The Internet, Taxation, and the Constitution

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During the 2000 presidential election campaign, candidates fell over one another to proclaim their devotion to the fashionable idea that the Internet should not be taxed. Most realized that taxing the Internet meanttaxing a new method of commerce, just when many of their constituents were beginning to enjoy what appeared to be driving a new economic boom in America. Now that the dot.com bubble has burst, lawmakers are taking a harder look at whether or not issues of "tax equity" are being addressed and whether they can successfully extract some Internet wealth to fatten state and local government coffers. It is the purpose of the present study to examine whether this approach is compatible with constitutional safeguards for freedom of commerce or whether Internet taxation is simply a policy question to be decided by the traditional authority of the states to levy taxes.

We will examine the relevant sections of the Constitution, debates during the Constitutional Convention, Supreme Court cases pertaining to interstate commerce, and current proposals to tax the Internet. Based on our findings, we regret to conclude that there are constitutionally permissible methods for taxing the Internet. This much is plain to anyone who currently pays sales taxes on items bought from a web site that also has a store in his or her state, such as Barnes and Noble or Tower Records. There are however, constitutional means available to Congress to prevent further taxation, and even to roll back some of the existing taxation. We propose a reexamination of current case law that permits "remote" or interstate taxation when a "nexus" exists between an Internet-based business and its in-state retail store. Further we describe the constitutional hurdles that must be overcome if states and Congress should choose to tax Internet commerce.

BACKGROUND

At the time of this nation's birth, the Framers of the Constitution—and before it, the Articles of Confederation—understood how important free trade among the new states was to the survival of the nation as a whole. America was then and is now a commercial republic. This means that the life of the nation involves trade and commerce. Free men and women would produce goods and sell them to each other and to other states and to other nations. By this method, people provide for themselves and for their families. Laws regulating trade are meant to encourage and protect the freedom of such trade.

Consider the fur trade at the time of the American Founding. Obviously there was no such thing as efurs.com, offering finished fur products shipped directly to consumers with a few clicks of a computer's mouse.[1] Instead, fur traders had to take a laborious and often dangerous journey west, towing supply boats upstream to the trapping grounds. Once they had the furs, they had to wait for good weather to start the journey downstream, and then overland to an American port. At that point, traders sold the furs to merchants headed to Britain, where they could be finished into hats or other goods and then sent back to America for sale. Upon their return to America the goods would have a tariff put on them. This was a means to raise funds for the new colonies and an encouragement to domestic industries that were in competition with British merchants. What was not permitted was a similar tariff between the states to encourage one industry or state over another. This arrangement allowed free trade and commerce to thrive among the free peoples of the United States. Over time, as American industries matured, even the need for tariffs on goods imported from outside the country was seen as detrimental to commerce and the prosperity of the United States.

The current debate over Internet taxation arises out of different circumstances, but the principles that must guide the debate are no different. Sales taxes are regarded, as tariffs were in the 18th century, as a means to raise money for public purposes. Also, they are meant to balance the interests of traditional retail merchants with their new competition, on-line merchants. But, as in the example of the fur trade, we must ask whether sales taxes—and indeed the further expansion of remote sales collection—are good for commerce. Further, are they compatible, in the age of the Internet, with constitutional safeguards for freedom of commerce?

CURRENT CONTROVERSY

With the current moratorium on Internet taxation set to end on October 21, 2001, many advocates for Internet taxation are rushing to establish their plans as a new standard. Those who oppose levying e-commerce taxes often do so on practical grounds—that such efforts would result in a potential loss of privacy for consumers and could crush the growth of new Internet-based industries. For our purposes here we have focused primarily on the constitutional ques-

tions raised by such proposals.

When e-commerce began to blossom in the late 1990s, one reason Congress adopted the Internet Tax Freedom Act of 1998 was for fear that complex or heavy taxes would smother an industry in its infancy. The law placed a moratorium on new or discriminatory taxation of e-commerce and Internet access. It will expire October 21, 2001 unless Congress renews it. Several bills are under consideration in Congress to extend the moratorium, and the Bush administration has recently stated its support for doing so.

The law also set up a presidential advisory commission to study the issue and make recommendations for future action. The committee issued a report in April, 2000. No formal recommendations were made because the commission was unable to find the needed 13 of 19 votes for any specific policy proposal.

The main questions facing policymakers are as follows: Do states need new ways to tax out-of-state purchases in the era of e-commerce? Can they do so without violating the Constitution?

Some state-level organizations—such as the National Governors Association and the National Conference of State Legislatures—opposed Congress' moratorium on Internet taxes. In fact, the NGA opposed the very existence of the presidential advisory commission and litigated to prevent it from meeting. Its arguments center on the sales tax revenues lost by their states and localities with the rise of e-commerce.

These groups are doing more than just opposing an indefinite moratorium, however. Both the NGA and the NCSL have devised plans to "harmonize" state sales tax regimes through a compact the NGA calls the Streamlined Sales Tax Project. The SSTP would establish a uniform sales tax base and rate among member states, and would oblige one state to collect sales taxes for another if a resident of the second state bought something from a company in the first. The SSTP proposal now has backing from 32 states. [2]

Major high-tech states—California, Colorado, Massachusetts, and Virginia—actively oppose the NGA and NCSL proposals, however. Virginia Gov. Jim Gilmore, the chairman of the Republican National Committee, is a strong advocate for extending the federal moratorium.[3] The fact that these states do not want to participate in the SSTP remains a significant political hurdle to its adoption. However, as will be discussed below, there are important constitutional issues to consider.

CONSTITUTIONAL QUESTIONS

The Commerce Clause

The central constitutional question to consider is whether or not such Internet taxation proposals violate the Commerce Clause of the U.S. Constitution.

To answer this question, the history of the Commerce Clause is instructive.

It is a commonplace lesson of American history that the Articles of Confederation, which went into effect in November 1777 as the legal framework of an independent United States of America, failed because the central government had no power to levy taxes. Less well known is the fact that the primary impetus for the Constitutional Convention itself was the Annapolis Convention—a meeting in 1786 of five states to try to resolve problems arising from interstate commerce.

Under the Articles, individual states could effectively levy their own duties on imports from other countries and other states. The Framers of the Constitution—from George Washington to James Madison to Alexander Hamilton—were unanimous in the belief that the problem of interstate trade, left unresolved, would tear the union apart.

Foreign countries hesitated to engage in trade negotiations with the United States because the government could not prevent each state from violating any international pact. As Alexander Hamilton noted in Federalist 22, the absence of a federal power to regulate interstate commerce made the Articles "altogether unfit for the administration of the affairs of the Union." Without a central government to check state-by-state protectionist policies, the hope of a harmonious union of states was collapsing into a collection of states engaged in commercial warfare.[4] States sharing access to rivers clashed over their control. States with ports slapped imposts on goods headed for export from inland states, who then retaliated with duties on imports.

In Federalist 42, Madison wrote, "The defect of power in the existing confederacy [The Articles of Confederation], to regulate the commerce between its several members, [is the cause of] unceasing animosities, and [will] not improbably terminate in serious interruptions of the public tranquility."

In 1785, Washington wrote to Madison on the subject: "I hope the resolutions … respecting the reference to Congress for the regulation of a Commercial system will have passed. The proposition in my opinion is so self evident that I confess I am at a loss to discover wherein lies the weight of the objection to the measure."[5] On the subject of congressional power to regulate commerce, Washington wrote to a friend in the same year, "I am sorry I cannot agree with you in sentiment not to enlarge them [congressional powers] for the regulating of commerce."[6]

And in Federalist 22, Hamilton pointed out that state-by-state trade duties might prevent the United States from fully benefiting from its natural advantages. He cited the example of Germany, where each state had its own trade duties. The resulting web of tariffs made Germany's rivers and waterways "almost useless" in fostering robust internal trade.

These arguments in favor of a federal power to regulate interstate trade ultimately led to the Constitution's Commerce Clause contained in Article 1, Section 8. It reads, in part, "Congress shall have the power to regulate commerce with foreign nations, and among the several states, and with Indian tribes."

In the current debate over Internet taxation, it is critical then to revisit the original intent of the Commerce Clause. And, whether commerce is conducted with the click of a mouse or by a mule train, the clause's meaning could hardly be more clear. States retain the primary "police powers"—the authority and duty to protect the health, welfare, and morals of the community. Congress, on the other hand, is explicitly charged with ensuring that state actions do not impede the free flow of goods and ideas between states—a principle that the Constitution, in part, was created to guarantee.

The debate over e-commerce raises questions about the authority of states to collect taxes on purchases made by the state's residents from out-of-state vendors. The Supreme Court has ruled that only when an out-of-state firm has what it calls a "nexus," or a "substantial physical presence" in another state can it be treated as an in-state company for tax purposes. The Court's decision in *Quill v. Heitkamp* noted that Congress was free to codify any meaning for the word "nexus."[7]

If Congress were to pass a law codifying the Supreme Court's existing definition, and exclude things like web servers and telecommunication lines from constituting a physical presence, the result would likely pass constitutional muster. This would more or less keep Internet commerce within the zone of hard-to-collect "use" taxes.

In fact, it is probably news to most consumers that when they buy something over the Internet or through a catalog that is not subject to their home state's sales tax, they are themselves supposed to calculate a parallel "use tax" and pay it to the proper authorities in their own state. States find it difficult and politically unpopular to enforce these taxes, so they have long gone unpaid. The SSTP and similar plans aim to "fix" this by obligating out-of-state companies to collect the tax for the state where the consumer makes the purchase.[8] In short, if taxes on online purchases are not paid, it is not because they are tax-free. Rather, it is because states don't collect the tax.

Given its authority under the Commerce Clause, Congress must carefully consider any plan to extend the power of the states to collect use taxes on out-of-state purchases. Proponents of the Streamlined Sales Tax Plan claim that their proposal for standardized tax rates and collection policies will facilitate, rather than impede, free trade among the participating states. But Congress must bear in mind the important point that the Constitution seeks primarily to protect interstate *commerce*, not interstate *tax collection*. One of the fundamental purposes of the Commerce Clause was to promote a healthy competition among the states in terms of taxation and regulation.

Article 1, Section 10

The Commerce Clause is not the only section of the Constitution relevant to Internet taxation. The parts of Article 1, Section 10 known as the Import-Export Clause and the Compact Clause provide even clearer constitutional instruction on this subject. Taken together, these lesser-known constitutional clauses offer additional ground to the opponents of current state plans to tax interstate e-commerce.

The Import-Export Clause

The Import-Export Clause prohibits states from levying "Imposts or Duties on Imports or Exports," except for the purposes of inspection. Congress has the right to waive this restriction. But if it does, the clause clearly states that any resulting revenue would accrue to the U.S. Treasury.

It reads as follows: "No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing it's inspections Laws: *and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports*, shall be for the Use of the Treasury of the United

States." (Emphasis added.)

When the Framers of the Constitution wrote this clause, they were not just referring to imports from and exports to foreign countries. Unfortunately, more than a century of judicial misunderstanding has clouded the meaning of this clause. But a look at legal, commercial, and historical documents reveals that the words import, export, duty and impost were commonly understood to refer to goods moving from state to state, and tariffs levied on interstate trade.

Writing separately in *Camps Newfound/Owatonna, Inc. v. Town of Harrison et. al.*, Justice Clarence Thomas examines 1780s-era statutes and newspaper advertisements from Connecticut, Virginia, Massachusetts, Maryland, and New York to provide convincing evidence that "duties" and "imposts" included interstate commerce, not merely goods purchased from foreign nations.

> ….[M]erchants frequently published advertisements in local newspapers announcing recent shipments of such "imported goods" as "Philadelphia Flour," "Carolina Rice," and "Connecticut Beef." Similarly, the word "export was used to refer to goods shipped both to other states and abroad…. Thus, based on this common 18th century usage of the words "import" and "export," and the lack of any textual indication that the Clause was intended to apply exclusively to foreign goods, it seems likely that those who drafted the Constitution sought, through the Import-Export clause, to prohibit States from levying duties and imposts on goods imported from, or exported to, other States as well as foreign nations.[9]

Article 4 of the Articles of Confederation confirms this understanding of how these terms were used in the Founding era. The Articles specified that "duties" and "impositions" were permitted on property shipped from one state to another so long as the property did not belong to either the U.S. government or either of the states in question.

Finally, in the time between the adoption of the Articles of Confederation and the Constitution, the terms duty and impost were regularly used to describe interstate commerce. For example, at the Continental Congress in 1785, an amendment to the Articles was proposed. It would have vested power in the Congress to lay "such imposts and duties upon imports and exports, as may be necessary for the purpose" of "regulating the trade of States, as well with foreign Nations, as with each other."

What is the relevance of this to the e-commerce tax proposals? In short, any discriminatory rates on e-commerce would be unconstitutional. If the proposed tax cartel were to tax Internet purchases at a higher rate, or impose higher taxes on goods purchased out-of-state, this would be a clear violation of the Import-Export Clause. According to the Import-Export Clause, the revenue from any taxes collected this way—that is, at discriminatory rates—must go to the federal government. Those who see the SSTP as a boon to state treasury coffers should bear this in mind.

Technology is making the practice of sales tax collection in any form increasingly difficult. The response is ever more elaborate arrangements between Internet companies and "brick-and-mortar" establishments. A business may have a web-server in one state, maintain its site in another, and warehouse and ship its products from another, to name only a few variables. Given these factors, the attempt to define an appropriate nexus must necessarily become increasingly baroque.

Rather than adding layers of tax-collecting authority in an attempt to capture the digital fly in amber, perhaps the increasing complexity and geographic diversity of e-commerce should spur us to reconsider altogether the efficacy and fairness of point-of-origin sales tax. Take as an example the consumer in Northern California whose nearest Barnes and Noble bookstore is over 100 miles away but who can easily order a book from the chain on-line. If she orders from Barnes and Noble, she must pay a state sales tax because of the many Barnes and Noble stores in California. But if she orders from another popular on-line retailer, Amazon.com, she will not be charged a sales tax—even if she still owes a state use tax—because Amazon has no store in California. It is to Amazon's advantage, then, to never build a store in California and it is Barnes and Noble that is penalized by what amounts to, in effect, a discriminatory tax. Rather than extending the grasp of the tax collector to Amazon, perhaps it would be fairer, and better for the economy, to release the tax collector's grip on Barnes and Noble.

COMPACT CLAUSE AND MULTI-STATE TAX CARTELS

The final portion of Article 1, Section 10 is often called the Compact Clause. It provides that no state, without the consent of Congress, shall "lay any Duty of Tonnage" or "enter into any Agreement or Compact with another State."

Congress can also waive these prohibitions.

The Compact Clause's ban on duties of tonnage might be thought to translate easily into digitized goods. But tonnage duties had a very particular, and limited, purpose. They were designed to allow states (with congressional consent) to charge ships for harbor improvements based on the degree of use necessitated by those ships. Heavier ships needed more substantial dredging operations, for example, and so could be taxed more. The clause thus permitted a type of user fee. The Internet taxes being proposed today are nothing like user fees. There is no infrastructure that the state maintains to accommodate the Internet shipping that is being paid for with the tax. Such taxes instead would merely go into a state's general revenue coffers. This is an important distinction that warrants consideration.

What is more relevant to actual plans before Congress, however, is the Compact Clause's prohibition on any multi-state compact that does not have express congressional approval. This applies directly to the SSTP and other plans and is the chief constitutional safeguard against Internet taxation.

The competing bills offered by Senators Byron Dorgan (D-ND) and Ron Wyden (D-OR) both contain a mechanism for Congress to approve multi-state sales tax plans such as those promoted by the NGA and NCSL. Without explicit congressional approval, however, the proposed tax cartel would clearly violate the Compact Clause. But before Congress moves ahead, it should deliberate carefully on whether these plans promote the common good. Congress is by no means compelled to authorize the states' request for a tax compact. It should do so only if lawmakers believe that the compact would promote good public policy. There is ample reason to think it would not.

POLICY QUESTIONS

State and local governments would have a hard time proving, despite their insistence to the contrary, that they are losing billions of dollars in revenue from untaxed e-commerce purchases. The ability to buy things, spontaneously and conveniently, on the Internet—things that might not have been bought otherwise—simply cannot be measured. Although overall state revenues are down slightly in the last few months because of a slowing economy, most states have been running substantial surpluses in recent years. In his February 2001 "State Fiscal Outlook," National Council of State Legislatures President Jim Costa remarked, "Most state budgets in recent years have purred like the engine of a luxury car."[10]

Furthermore, careful studies show "lost" revenue to be a tiny share of the revenues garnered by state sales and use taxes. In 1998, the adverse effect of e-commerce was about one-tenth of one percent of total state and local sales and use tax revenues ($200 billion approximately) according to economists at Ernst and Young.[11] In 1999, economists Austan Goolsbee and Jonathan Zittrain estimated "lost" revenue at $210-$430 million—one quarter of one percent.[12]

The General Accounting Office calculates that these figures will increase by 2003 (see chart below), but will still not exceed five percent of total revenue, even by the highest estimates.

What's more, these projected "losses" stem from projections of what state use taxes would generate—if the states bothered to collect them. As mentioned above, states find it difficult and politically unpopular to enforce these taxes, so

Estimated State and Local Sales and Use Tax Losses for Internet Sales in 2003.

	Low estimate (in millions)	High estimate (in millions)
California	$86	$1,720
Florida	48	595
Michigan	39	415
Massachusetts	25	274
North Carolina	25	279
Tennessee	22	282
Colorado	18	181
All states	$1 billion	$12.4 billion

they have long gone uncollected. The SSTP and similar plans aim to "fix" this by obliging out-of-state companies to collect the tax for the state where the consumer makes the purchase.

In fact, the vast majority of online purchases occur between two businesses—sales that are generally not subject to sales tax. Less than five percent of online transactions are retail sales to consumers, according to the U.S. Department of Commerce. Nor are many online purchases, such as travel and financial services, subject to sales tax. Only if the online seller has a substantial presence in the buyer's state, are sales taxes collected. Finally, the Internet exists thanks to underlying telecommunications networks that are heavily taxed at all levels of government.[13]

If Congress were to allow states to engage in their tax-harmonization plans, a key principle of limited government would suffer. That is the principle of competition between the states. When one state has an advantageous sales tax regime, its citizens reap the benefit of cheaper consumption. But taxpayers in nearby states benefit as well, because competition among the states creates a downward pressure on tax rates.

This is the reason that Granite Staters have boasted for generations of the "New Hampshire Advantage." New Hampshire has neither a broad-based sales tax nor an income tax. Certainly the citizens of New Hampshire reap a benefit. However, citizens in neighboring states also reap rewards as their tax rates are held down in an effort to compete. Neighboring Massachusetts, for example, must consider the effect its tax rates have on its citizens and entrepreneurs who need only cross a nearby border to find tax relief.

SUMMARY AND CONCLUSION

The founding principles of American government do not need to change for the era of e-commerce. They have guided a strong country and growing economy through the changes to commerce wrought by the steamboat, the telegraph and telephone.[14] They have applied throughout an era of innovations in broadcast technology, and wireless and satellite communications have not required the abandonment of constitutional principles. And they continue to apply today, in the Internet era. That is why we urge extending, or making permanent, the current moratorium on e-commerce.

If state revenue collectors fear a shrinking tax base, they can and should adapt to new methods of commerce. It may well be the case that sales and use taxes are no longer a good way to raise state funds.[15]

At this point, the economic arguments against Internet taxation suggest those fears have yet to become real. But this should not necessarily be the most important concern to American citizens. After all, the Constitution was established to "secure the Blessings of Liberty," not merely to promote the ease of tax collection.

A careful look at the Constitution—and the Commerce, Import-Export, and Compact Clauses, in particular—together with legal precedents should give any citizen ample reason to be suspicious of multi-state tax-collection cartels. Such efforts would undermine the federalist principles on which this nation was founded—and on which it has thrived.

ENDNOTES

[1] Hiram Martin Chittenden, The American Fur Trade of the Far West, vol. 1, reprint. Lincoln: University of Nebraska Press, 1986.
[2] See for example the SSTP website at *http://www.geocities.com/streamlined2001/*. Also Alison Bennett, "Sixteen States Considering Legislation To Simplify, Streamline Sales Taxes," BNA, February 26, 201.
[3]Andrew Caffrey, "States at Odds Over Web Taxes," *The Wall Street Journal*, page B-3, March 7, 2001.
[4] For an accessible discussion of the Articles and the Constitution in context of emerging technologies – from steamship to rail to 21st century telecommunications networks – see also "The Delicate Balance: Federalism, Interstate Commerce, and Economic Freedom in the Technological Age" by Adam D. Thierer, The Heritage Foundation, 1999.
[5] George Washington, letter to James Madison; posted from Mount Vernon, November 30, 1785.
[6] George Washington, letter to James McHenry; posted from Mount Vernon, August 22, 1785.
[7] *Quill v. Heitkamp* (504 U.S. 298), 1992. The case followed on the 1967 decision of *National Bellas Hess, Inc*. v. *Illinois Department of Revenue* (386 U.S. 753), 1967.
[8]See for example, Jason M. Thomas, "Oregon Plan Can Reignite the Flame of Internet Tax Freedom," Issue Analysis No. 116, Citizens for a Sound Economy Foundation, March 14, 2001.
[9] *Camps Newfound/Owatonna, Inc.* v. *Town of Harrison et. al.*,(520 U.S. 564) 1997.
[10] "State Fiscal Outlook: February Update," National Council of State Legislatures, Februrary 28, 2001.
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[12] Goolsbee, Austan and Jonathan Zittrain, "Evaluating the Costs and Benefits of Taxing Internet Commmerce," *National Tax Journal*, September 1999.
[13] See, for example, Joseph J. Cordes, Charlene Kalenkoski and Harry S. Watson, "The Tangled Web of Taxing Talk: Telecommunications Taxes in the New Millennium," Progress on Point Release 7.2, The Progress & Freedom Foundation, September 2000; see also Aaron Lukas, "Tax Bytes: a Primer on the Taxation of Electronic Commerce," Trade Policy Analysis No. 9, December 17, 1999; Adam D. Thierer, "After the Net Tax Commission: The Gregg-Kohl Nexus Solution," Backgrounder No. 1363, The Heritage Foundation, April 25, 2000
[14] See for example the history and decisions in *Gibbons* v. *Ogden* (9 Wheat. 22 U.S. 1), *Willson* v. *Blackbird Creek Marsh Co*. (2 Pet. 27 U.S. 245), and *Genesee Chief* v. *Fitzhugh* (12 How. 53 U.S. 443).
[15] Kent Lassman, "An Internet Friendly Policy Agenda," Testimony Presented Before the Florida House of Representatives, Committee on Utilities and Communications, February 1, 1999; or more recently, Hal Varian, "Economic Scene: Forget Net Taxes. Forget Sales Taxes Altogether," p. C-2, *The New York Times*, March 8, 2001.

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