-commerce advocates oppose taxing e-commerce because of the administrative burdens placed on commerce as well as the possibly restrictive effect on demand for on-line goods and services. These advocates argue that the administrative aspect of doing business with states will become unduly burdensome due to the fact that merchants will be subject to taxation in different taxing jurisdictions, each with different tax laws and administrative requirements.[1] Further, tax opponents argue that government should

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[1] Corporate tax executives sampled by *CFO* magazine reported that they were primarily disturbed by:

- 'Inconsistent treatment of similar transactions by different states.'
- 'States are too slow in resolving issues and responding to changes';
- 'A wide range exists regarding the flexibility, common sense, and fairness employed by each auditor';
- 'Managing the horde of state, county, and city tax filings';
- 'Dealing with aggressive states like California and having to fight long court battles on ludicrous issues'; and
- 'Lack of uniformity.'

encourage use of the Internet. Assessing taxes on goods and services available on-line, the argument is made, causes transaction costs to increase, which will result in a corresponding drop in demand, thus suffocating the economic viability of e-commerce.

Much of the current debate between the proponents and opponents of taxing e-commerce is merely a continuation of catalogue company litigation from the early 1990s. Since the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota,*[2] states have been unable to force catalog companies to collect taxes for them, absent physical presence or "nexus" in the taxing state.[3] The Court stated that concerning the issue of whether states have authority to tax cross-border mail order sales, "Congress may be better qualified to resolve [it] and ... [Congress] has the ultimate power to resolve [that issue]."[4] Currently, 45 states impose some type of sales and use tax.[5]

Following is a presentation and discussion of the present status of e-commerce taxation (or “Cybertaxation") in the United States, in light of the opposing positions presented by those in favor of the moratorium on Cybertaxation, and those in favor of new taxation of online goods and services. Finally, this paper will discuss how the conflict between these very divergent views can be reconciled.

II. Present status of Internet Taxation.

George Donelly, States of Confusion: The Methods States Use to Determine Taxable Presence Are All Over the Map, *CFO Magazine*, September 2000, p. 56.

[2] 504 U.S. 298, 311 (1992) (upholding the proposition that a vendor whose only contacts with the taxing State are by mail or commercial carrier lacks the "substantial nexus" required by the Commerce Clause).

[3] *Quill* at p. 312.

[4] *Id.*

[5] Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues*, 52 U. Miami L. Rev. 691, 697 (1998).

The sudden explosive growth of the Internet and e-commerce has provided greatly increased revenues for many companies worldwide. No sooner were the streams of revenue established than, like sharks for chum, the various taxing jurisdictions began searching for a way to tax that revenue, whether through the access to the Internet or sales taxes on goods sold.[6] Concerned about the effect that excessive state taxation might have on the fledgling new economy, the Internet Tax Freedom Act ("ITFA") was signed into law. The original purpose of the legislation was to establish a national policy against states interfering with interstate commerce on the Internet.[7] The ITFA was initially met with strong opposition from organized groups such as the National League of Cities, the National Governor's Association and others.[8]

By the mid-1990s, state and local governments were losing as much as $3 Billion a year in revenue on tax-free mail-order sales.[9] According to Forrester Research, Internet sales topped $18 Billion in 1999, and could reach $108 Billion by 2003.[10] Assuming an average aggregate tax rate of six percent, and the budgetary threat to state and local government is staggering.

After eighteen months of debate, Congress finally passed the ITFA in 1998.[11] Though the enacted version of the ITFA was a watered-down version of the original, many state and local government and business organizations supported its passage.[12] The ITFA bars three specifically identified categories of tax levies: (1) taxes on Internet access,

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[6] U.S. Rep. Christopher Cox, Internet Tax Freedom Act at One: No Net Taxes, More Sales Tax Revenue (*L.A. Times*, October 31, 1999).
[7] Kevin J. Smith, *Internet Taxes: Congressional Efforts to Control States' Ability to Tax the World Wide Web*, 7 Rich. J.L. & Tech. 3, Fall, 2000, *10.
[8] *Id.*
[9] Christopher Swope, E-conomics Problem, *Governing Magazine*, March 2000.
[10] *Id.*
[11] Smith, 7 Rich. J.L. & Tech. 3, at *11.

(2) multiple taxes on electronic commerce, and (3) discriminatory taxes on electronic commerce.[13] The ITFA is essentially a holding action to give Congress more time to consider a long-term solution.[14]

First and foremost, the IFTA provides for a moratorium on taxes on Internet access and e-commerce.[15] The moratorium was effective on October 1, 1998, but allowed the continued taxation of Internet access by those states that were already taxing Internet access.[16] A limited "grandfather" clause permits the handful of states already taking steps to tax Internet access -- Connecticut, Wisconsin, Iowa, North Dakota, South Dakota, New Mexico, South Carolina, Tennessee, Texas and Ohio -- to continue to do so if they can demonstrate that their taxes had already been "generally imposed and actually enforced" on Internet access providers prior to October 1, 1998.[17]

The moratorium exists for a three-year period that ends October 1, 2001.[18] After the moratorium ends, Congress may either renew the moratorium or choose not to renew it, thus allowing States to tax the Internet once again. The authors, however, intended the moratorium to become permanent in the future.[19] The plain meaning of the ITFA is to prevent Internet taxes, not generate, encourage, or authorize them. Section 1204 expressly states, "this law is not to be construed to expand the duty of any person to collect or pay taxes beyond that which existed immediately before" the law was enacted.[20] Additionally, a State or local government's tax that is not prohibited by the provisions of the ITFA

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[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *"Plain English" Summary of The Internet Tax Freedom Act* (P.L. 105-277).
[16] *Id.*
[17] *Id.*
[18] Smith, 7 Rich. J.L. & Tech. 3, at *12.
[19] *Id.*

would not be valid if it constituted an undue burden on interstate or foreign commerce.[21] One thing that can be said about Internet taxation in the United States is that there is a lack of uniformity of taxation.[22] For example, the transfer of digitized product (such as software or other commodity) is treated as the sale of tangible personal property in some states, but not in others.[23]

III. Proponents' Arguments in favor of Internet Taxation.

The proponents in favor of Cybertaxation are comprised of two groups. One group, in favor of the ban against new Internet taxes, wishes to tax certain Internet transactions under existing tax laws. A second group is against any ban on Internet taxation, viewing the same as a threat to their tax base.

The National Governor's Association ("NGA") already publicly declared its support for the extension of the ban on new Internet taxes. A few states, even before Congress passed the ITFA, passed legislation exempting Internet access charges from the sales tax. However, the NGA opposes congressional proposals that would eliminate all

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[20] The Internet Tax Freedom Act (P.L. 105-277).
[21] Smith, 7 Rich. J.L. & Tech. 3, at *12.
[22] Some states tax Internet Access Services (e.g., Connecticut, Hawaii, North Dakota, South Dakota, and Tennessee), for albeit, different reasons. For example, North Dakota, Iowa (until 1999), and Tennessee, tax Internet access services as a communications or telecommunications service. On the other hand, other states tax Internet access services under some other category of taxable service such as a computer or data-processing service or an information service. Karl Frieden, *Cybertaxation: The Taxation of E-Commerce*, © 2000 Arthur Andersen, LLP, Chapter 2, p. 7.
[23] South Carolina ruled that computer software sold and delivered by electronic means does not meet the definition of tangible personal property and is not subject to South Carolina sales/use tax. This is also true in Florida. The courts of Louisiana, however, have held that the sale of canned software transferred electronically constituted the taxable sale of tangible property. The Courts in Louisiana focused on the fact that the software was on a tangible medium before it was transferred and was downloaded onto a tangible medium (a computer hard-disk drive) after it was transmitted. The divergent views on whether digital products should be classified as tangible or intangible personal property are compounded by the absence of clear statutory or regulatory language in may states regarding whether the jurisdiction applies

taxes on the Internet. An intense lobbying effort by the NGA and the National Association of Counties is directed at ensuring that no such proposals pass.[24]

By virtue of the Internet, a large amount of international business can be conducted without the need for persons or facilities located in the customer's market place. Digitization and electronic delivery allow a new universe of intangible products to cross borders without going through the normal entry procedures.[25] The potential anonymity of Internet activity, the development of electronic cash, the high mobility of cyber-business, the use of private Internet communications networks, and the allure of tax havens have combined to raise fears of massive tax-base erosion.[26]

IV. Arguments of Opponents of Internet Taxation.

Using classical economic principles of supply and demand analysis, taxation of the Internet will tend to reduce demand for Internet goods and services. Taxation, when combined with security anxieties and the lack of universal acceptance of the Internet as a medium, can become a threat to the continuing viability of e-commerce. Active Research, Inc., a provider of Web-based market intelligence services, reported that of 539 individuals surveyed, 66% claimed their online shopping behavior would decrease if the

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the sales or use tax to canned software that is transferred electronically. Frieden, *Cybertaxation: The Taxation of E-Commerce*, Chapter 2, p. 16-17.

[24] Mark Schmidt, Why Taxing Internet Sales is a Bad Idea, *The San Diego Union-Tribune*, Dec. 15, 1999, at B-9, 11.

[25] Ned Maguire, *Taxation of E-commerce*, 47-Jun Fedrlaw 24.

[26] *Id.*

government taxed Internet sales.[27] The survey also found that significantly more women (71%) than men (64%) would decrease their online shopping.[28]

Opponents of taxing e-commerce argue that the current ban is consistent with the enlightened self-interest of the participants in the economy: consumers, businesses and the taxing jurisdictions. According to Representative Christopher Cox:

> Our ultimate goal should be to provide simplicity and certainty in the imposition of local taxes and questions of interstate tax liability. It's in everybody's best interest to do that. It's in the best interest of a Main Street business or a rural family that wants to set up operations on the Internet because it will give them access to a global marketplace. It's in the best interest of any Internet user because people who use the Internet want to know that their products and services are not subject to multiple, discriminatory, or special taxes.
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> And it's in the best interest of tax collectors because tax collectors need clear rules about what kinds of transactions are and are not subject to tax, and who is going to collect that tax.[29]

In sum, opponents of taxing e-commerce base their arguments on the administrative burdens that multi-jurisdictional taxes would impose on interstate commerce and the effects that taxes would have on demand for e-commerce. The opponents point to the fact that the Internet is a medium for transactions in our economy that will yield significant efficiencies that will benefit society as a whole, thus justifying the different tax treatment from competing "bricks and mortar" competitors.

V. Solution to Problem of Internet Taxation.

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[27] Business Editors, Study Finds New Internet Taxes Will Slow Growth of e-Commerce*, Business Wire, Inc.*, October 19, 2000.
[28] *Id.*
[29] Representative Christopher Cox, Speech to National League of Cities Annual Conference in Washington, D.C., March 13, 2000, www.house.gov/chriscox/press/speeches/2000.

As discussed above, the arguments by proponents and opponents of Internet taxation are largely concerned about the chilling effect that taxing e-commerce will have in terms of reducing consumer demand for e-commerce goods and services and the administrative difficulties due to the lack of a uniform tax. One potential solution to the problem is a Canonical[30] Consumer-Delivered Sales Tax ("Canonical CDS Tax" or sometimes referred to herein as a "CDS Tax").[31] Under the CDS Tax, the consumer pays the consumption tax to the taxation agency in the consumer's country.[32] In order to function properly, the CDS Tax system requires precise definitions of who is required to pay what, when the tax is imposed, and how it is collected and remitted to the government.[33]

According to the Committee on Fiscal Affairs (the "CFA") of the Organization for Economic Cooperation and Development (the "OECD"), taxation practices in global electronic commerce should satisfy the following seven criteria:

1. The system should be equitable. A taxpayer in similar situations should be taxed in the same way.
2. The system should be simple. Transaction and auditing costs should be kept down.
3. The rules should engender taxpayer confidence.
4. The system should be effective so as to minimize tax evasion and avoidance.
5. The system should avoid economic distortions that might induce consumers to seek tax havens.

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[30] The Canonical CDS Tax is a sales tax imposed on the consumer by the taxation agency of the supplier's country in a manner that is consistent in both physical and cyberspace. The Canonical CDS Tax is a more specific term. A CDS Tax, by contrast, is a broader term that refers to any tax on the consumer, directly or indirectly, on e-commerce transactions, whether the merchant or third parties collect this tax. For purposes of discussion in this paper, the terms "Canonical CDS Tax" and "CDS Tax" will largely be treated as interchangeable. Jae Kyu Lee and Yeoul Hwandgbo, *Cyberconsumption Taxes and Electronic Collection Systems: A Canonical Consumer-Delivered Sales Tax*, International Journal of Electronic Commerce, Winter 1999-2000, Vol. 4, No. 2, pp. 69-70.
[31] Lee and Hwandgbo, pp. 61-62.
[32] *Id.*
[33] *Id.*

6. The Internet tax base should be fairly shared between countries so as to keep clearance costs down.
7. The system should adapt current tax arrangements to the Internet rather than introduce new forms of taxation. The sales tax and VAT are the preferred systems for cybertrading rather than a new one like the bit tax.[34]

Due to concerns over physicality and the problems presented by multi-jurisdictional tax schemes, there are two possible models: the Supplier's E-Mall Server-Based Model and the Consumer-Based Model.[35] The server-based jurisdictional model is a direct mapping in cybertrading of the traditional procedure for collecting consumption taxes.[36] Under a server-based jurisdictional model, the tax goes to the jurisdiction where the server is installed.[37] The consumer pays the tax to the supplier along with the purchase price, and the supplier remits the payment to the taxing agency of the taxing jurisdiction, where the server is located.[38]

A downside to the server-based jurisdictional model is the fact that servers might be tempted to move to tax haven countries, and thus could adversely affect the global electronic commerce environment.[39] Further, it is not in keeping with the spirit of a consumption tax borne by the consumer.[40]

Under the consumer-based jurisdictional model, the tax revenue goes to the taxing jurisdiction in which the consumer resides.[41] According to this model, the supplier is an

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[34] Lee and Hwangbro, p. 62.
[35] Lee and Hwangbro, pp. 63-64.
[36] Lee and Hwangbro, p. 65.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*

importer bringing merchandise to the consumer's taxing jurisdiction.[42] In contrast to the server-based jurisdictional model, the consumer-based jurisdictional model satisfies the principle of avoiding economic distortions that might induce consumers to seek tax havens.[43] For this reason, the consumer-based jurisdictional model is the preferred model for the CDS Tax System.[44]

The consumer-based model is not without disadvantages, however. Basing the tax on the place of consumption is impracticable because it is too difficult to ascertain where goods and services provided over the Internet are consumed.[45] Basing the tax on the place of delivery may in fact tax gifts to the recipient.[46] The location of a residence is not easily confirmed, and this will continue to be the case unless suppliers in the field of electronic commerce uniformly adopt the use of certificates that include residential addresses of consumers.[47]

The location of the order can be confirmed by identifying the IP address, but consumers may use foreign IP addresses in order to avoid taxation.[48] On the other hand,

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[42] *Id.*
[43] *Id.* A principal concern of tax authorities is that "the highly mobile nature of the new Internet technologies will lead to the proliferation of tax haven operations that will further erode their tax base. For the country where the business is owned, the question is the effectiveness of the CFC legislation, which may or may not capture all types of income derived in e-commerce, as well as transfer pricing. For the countries where the customers are located, the feared tax base erosion will be offset by the collection of import duties. VAT and customs duties on goods and withholding tax on payments that are characterized as royalties. Few countries have tax treaties with tax havens, so the typical treaty reduction or elimination of withholding taxes on royalties would not be available. Internet-delivered sales of software from a tax haven will not be subject to withholding tax where the transaction is treated as a sale of goods." Maguire, *Taxation of E-commerce,* 47-Jun Fedrlaw 24.

[44] Lee and Hwangbro, p. 65.
[45] Lee and Hwangbro, p. 66.
[46] *Id.* However, most jurisdictions would be less troubled by this possibility inasmuch as taxable goods that arrive in the taxing jurisdiction would likely be subject to a use tax. For example, in Tennessee, to the extent that no sales tax has been paid with respect to tangible personal property brought into Tennessee, a use tax calculated based on the difference between the use tax imposed less any sales taxes paid in an outside jurisdiction are assessed against the consumer of the tangible personal property.
[47] *Id.*
[48] *Id.*

location of order would be a feasible method if the tax rate were consistent across taxing jurisdictions.[49] Nationality of the payer's bank is very easy to confirm, but foreign banks may be used for making payments, thus obfuscating the collection of taxes.[50]

There are four criteria under which a Canonical CDS Tax system is evaluated: (1) the transaction costs involved (i.e., the cost of tax billing and collection); (2) auditing cost (i.e., the cost of resources in technology and manpower to prevent tax evasion); (3) clearance cost (i.e., the costs associated with clearing imbalances between two taxing jurisdictions); and (4) the risk of tax evasion (i.e., the risk of intentional tax evasion).[51] Generally, the transaction costs will not be any greater than existing sales and use and VAT tax systems.[52] Software can perform the steps of identifying the buyer as an individual or a business and transferring the tax to the taxing agency's account.[53] There needs to be a common CDS Tax system protocol that allows for auditing merchants' records.[54]

Under a CDS Tax system, clearance between different taxing jurisdictions would be optional and only becomes important if there are significant imbalances.[55] Risk of tax evasion will largely depend upon personal motivation, technical ease of illegally modifying

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[49] *Id.*

[50] *Id.* In reality, the CDS tax delivery method is determined by the tax deliverer, the consumer's location, the tax billing agent, the tax billing time, the tax collection time, the jurisdictional basis, the number of taxing stages, the tax rate determinants, and the taxation agency's frontier account. Lee and Hwangbro, p. 67. Clearly the consumer's bank is the more reliable tax deliverer than the consumer. Lee and Hwangbro, pp. 67-68. The location of the consumer's bank is easier to ascertain than that of the consumer. Lee and Hwangbro, p. 68.

[51] Lee and Hwangbro, p. 71.

[52] *Id.*

[53] Lee and Hwangbro, pp. 71-72.

[54] *Id.*

[55] Lee and Hwangbro, p. 73.

tax software, level of audits, and legal prohibitions.[56] Therefore, software and common protocols will be needed to allow the taxing jurisdictions to remain ever vigilant in their efforts to thwart tax evasion.

The parties necessary to make a CDS Tax system work include the consumer, the merchant, banks, certifying authorities, and a taxation agency.[57] To put the CDS tax system into place, it should be applied to typical electronic payment systems, such as Electronic Fund Transfer ("EFT"), electronic credit cards, and electronic cash systems.[58]

The NGA has its own proposal for implementing a uniform and simplified system to allow state and local government to collect taxes on e-commerce transactions without unduly burdening e-commerce. The NGA proposes a "Streamlined Sales Tax" that will require large out-of-state mail order firms to collect sales and use taxes from their customers.[59] According to the NGA, "such action is necessary to restore fairness to competition between local retail store purchases and out-of-state mail transactions to provide a means for the states to collect taxes that are owed under existing law."[60] The NGA further points out that "the recent rapid growth of the Internet has underscored the importance of this equitable treatment."[61]

The Streamlined Sales Tax would require one uniform tax rate from state-to-state.[62] States will continue to have the option of not imposing the sales tax.[63] In each state in which the tax is collected, a uniform rate would apply.[64]

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[56] Lee and Hwangbro, p. 74.
[57] Lee and Hwangbro, pp. 75-76.
[58] *Id.*
[59] 12.1, Preamble, EC-12, Streamlining State Sales Tax Systems, www.nga.org/pubs/policies/ec/ec12.asp.
[60] *Id.*
[61] *Id.*
[62] 12.2.1, One Sales Tax Rate Per State, EC-12, Streamlining State Sales Tax Systems, www.nga.org/pubs/policies/ec/ec12.asp.

Under the Streamlined Sales Tax proposal recommended by the NGA, the definition of goods and services would be standardized, thus making them uniform and consistent across state lines.[65] Industry and government would also develop simplifications in the administration of the sales tax in areas such as uniform registration, tax returns, remittance requirements, and filing procedures.[66]

The NGA also recognizes that the Streamlined Sales Tax would best work through a system of third party administrators who would be responsible for remitting taxes to state and local governments.[67] Under this third party system, remote sellers would use a software package preapproved by the states that would calculate the tax due on the purchase based on the state tax rate where the item is sent, and electronically remit the tax to the collecting tax jurisdiction or the jurisdiction's agent.[68] Taxware, a small computer software company, has since 1980, been developing computer systems that help businesses comply with state sales and use tax laws.[69] The task is a complex one that involves determining how 7,600 taxing jurisdictions tax some 1,500 different products.[70]

VI. Conclusion.

The current state of Internet taxation in the United States is that the IFTA moratorium prevents states from discriminating against Internet sales and prohibits states from enacting laws that tax Internet sales. Proponents of taxing e-commerce primarily

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[63] *Id.*
[64] *Id.*
[65] 12.2.2, Uniform Structure and Simplified Compliance with the Sales Taxes, EC-12, Streamlining State Sales Tax Systems, www.nga.org/pubs/policies/ec/ec12.asp.
[66] *Id.*
[67] 12.2.2, Uniform Structure and Simplification Compliance with Sales Taxes, EC-12, Streamlining State Sales Tax Systems, www.nga.org/pubs/policies/ec/ec12.asp.
[68] *Id.*
[69] Swope, E-conomics Problem, *Governing Magazine*, March 2000.
[70] *Id.*

point to the loss in tax revenue for state and local governments. Opponents of e-commerce taxation primarily argue that taxation without uniformity or consistency is unduly burdensome and harmful to the fledgling e-commerce economy. Opponents also argue that taxes decrease demand and this decrease will ultimately place e-commerce sellers at a disadvantage against competitors competing in a traditional manner.

Assuming for purpose of argument that taxing e-commerce in some form is in everybody's best interest, both sides agree that there needs to be simplification and uniformity in taxing e-commerce. Simple and uniform tax rates, administration and third party administrators will be needed to make a uniform tax system work for industry and for government taxing authorities.