Overview of Internet Taxation Issues

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Introduction

Essay Overview

Widespread use of the Internet and its use for many different types of business and personal transactions raise a variety of tax issues for taxpayers, practitioners, legislators, and tax agencies. Despite the prevalence of Internet use for business transactions for well over a decade, Internet and web-based transactions and assets continue to challenge tax rules that have not been updated for a world where borders and tangible goods are not the focal points. Legislatures and tax agencies struggle to understand the nature of web-based transactions, new ways of doing business and whether and how existing tax rules should be modified to effectively and appropriately apply to Internet transactions. Also, Internet-based transactions and business models continue to evolve, continually challenging tax rules and proposed changes. The changes require lawmakers, tax auditors and tax practitioners to also understand the technology and transactions in order to apply tax rules correctly or to know if existing rules require modification.

This essay provides an overview to why tax issues exist in the e-commerce business model. In addition, the basics of state and federal tax rules and principles relevant to Internet and web-based transactions are explained along with selected current developments that sometimes bring clarity, but can also increase the confusion due to sometimes conflicting rulings or varying technologies underlying seemingly similar transactions. Areas of the tax law that pose the most significant challenges—nexus determinations and nature of the transaction, among others, are covered. Finally, this essay summarizes some of the actions and reports on Internet, cloud computing and e-commerce taxation from legislatures, government agencies and others to provide a sense of the ideas offered to address issues raised by new ways of doing business.

The term "Internet transactions" is used throughout this essay for convenience. Consider that for this essay, the term includes all technology elements of the Internet (including telecommunications), web-based transactions and operations, cloud computing, and e-commerce.

Considerations in Understanding Internet Taxation Issues

Listed and explained below are seven concepts for understanding and evaluating Internet taxation issues and the challenges and methods for resolving them.

1. Many of the issues are not entirely new ones

One of the biggest concerns raised by state and local tax agencies regarding the Internet is the potential loss of sales and use tax revenues. This is not a new problem though. In 1992, the U.S. Supreme Court confirmed an earlier ruling (*Bellas Hess, Inc.*, 1 ILR 853, 386 U.S. 756 (1967)) that a vendor must have a physical presence in a state in order for the state to require the vendor to collect sales and use tax from its customers in the state (*Quill*, 2 ILR 242, 504 U.S. 298 (1992)). This case involved a vendor making sales via mail order catalogs, not the Internet. And the issue of states not being able to collect sales and use tax from remote (non-present) vendors, predates the *Quill* case. In 1965 the "Willis Report" prepared by members of Congress described the problem states faced in losing sales tax revenue from catalog sales where the vendor did not have nexus in the state.[1]

The Internet and e-commerce has heightened awareness of the complexities of state and local sales and use tax systems. Definitions of taxable items vary among the taxing jurisdictions, as do rates and exemptions. These complexities reduce the likelihood that Congress will exercise its authority under the Commerce Clause to require remote vendors to collect sales tax on all sales, unless the rules of simplified. These complexities, are not new issues, there is just heightened awareness of them in trying to address Internet taxation issues.

Another example of an old issue that has received heightened attention with the e-commerce model is the *tax gap*. The tax gap is the amount of tax that is owed, but not remitted due to both intentional and unintentional errors. Tax gap concerns related to e-commerce have been raised by both state tax agencies and the Internal Revenue Service (IRS).

An increase in the number and amount of sales by remote vendors raises the tax gap because many consumers either do not know that they owe use tax or do not keep adequate records to compute it. Estimates of the amount lost from the failure to collect sales and use tax on remote sales vary greatly due to differences in the expected growth of such transactions, the current level of compliance, and assumptions made about business compliance. A June 1999 study concluded that 63% of business-to-consumer online sales were non-taxable (such as airline tickets, gambling, and interactive games). Of the remaining 37% of business-to-consumer sales, sales tax was paid on 4% (4% of the 100% of business-to-consumer sales), and 20% was a substitute for other remote sales for which no tax was collected, leaving 13% of total business-consumer sales untaxed. The study applied an average state and local sales tax rate of 6.5% to determine that the estimated sales tax loss was $170 million for 1998, representing one-tenth of 1% of total state and local sales tax collections.[2]

In contrast, a June 2000 General Accounting Office (GAO) study estimated that the state and local sales and use tax loss for all Internet sales for 2000 was between $0.3 and $3.8 billion (about 2% of projected sales tax revenue). This included both business-to-business and business-to-consumer Internet sales. The projected loss for 2003 was between $1.0 and $12.4 billion (5% of projected sales tax revenue). The differences between the high and low

[1] Special Subcommittee on State Taxation of Interstate Commerce, House Comm. on the Judiciary, State Taxation of Interstate Commerce, H.R. Rep. No. 1480, 88th Cong., 2nd Sess. (1964) and H.R. Rep. No. 565, 89th Cong., 1st Sess. (1965).

[2] Ernst & Young, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by The Internet in 1998*, June 18, 1999; available at http://govinfo.library.unt.edu/ecommerce/document/Ernst&Young1.pdf.

figures are due to varying assumptions as to business-to-business compliance rates and the estimated amount of e-commerce sales.[3]

The June 2000 report from the GAO indicated a wide range of estimates on consumer and business compliance rates with respect to paying use tax. In its estimates, GAO used a consumer compliance rate of between 0% and 5% and 50% to 90% for business purchases with the exception of auto purchases. Because cars must be registered, the use tax can be collected and use tax compliance is about 100%.[4]

In 2010, California estimated that about $1.2 billion of use tax goes uncollected on Internet and mail order sales.[5]

In annual reports to Congress, the National Taxpayer Advocate (NTA) has called attention to the growing tax gap. The 2005 report includes a significant discussion on the cash economy, which the NTA notes "may grow faster as cash transactions move to the Internet." The report notes IRS research and forums that found that practitioners believe that Internet sales, such as through eBay, have generated a lot of unreported income.[6] The Small Business/Self-Employee (SB/SE) Division of the IRS has been studying ways to identify and reduce the tax gap generated from e-commerce.

Issues of uncollected taxes have existed well before the Internet generated business activity. Some traditional means of reducing the tax gap, such as audits, will help address this issue for Internet transactions, as well as new ways to find non-compliance and to make better use of technology in tax compliance and administration.

Some business models and transactions have been energized due to capabilities of the Internet. For example, deal-of-the-day, vouchers and similar offers, have been used to create companies such as Groupon, launched in 2008. Groupon offers "daily deals" in 45 countries.[7] A transaction with such a company may enable a customer to purchase a coupon to obtain a product or service at a reduced price. The customer then takes the coupon to the seller of the produce or service to obtain the item. Tax issues that arise include whether sales tax is owed on the purchase of the coupon and how it is calculated on the purchase of the produce or service at the reduced price. These transactions are not entirely new in that special deals have been offered without the Internet. Many states have rules that help determine the sales tax base when a discount is offered. Several states have issued guidance on how sales tax applies to vouchers and deals-of-the-day offered by Internet companies.[8]

2. Changes in business practices can affect tax bases

The business realities of the Internet can affect existing tax bases in various ways. These include making it easier to avoid some taxes, modifying delivery techniques to legally move an item from a taxable to a non-taxable category and changing land use patterns in cities that can adversely affect tax bases.

Amazon.com is a good example of the new business realities of the Internet. While this company only started operations in 1995, it has customers throughout the world, but only a few physical locations. Without the Internet, Amazon.com would likely have needed a physical location in a state or country to be able to sell merchandise to customers there. Such physical locations would have also required it to collect sales tax from customers. Instead, as a remote vendor, the tax collection responsibility falls to consumers to self-assess, which is not a reliable approach to sales and use tax collection.

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[3] GAO, *Sales Taxes—Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000; available at http://www.gao.gov/archive/2000/g600165.pdf.

[4] GAO, *Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, pages 34-35.

[5] Yee, Betty; California Board of Equalization newsletter, January – March 2011, Vol. V, Issue 1, page 6; http://www.boe.ca.gov/members/yee/pdf/Volume5Issue1.pdf.

[6] National Taxpayer Advocate, 2005 Annual Report to Congress, page 58; available at http://www.irs.gov/pub/irs-utl/section_1.pdf.

[7] Groupon website, "About us," http://www.groupon.com/about.

[8] For example, Illinois Department of Revenue, ST 12-0009-GIL 02/28/2012, http://www.revenue.state.il.us/LegalInformation/Letter/rulings/st/2012/ST-12-0009.pdf; Massachusetts Department of Revenue, Working Draft Directive 11-XX: Application of Sales Tax to Sales and Redemption of Third Party Coupons, Sept. 2011, http://www.mass.gov/dor/businesses/help-and-resources/legal-library/directives/directives-by-decade/2011-directives/working-draft-directive-3.html; and New York Department of Taxation and Finance, TSB-M-11(16)S, 9/19/11; http://www.tax.ny.gov/pdf/memos/sales/m11_16s.pdf.

Also, the Internet makes it easier for more types of transactions to be completed in an intangible manner—that is, without the need to provide tangible personal property to the customer (such as electronic transfer of a digitized book). Such transactions will continue to erode sales tax bases in states that primarily only tax tangible personal property, but not services and intangibles. For example, instead of having your roll of film processed and delivered to you as tangible prints, you can have them delivered to you electronically. If the state does not tax the film processing service, just the taxable prints, the tax base has disappeared. Or, a person could just use a digital camera and computer-displayed images.

The Internet also makes it easier to purchase from a non-U.S. vendor. If the purchased item is subject to sales tax, the state will have to rely on collecting the use tax from the resident buyer as it is unlikely that a system will be designed to enable states to demand sales tax collection by foreign (non-U.S.) vendors.

New ways of doing business will not only impact the sales and use tax base, but also land use decisions and competition among cities and states. The growth of "dot-com" businesses caused some cities to rethink land use considerations. Years ago, some "dot-com" businesses bid up rents causing some small retail and service businesses to go elsewhere. For cities trying to maintain a certain percentage of retail space in their downtown areas (and generation of sales tax), decisions have to be made as to whether restrictions should be placed on land use. For example, in September 2000, the City Council of the City of San Carlos passed a 45-day permit moratorium against conversion of retail spaces into office space. A study was to be conducted during that time period to determine the ideal policy.[9]

While these examples of how new types of transactions affect tax bases are negative ones, there are positive benefits of the Internet for improved tax compliance and administration. For example, a system could be designed by tax agencies to enable consumers to pay and remit sales tax at the same time their credit card is charged for the purchase with the tax going directly to the tax agency. Also, pop-up ads could be used by tax agencies to help educate Internet users about possible tax obligations.

3. While e-commerce represents a small amount of retail sales today, the growth potential concerns state and local governments

E-commerce is still in its infancy because in 2009 it represented just 4% of total retail sales. But, the growth potential continues to be strong. The U.S. Census Bureau reported that from 2002 to 2009, total retail sales grew at an average annual growth rate of 2.2% while e-commerce retail sales had an average annual growth rate of 18%.[10] The Census Bureau defines e-commerce sales as ones where the order for goods or services is placed online or the price and terms of sale are negotiated online. It does not matter how payment is made.[11]

The purchase of e-books has also increased. The Association of American Publishers reports that market share of e-books grew from 0.6% in 2008 to 6.4% in 2010.[12] This phenomenon along with the movement of other types of goods from tangible to intangible, such as music and movies, will result in reduced sales tax collections for state and local governments that only subject tangible goods to sales tax.

While some commentators might argue that tax agencies should not be concerned with the tax gap because e-commerce sales are a small portion of total sales, it is the growth and expected continued growth of e-commerce that leads tax agencies and many legislators to look for solutions to the growing tax gap stemming from e-commerce.

4. An understanding of the concerns of all players is important in resolving Internet taxation issues

The tax mix for each level of government differs, and thus, the tax concerns raised by e-commerce and Internet transactions also differ. A solution that might help state government might not be ideal for its cities, and vice versa. Also, tax and business issues raised by e-commerce differ among industries. A solution for a retail clothing distributor may not be ideal or workable for a service business or manufacturer, or vice versa. To obtain the best

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9 Martha McPartlin, "San Mateo halts influx of dot-coms," *San Mateo County Times*, 9/7/00.

10 U.S. Census Bureau, E-Stats; May 26, 2011; http://www.census.gov/econ/estats/.

11 Data can be found at http://www.census.gov/econ/estats/. Also see California Board of Equalization, "Remote Sales and Use Tax," *Economic Perspective*, Vol. XVII, No. 1, Feb 2011; http://www.boe.ca.gov/news/pdf/EP2-11.pdf.

12 Association of American Publishers, Book Stats, http://publishers.org/bookstats/formats/.

approach to application of tax rules and systems to e-commerce transactions, consideration must be given to the varying concerns and interests, as well as to principles of good tax policy.[13]

For example, some commentators and politicians have downplayed concerns of cities over their sales tax base due to new the potential growth of businesses similar to Amazon.com, stating that income taxes have been increasing. However, very few cities in the U.S. impose an income tax, or share in the state income tax.

Another example of differing concerns is between main street vendors and remote vendors. The typical concern (expressed at least as far back as 1965) is that main street retailers face an unfair competitive situation relative to remote vendors who need not collect the sales tax from customers (although customers owe a use tax). However, to change the law (without greatly simplifying it) to make remote vendors collect sales tax from all customers then "unlevels" the playing field in terms of compliance obligations and costs. The main street vendor often has just one rate of sales tax to collect and one form to file. The Internet vendor potentially faces over 46 filing obligations with differing rates and rules defining what is subject to sales tax (although this has been simplified in states that have adopted the Streamlined Sales and Use Tax Agreement, discussed later).

Also, some solutions, such as allowing states to require remote vendors to collect sales tax, will be far more costly for small businesses to comply with than large retailers. The costs to comply with the tax rules of multiple domestic and foreign taxing jurisdictions can be quite high in terms of labor costs, training, computer systems, need for continual updates due changes in laws and regulations, audits, and risk of error. A 1998 study by the State of Washington on sales tax compliance costs reached the following conclusions:[14]

Costs as a percent of total state and local sales tax collections:

Small business: 6.47% (gross sales between $150,000 and $400,000)

Medium business: 3.35% (gross sales between $400,000 and $1,500,000)

Large business: 0.97% (gross sales over $1,500,000)

Total cost weighted by number: 4.23%

Total cost weighted by dollars: 1.42%

The costs of compliance can also be complicated and costly due to the frequent changes to tax rules and forms. While many companies rely on software systems for compliance, such systems can be expensive to obtain and maintain. Also, many large companies may find that they need to create their own software systems rather than purchase canned programs. Technology-based collection systems that are part of the Streamlined Sales and Use Tax Agreement may simplify and reduce collection costs for medium- to small-size businesses.

Finally, concerns of consumers must also be considered in finding ways to effectively tax Internet transactions. No one is eager to pay more taxes or new taxes. Consequently, discussions of taxing remote commerce or Internet access lead to complaints by consumers (complaints of business typically stem from complexity and double taxation). However, when it comes to the use tax, the cause of taxpayer rumblings is arguably due to the fact that they view it as a new tax (although it has existed in most states since the 1930's). Very few states make any serious effort to educate their residents about their use tax obligations.[15]

While state and local governments would logically prefer to have vendors collect use tax in order to reduce administrative costs and improve compliance, it is unlikely that such a result will be allowed by Congress without simplification of these tax systems.[16] However, even when such simplification is achieved, it will not cause all use tax to be collected. For example, proposals to allow states to require remote vendors to collect sales tax typically

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[13] For more on Internet taxation and principles of good tax policy, see Nellen, "Internet Taxation and Principles of Good Tax Policy," Policy & Internet: Vol. 4: Iss. 1, Article 2 (2012), http://www.psocommons.org/policyandinternet/.

[14] Washington State Department of Revenue, *Retailers' Cost of Collecting and Remitting Sales Tax*, December 1998; http://dor.wa.gov/content/aboutus/statisticsandreports/retailers_cost_study/default.aspx. The report also notes that the costs of collection can be offset somewhat by the float that retailers enjoy due to the lag between collection and remittance of the tax, and the ability to deduct these costs on their income tax returns.

[15] Several states, such as California, Connecticut, Idaho, Indiana, Kentucky, Maine, Michigan and Wisconsin, have a line on the individual income tax form for reporting of use tax on mail order and similar purchases. However, without education efforts and publicized enforcement efforts, there is likely to be a significant tax gap for the use tax.

[16] It is possible that if states did achieve sales tax simplification, the U.S. Supreme Court may find that the tax no longer impedes interstate commerce and allow states to collect the tax from remote vendors.

exempt small vendors from compliance. Also, such legislation would not enable states to require non-U.S. vendors to collect and remit use tax.

5. E-commerce issues and complexities are not only in the tax area

A variety of issues are raised by the borderless and intangible nature of the Internet. Congress has introduced a variety of proposals to regulate the Internet, such as prohibiting online gambling and distribution of materials that are harmful to minors. Various bills have been introduced to deal with consumer privacy concerns at the federal and state levels. Some of these actions can also impact the growth and nature of e-commerce. Technical developments, such as increasing bandwidth, will present new challenges to subnational governments as more products move from the taxable tangible personal property form to the often non-taxable intangible form.

6. Many studies about state and federal tax issues as well as e-commerce taxation have been completed and should not be ignored in looking for solutions

Many organizations and governments have studied and debated various tax issues and concerns presented by the Internet. Much of this work has occurred in the U.S. The U.S. Treasury Department issued one of the first papers on global tax issues in November 1996, and the White House issued a framework document covering taxes and other rules in July 1997. Industry associations, foreign governments, and the OECD have also issued policy papers.[17]

Subnational governments should stay apprised of this work, even at the international level, because it may impact local solutions. The federal Advisory Commission on E-Commerce, formed by the Internet Tax Freedom Act (ITFA) in October 1998, was given a very broad charge to examine tax issues at the international, national, and subnational levels. A report was submitted to Congress in April 2000, but the Commission failed to reach the required 2/3 vote for any of its tax proposals to be recommendations as defined under the ITFA. A study group formed by the National Tax Association (NTA) in late 1996 to look only at state issues was unable to reach consensus on the issues it discussed for over two years. However, state tax agencies, trade associations, tax professional associations and others continued to study the issue and provide information and suggestions to legislators. Various tax commissions have been formed by state governments to study tax reform in general and would also be good starting points for developing solutions to Internet taxation issues.[18] In addition, Congressional committees, most notably the House Judiciary Committee, have held hearings on certain aspects of Internet taxation.[19]

Within the section on "most serious problems," the IRS National Taxpayer Advocate's annual report to Congress for 2008 included a chapter entitled, "The IRS Should Proactively Address Emerging Issues Such as Those Arising from 'Virtual Worlds'."[20] The report explains the nature of virtual worlds, provides data on usage and notes some federal tax issues for the IRS to address such as the tax treatment of economic activity in virtual worlds, such as Second Life.

7. New approaches should be considered

In attempting to resolve taxation issues, "out-of-the-box" thinking can be a good first step. Policymakers must also be able to distinguish between difficult problems and the rare problems that are truly unsolvable. Discussions regarding a workable tax system should include:

- Whether sales tax should be sourced based on the origin (location of seller) or the destination (location of buyer) approach. This analysis must consider source versus residence approaches for assessing income tax on e-commerce, ease of application, impact to government tax bases and competition, and what consumers

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[17] The OECD (Organization for Economic Co-operation and Development) is an organization of industrialized countries. It was works to promote policies to achieve high economic growth and employment, rising living standards, financial stability, and expansion of world trade. The OECD held two major conferences on taxation and e-commerce in the late 1990's. See further discussion later in this outline.

[18] Several of these reports can be found at the website of the National Conference of State Legislatures at http://www.ncsl.org/programs/fiscal/taxcomms.htm.

[19] See congressional hearings list maintained by the author at http://www.cob.sjsu.edu/nellen_a/112th-hearings.htm (under state tax reform).

[20] National Taxpayer Advocate, 2008 Annual Report to Congress, page 213 -226; http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf. For links to law review articles on tax issues of virtual worlds, see Tax Prof Blog post of May 11, 2010, Real World Tax Consequences of Property Transactions in Virtual Worlds; http://taxprof.typepad.com/taxprof_blog/2010/05/real-world-tax-consequences-.html.

expect when they pay a consumption tax. In some states, such as California, a mixed system exists in that the state sales tax follows the destination approach, while most local taxes follow the origin approach.

- What simplification techniques are possible, including better use of technology, in the compliance and administration areas?

- How fundamental tax reform discussions at the federal level might present solutions for subnational governments.

- Whether states can make better attempts to educate consumers about the use tax and collect it, such as by collecting it along with income taxes (which many states do today). In addition, consideration should be given to better educating the press who often imply that use tax collection is the collection of a new tax.

- Whether new solutions will be adaptable to new technologies and ways of doing business. Will solutions and answers to today's issues also work as technology continues to change—such as through expanded use of "cloud" computing? Also, what about possible changes in telecommunications billing practices, such as once proposed by Sprint, where customers would be billed based on the quantity of digital bits they used monthly?[21] Would such a feature make a new tax, such as a "bit tax," feasible?[22] And, if feasible, would it be prudent or logical to create a bit tax?[23]

Overview to Types of Internet-Related Tax Issues

Why the Internet Raises Tax Issues

The Internet offers new business models. As such, it creates some challenges to tax systems that were designed with different business models in mind. Some of the key reasons why the Internet raises tax issues are explained below. Table A which follows the list highlights specific disconnects between the e-commerce business model and the traditional sales and use tax.

1. *Location*: Tax systems designed in the 20th century tend to determine tax consequences based on the physical location of the taxpayer. The e-commerce model enables businesses to operate with very few physical locations. An online vendor can easily sell to customers throughout the world from a single physical location. The e-commerce business model also involves more customized inventories, as well as digital goods, so storage needs (and thus the need for many physical locations) are reduced. Also, the model involves less vertical integration and more outsourcing—again, fewer physical locations are used by a vendor. In addition, some business assets, such as servers, are not necessarily tied to a single physical location, but can easily be relocated without any interruption to business operations. That is, the location of the server is not relevant for business purposes and thus, may not be a logical taxing point.

Location factors primarily raise tax issues at the international and state and local levels, rather than at the federal level. For example, the U.S. Supreme Court has ruled that a state may only require a vendor to collect sales and use tax if the vendor has a physical presence in the state.[24] Also, outsourcing raises issues as to the nature of the relationship between the company and the supplier to determine if the supplier is the company's agent creating a taxable presence (nexus) for the company in the state.

2. *Nature of Products*: The Internet allows for some types of products, such as books and music, to be delivered in digitized (intangible) form, rather than in tangible form. Digitized products raise issues at the state level as to whether sales tax applies and in which state income is generated for state income tax purposes. Public Law 86-272, enacted in 1959, prohibits a state from taxing a foreign corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved and shipped from outside the state. This law is out-of-date today where the transfer of services and

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[21] See John J. Keller, "The Old Phone System Is Facing an Overload, So Sprint Has a Plan," *Wall Street Journal*, June 2, 1998, page A1.

[22] H.R. 4105 (105th Congress) defines a bit tax as "any tax on electronic commerce expressly imposed on or measured by the volume of digital information transmitted electronically, or the volume of digital information per unit of time transmitted electronically, but does not include taxes imposed on the provision of telecommunications services."

[23] While discussion of a "bit tax" seems to have waned after the 1990s, it was mentioned at least in 2010. See discussion and links at author blog post of March 19, 2010; http://21stcenturytaxation.blogspot.com/2010/03/internet-usage-or-bit-tax.html.

[24] *Quill*, 2 ILR 242, 504 U.S. 298 (1992).

intangible items is a significant business activity. The nature of products can also raise income tax issues regarding the type of revenue generated and how it is to be sourced, as well as whether digitized products are subject to traditional inventory accounting rules.

3. *Nature of Transactions*: The Internet allows for paperless transactions, the potential for the use of electronic cash, and elimination of payment intermediaries. This raises administrative concerns for the IRS and other tax agencies as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed. In a speech entitled, "Tax Administration in a Global Era," (former) Treasury Secretary Summers stated:

> "The Internet provides new ways for tax administrations, such as the IRS, to improve the ease and transparency of tax collection. But new technology also raises certain problems. In a world where cyber-transactions are growing at a rapid pace, tax administrations face the challenge of adapting existing tax systems to an economy that increasingly ignores physical borders.
>
> In such a world, it will be easier for companies to avoid tax collectors by operating worldwide through web-sites based in jurisdictions that are unwilling to share taxpayer information."[25]

Technology can change traditional ways of doing business and exchanging value or payment. For example, fractal transactions can allow a customer payment to be distributed directly to the businesses in the supply chain.[26] Similar approaches could be used for payment of sales tax, where tax is charged directly by the tax agency at the time of the taxable purchase.

"Cloud computing"[27] where transactions or data are handled or stored away from the customer's premises also raise a variety of multistate and international tax issues that arise due to issues of understanding and classifying the nature of the transaction. These include whether a server creates a taxable presence, the nature of the transaction (services, purchase or license of software, access to intangibles), and where income should be sourced. State sales taxes can also require that the details of the technology and transaction be determined because some states subject certain intangibles and services to sales tax and there could be a need to distinguish between data processing services and the sale of software, for example.

4. *New Types of Assets*: Some of the new assets created by commercial use of the Internet are domain names (URLs) and websites. For income tax purposes, issues exist as to how to treat the costs of creating or acquiring such assets, as well as the characterization of any gain or loss generated upon disposition of the asset. Sellers of such assets may face uncertainty in the law as to how to characterize the gain or loss generated from the disposition (capital or ordinary).

5. *New Ways to Transact Business:* The Internet has allowed for new ways of selling and buying goods and services. For example, individuals can offer their unwanted items to a worldwide group of potential buyers via auction sites, such as eBay. The Internet can also be used to easily link business buyers and sellers through exchange websites where buyers post what they have to sell and sellers match up with them, or vice versa. Such sites can almost operate without human intervention for the matching function. In addition, the Internet has increased the use of bartering, most notably with respect to exchange of web banners that serve as advertisements. These new techniques raise various tax issues at all levels. For income tax purposes, issues include whether an exchange intermediary or broker should be accounting for inventory, and what amount of information reporting should be required for low-value bartering transactions, and how such transactions should be valued. At the international level, the source of the income generated (which country) might be uncertain. At the state and local level, issues exist as to when individuals have sold enough goods to be required to become sales tax collectors and how to enforce such rules.

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[25] From a speech to the 34th General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.

[26] Frey, Thomas, "Fractal Transactions: Launching the Future of Money," *The Futurist*, Jan.-Feb. 2007, page 10; http://www.wfs.org/trend2jf07.htm.

[27] The National Institute of Standards and Technology (NIST) has detailed information on types of cloud computing and the technology involved and operational characteristics that may be useful in understanding a cloud business model in order to understand how tax rules apply to it. See http://www.nist.gov/itl/csd/cloud-012412.cfm and http://csrc.nist.gov/cyber-md-summit/documents/posters/cloud-computing.pdf.

Marketing options can affect tax collections at any level. For example Andy, who lives in San Jose, California, wants to purchase a book for personal use. His options for purchasing this book and the resulting tax consequences follow.

Purchase Technique	Sales Tax for California	Sales Tax for San Jose
a. Buys the book at a bookstore located in San Jose	6%	1%
b. Buys the book at a bookstore in Cupertino (near San Jose)	6%	0% (1% goes to Cupertino)
c. Buys the book from the San Jose bookstore's website and it is mailed to him.	6%	1%
d. Buys the book over the Internet from a store not physically located in California	0% (however, Andy owes 6% use tax)	0% (however, Andy owes 1% use tax)
e. Buys the book in digitized form and it is delivered to him over the Internet or Andy may access it on the provider's server (it is not on Andy's computer)	0% (no tax owed on intangibles in CA)	0% (no tax owed on intangibles in CA)

Another example of a new way to transact business involves web advertising. Technology (software and the Internet) enables the number of clicks on a website ad to be tracked and the advertiser can be billed based on the number of clicks. Or, the clicks can be traced to see what people who click on the ad do at the website they are directed to. For example, if they buy goods at that site, the advertiser can pay the website owner a commission or fee based on the ultimate sale that was made. This advertising approach is often referred to as "performance marketing" or "performance advertising." The website owner with whom the advertiser contracts with to set up a link on the website is often referred to as an affiliate or associate.

The affiliate advertising or performance marketing arrangement has raised issues on what distinguishes advertising from solicitation of sales. In traditional advertising, such as television commercials, the advertiser pays based on the expected viewership of the show and the length of the commercial. The number of viewers is not known until after the show airs. In contrast, the Internet allows the advertiser to only pay for the level of activity generated by the website ad. Thus, instead of paying an upfront fee in the hopes that 5,000 people click on an ad, the advertiser only pays for the actual clicks or for the clicks that led the person who clicked the ad to do something at the final destination site (such as purchase goods from the advertiser). The advertising versus solicitation issue is relevant for sales tax nexus purposes. States tend to take the view that if the affiliate is paid a commission based on actual purchases, the transaction is more likely to be solicitation than advertising. In contrast, if the affiliate is paid per click, states tend to assume that it is advertising and the arrangement between the affiliate and out-of-state advertiser will not create sales tax nexus for the advertiser in the affiliate's state.[28]

Web-based applications and digital transactions offer new ways to handle old transactions. For example, the IRS and state tax agencies continue to move more filing applications from paper to electronic/digital form. Interestingly, in Nebraska, the Department of Revenue website has a link for "E-commerce" which provides information on e-filing.[29]

6. *Remote and Transient Workforce*: The Internet era involves "knowledge workers" who often can do their work from anywhere provided they have access to the Internet. Thus, the workforce of an Internet company may be in several different states or countries, rather than working in a single work location together. This can raise issues as to whether the presence of the employee in a particular state creates tax obligations (nexus) for the employer in that state.[30] Also, cities may find that employers owe business license taxes due to the presence of an employee in the city or if the worker is an independent contractor he or she may owe business license taxes. The need for revenue

[28] For example, see New York Department of Revenue and Taxation, TSB-M-08(3)S (5/8/08), http://nystax.gov/pdf/memos/sales/m08_3s.pdf.

[29] See link at http://www.revenue.ne.gov/.

[30] For example, see *Telebright Corporation, Inc. v. Director, New Jersey Division of Taxation*, A-5096-09T2 (App. Div. 2012), http://www.judiciary.state.nj.us/opinions/a5096-09.pdf.

and greater mobility of the workforce has led states to pay closer attention to when employers are required to withhold taxes on wages of visiting employees and when the employees owe taxes to the state.[31]

7. *New Uses and Optimal Use of the Internet May Challenge Old Rules*: The Internet provides opportunities to handle many types of transactions and activities in a different manner. This includes traditional tax compliance and administrative activities. One such area tax-exempt organizations. For example, a tax-exempt organization might allow donors to be listed on the organization's website. This may cause the entity to face issues as to whether the listing is merely an acknowledgement or whether it is advertising that may result in unrelated business taxable income (UBTI) for the organization. Another issue may exist where an organization that primarily operates on the web, such as a non-profit information exchange, meets the tax definition of a tax-exempt organization. Also, the Internet may allow for more efficient interactions between a tax-exempt organization and its donors, yet existing rules were not written with such interactions in mind. For example, a receipt is required for certain donations in order for the donor to be entitled to a deduction. Will a receipt generated by and printable from a website constitute an appropriate acknowledgement for tax purposes? In October 2000, the Service issued Announcement 2000-84, 2000-42 I.R.B. 385, listing various issues that tax-exempt organizations may face related to the Internet. The IRS asked for input from interested parties as to whether additional guidance is needed for tax-exempt organizations.[32]

The IRS acknowledges the use of the Internet for some tax reporting obligations. For example, regulations under IRC Section 6045B, *Returns relating to actions affecting basis of specified securities*, issued in October 2010 (T.D. 9504), allow for website posting of certain information to take the place of sending the standard information report. Reg. §1.6045B-1(c)(3) states: "*Exception for public reporting*: An issuer is not required to file a return with the IRS under this paragraph (a) if, by the due date described in paragraph (a)(2)(i) of this section, the issuer posts the return with the required information in a readily accessible format in an area of its primary public Web site dedicated to this purpose and keeps the return accessible for ten years to the public on its primary public Web site or the primary public Web site of any successor organization." In Notice 2012-11, the IRS allows corporations to post "Form 8937, Report of Organizational Actions Affecting Basis of Securities, or the required information in a readily accessible format to an issuer's primary public Web site."[33]

It is likely that the Internet and expanded use of web-based transactions will present more possibilities for new ways to comply with and administer the tax laws.

Internet-based activities can also challenge existing rules and call for new interpretations. For example, in 2011, the IRS issued an informal ruling on whether bloggers should be treated similarly to journalists for purposes of IRC Section 6104, *Publicity of information required from certain exempt organizations and certain trusts*. The IRS referred to Freedom of Information Act (FOIA) rules to determine that bloggers were not the same as journalists.[34]

The nature of Internet-transactions and e-commerce has also led many states to reconsider how income tax nexus rules should apply. While Congress provided nexus guidance in 1959 by enacting Public Law 86-272, this guidance only applies for sales of tangible personal property. For sales of intangibles (such as digital goods) and services, both of which are often web-based transactions, states have tended to take a position that physical presence should not be a requirement for nexus in today's e-commerce world. In a 2006 income tax nexus ruling of the Supreme Court of West Virginia, the court stated:

> "[W]e believe that the *Bellas Hess* physical-presence test, articulated in 1967, makes little sense in today's world. In the previous almost forty years, business practices have changed dramatically. When *Bellas Hess* was decided, it was generally necessary that an entity have a physical presence of some sort, such as a warehouse, office, or salesperson, in a state in order to generate substantial business in that state. This is no longer true. The development and proliferation of communication technology exhibited, for example, by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there. For this reason, we believe that the mechanical application of a

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[31] For information on issues of states seeking wage withholding on employees visiting the state, see House Judiciary Committee hearing of May 25, 2011 on "H.R. 1864, the 'Mobile Workforce State Income Tax Simplification Act of 2011' ", http://judiciary.house.gov/hearings/hear_05252011_2.html.

[32] For guidance on posting Forms 990 on the Internet for public availability, see Notice 2007-45, 2007-22 IRB 1320, as modified by Notice 2008-49, 2008-20 IRB 979.

[33] Notice 2012-11 addresses IRC Section 6045B, added by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343, 10/3/08).

[34] CCA 201125037 (6/24/11), http://www.irs.gov/pub/irs-wd/1125037.pdf.

physical-presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state."[35]

8. *Technology and Rules of Conduct for Tax Practitioners*: Various ethical issues arise from new uses of technology by tax practitioners. For example, is a tax client's privilege protected if confidential information is transferred over an unprotected network or via email? What precautions are required to protect client tax data from improper disclosure (such as to prevent penalties under IRC Sections 6713 and 7216) if data is stored on a third party's server ("in the cloud")? Tax practitioners need to have a basic understanding of the technology used to store, manipulate and transmit client data. As noted in California State Bar Formal Legal Opinion No. 2010-179, "the duties of confidentiality and competence that attorneys owe to their clients do require a basic understanding of the electronic protections afforded by the technology they use in their practice."[36]

Another consideration for tax practitioners is the degree to which they are required to follow IRS and state tax agency news releases provided through social media outlets such as Facebook and Twitter.

Note: Internet-based technologies and the possible rules of conduct issues and considerations are not covered in this essay.

Table A
How the Internet and E-Commerce
Challenge a Specific Longstanding Tax
Sales and Use Tax

Tax System Feature	Conflicting Internet Features
Is a Depression-era tax designed to broaden state revenue sources. It is also an industrial-age tax dependent on physical items that mostly stayed within state borders.	We are now in the information-age where borders are not very important, and intangibles and services are a bigger part of GDP than they were years ago. Also, taxes tend to be dependent on location and under the Internet business model, a company can reach a large customer base with very few locations.
Collection is best assured if the seller/transferor has a physical connection in the taxing jurisdiction (nexus per *Quill*). While states can still collect use tax from resident buyers, such collection is difficult.	Internet-based businesses may just need one physical location, yet sellers can deal with buyers throughout the world (from the single physical location). Thus, the quantity of remote sales (where non-present vendors are not required to collect use tax from customers) will increase and tax collections will decrease.
Usually, need to know if the transferred item is tangible or intangible.	With some of today's transactions, it is not always easy to tell if an item is tangible or intangible under sales tax rules. For example, cases have gone both ways in classifying software. Also, some tangible items can be converted into intangible forms (such as digitized music transferred via a modem). Should such transactions be taxed similarly to tangible goods—does the principle of neutrality warrant that similar items be taxed similarly regardless of form, or should the fact that an item is intangible override to make it non-taxable?
Usually, need to know the type of buyer and seller because some sellers may be exempt (such as those making an "occasional sale") and some buyers may be exempt (such as a business making a purchase for resale).	With some types of e-commerce transactions, it might not be easy to determine the type of buyer or seller. For example, some sellers at auction sites are businesses and others are individuals making an occasional sale. Also, exchange sites may have customers buying both for self-use and for resale and it may not be easy to track different types of purchases.
Typically structured as a destination-based tax where buyer's location is important.	For some transactions, the physical location of the buyer is not important (such as the transfer of software or other digitized items via a modem).
Is jurisdiction dependent. That is, most of the 6,000+ jurisdictions in the U.S. that assess a sales tax have differences in terms of rates, exemptions, due dates, forms, definitions, etc.	Is not jurisdiction dependent. An Internet user can access the Internet from any location using a portable computer and access to telecommunications. Cyberspace is a seamless environment that does not need to recognize borders or physical locations—it is mostly indifferent as to location.

[35] *Tax Comm'r of W. Va. v. MBNA*, 640 S.E.2d 226 (W. Va. 2006).

[36] State Bar of California, Formal Legal Opinion No. 2010-179; http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=wmqECiHp7h4%3D&tabid=837.

Jurisdiction, Types of Taxes and Examples of Issues

A sampling of tax issues at each level of government for key types of taxes is summarized in the following chart.

Tax	International	Federal (U.S.)	State and Local
Sales tax and VAT	When is a remote vendor subject to VAT collection in a country?	—	How should cloud computing activities be classified to determine if sales tax is owed? How should transfers involving customer activity or usage in multiple states be sourced (such as a software license to be used in multiple states)?
Income	Does a company have a permanent establishment in a country due to the existence of a computer server there?	When might income be generated from activities in virtual worlds? When has a person's online selling activity risen to the level of carrying on a trade or business? When does a website owner have reporting obligations for prizes won by player in virtual worlds? How should costs of developing a website be treated? Do revenues from cloud computing transactions generate domestic production gross receipts for purposes of IRC Section 199?	What types of activities and at what volume causes a business to have income tax nexus in a state? How should cloud computing activities that benefit a customer's business in more than one state be sourced? Is a non-present Internet business with customers in a jurisdiction subject to business license tax?

Sales and Use Tax

Introduction

All but four states[37] impose sales and use tax. Generally, a sales tax is imposed on sellers for the privilege of selling property or services. Most sales tax systems came about during the Depression as a way to generate additional revenue for states. In the 1930s, states enacted compensating *use* tax rules to ensure that the tax would be collected when the seller was not legally obligated to collect the sales tax. The rates for sales and use tax are the same within the states. Typically, the sales tax obligation is on the seller, but they are allowed to pass it along to buyers.

State and local sales and use tax has probably received the greatest attention in the Internet taxation arena. E-commerce has challenged this longstanding tax in many ways (as explained in Table A above). This section explains the basics of sales and use tax: tax base, state's authority to tax vendors (state law specifics, nexus, and federal legislative limitations), determining in which jurisdiction a sale occurred (sourcing), occasional sales rule, and determining the nature of items to determine if they are subject to sales and use tax.

Checklist

Generally, the existence of physical property and employees engaged in sales activity in a state constitute sales tax nexus. Questions typically arise when a business has customers in a state but no physical property or employees. Following are questions to consider in helping to determine if a seller of goods or services is subject to sales tax within any particular state in which nexus is not obvious. The discussion that follows provides further explanation along with noting some of the uncertainty that exists in the law.

1. Facts. It is important to review all facts of a transaction. For example, if a transaction enables customers to have access to software, contract terms and perhaps even the technology should be reviewed to determine if there is a licensing of the software, access to software without any rights, or any additional services provided. If determined to be services (no property or rights transferred), the exact nature of the services may be important in some states

[37] Delaware, Montana, New Hampshire, and Oregon do not impose a sales tax. While Alaska also does not impose a sales tax, many of its cities impose a sales tax.

that tax limited types of services, such as data processing. It is also important to examine how sales are made to customers in a state. The use of third parties to help make sales, a relationship with a related entity for sales or repair work, or even intangible property associated with a state might create sales tax nexus. The details of third party arrangements need to be examined.

2. Tax base. Are the goods or services sold to a customer in the state subject to that state's sales tax law? Is there any federal restriction on imposition of the tax (as there is for Internet access fees)?

3. Nexus/jurisdiction to tax. Does the seller have a physical presence in the state, such as a store, warehouse, sales agent, employee, contractor, agent, representative, or property? It is advisable to look at all possible relationships that a seller has to see if any might, under applicable state law, be viewed as substantial nexus (discussed later), and thus, create sales tax collection obligations for the seller.

4. Who is required to collect the tax. If more than one party was involved in getting the goods to the customer, such as with a drop shipment, who is liable to collect the tax under the nexus and state sales tax rules?

5. Occasional sales. If there were only a few sales, does that state have an occasional sale rule that may result in the seller not having to register for and collect sales tax?

6. Which state. Did the sale occur in the state as explained in that state's sales tax rules (sourcing)?

Tax Base

The tax base for sales and use tax (what the tax rate is applied to; what is taxable), varies from state to state and changes to the base can be a fairly regular activity in many state legislatures. States tax most types of tangible personal property although several exempt food and most have a variety of specific exemptions. Several states tax some types of services. Also, some states tax intangible items when they are equivalent to a tangible item, such as software. Some states impose sales tax on specified digital items (such as music, ringtones and software). It is imperative to review the sales tax law in each state in which a vendor has nexus to determine *what* is subject to tax. It is also important to understand the nature of the product or service sold to customers to determine if the item is part of the state's tax base, as well as review the laws governing the definition of the state's sales tax base.[38]

ITFA: The Internet Tax Freedom Act, originally enacted in 1998 and renewed three times, provides a federal level restriction. This restriction includes that state and local governments may not impose taxes on Internet access.[39]

Assistance: There are companies that sell software packages to help with sales tax compliance and keeping up with law changes. If the state has adopted the Streamlined Sales & Use Tax Agreement, it is required to have a "taxability matrix" to help identify what is included in the base.[40] State tax agency websites also provide information on what is subject to sales tax in the state.

Nexus

Sufficient *nexus* must exist in order for a state to subject a vendor to sales and use tax collection obligations. Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state's sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor. These constitutional provisions are explained below, along with an overview of the *Quill* case which provides the physical presence requirement for sales tax.

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[38] For example, New York State Department of Taxation and Finance ruling TSB-A-10(40)S (9/15/10) addressed the question of whether fees charged for subscriptions to a website, email services and similar services are subject to the state's sales tax. The answer depended on understanding the nature of the services and the New York tax base, which includes some types of services, such as "information services."

[39] The original legislation, P.L. 105-277 (10/21/98) was last extended and modified by P.L. 110-108 (10/31/07) with an expiration date of November 1, 2014.

[40] See website of Streamlined Sales Tax Governing Board, Inc. at http://www.streamlinedsalestax.org/index.php?page=state-taxability-matricies.

Due Process Clause

The 14th Amendment to the U.S. Constitution provides:

"No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

"[D]ue process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[41]

"The simple but controlling question is whether the state has given anything for which it can ask return."[42]

Unlike the Commerce Clause (discussed next), the Due Process Clause does not give Congress any power to enact a law that would modify or violate the due process standard.

Commerce Clause

Article I, Section 8, clause 3 of the U.S. Constitution provides: "The Congress shall have power . . . to regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

Courts often refer to the *dormant* Commerce Clause because the Commerce Clause does not specifically limit state activities—it just grants power to Congress to regulate commerce. In applying the dormant Commerce Clause, the courts consider the purpose served by the Commerce Clause and "whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve."[43]

The Four-Part Test and "Substantial Nexus"

Complete Auto Transit, Inc. v. Brady, 2 ILR 50, 430 U.S. 274 (1977), sets out a four-part test under which a tax on interstate commerce is valid if it—

1) is applied to an activity with a substantial nexus with the taxing state,

2) is fairly apportioned,

3) does not discriminate against interstate commerce, and

4) is fairly related to the services provided by the state.

As explained in *Quill*: "Due process centrally concerns the fundamental fairness of governmental activity. . . . In contrast, the Commerce Clause, and its nexus requirement, is informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. . . . The *Complete Auto* analysis reflects these concerns about the national economy. The second and third parts of that analysis, which require fair apportionment and non-discrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce. The first and fourth prongs, which require a substantial nexus and a relationship between the tax and State-provided services, limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce. Thus, the "substantial-nexus" requirement is not, like due process' "minimum-contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."

Physical Presence Standard—*Quill Corporation v. North Dakota*[44]

The *Quill* case involved a seller of office equipment and supplies (Quill), a Delaware corporation, with offices and warehouses in Illinois, California, and Georgia. Quill did not have any property or employees in North Dakota. Quill sold office supplies and equipment to customers in North Dakota. Quill mailed catalogs to these customers and advertised in national magazines. Under North Dakota law, Quill was required to collect use tax on its sales made to North Dakota customers because Quill was engaged in regular solicitation of customers in the state. Quill challenged the North Dakota law as violating both the Due Process Clause and the Commerce Clause of the U.S. Constitution.

The U.S. Supreme Court had previously addressed the "minimum connection" requirement of the Due Process Clause back in 1967 in *National Bellas Hess v. Department of Revenue of Illinois*.[45] In that case, the Court ruled that

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41 *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 345 (1954).

42 *National Bellas Hess, Inc. v. Dept. of Revenue of Illinois,* 1 ILR 853, 386 U.S. 753, 756 (1967).

43 *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1 (1986).

44 *Quill Corp. v. North Dakota*, 2 ILR 242, 504 U.S. 298 (1992).

some type of minimum contact was necessary for a state to tax an out-of-state business. The necessary minimum contact existed if the out-of-state company had a sales office or sales personnel in the state.

In *Quill*, North Dakota challenged the 1967 ruling as being out of date with today's ways of conducting business. Today, a company doesn't need a salesperson in a state to obtain a sale. Instead, a catalog and a mail-order sales system can be just as successful for a company. The taxing authority in North Dakota pointed out that $1 million of Quill's $200 million of sales were to 3,000 customers in North Dakota. Quill was also the sixth largest supplier of office supplies in the state. North Dakota also argued that it had created an economic climate that helped Quill's sales, that it maintained a legal infrastructure to protect the market, and that it had to dispose of 24 tons of catalogs and other mail that Quill sent into the state each year. Per North Dakota, all of this created the requisite minimum connection to enable it to collect use tax from Quill without violating the due process clause of the U.S. Constitution.

North Dakota was partially successful in its argument that the *Bellas Hess* nexus standards for sales and use tax purposes were outdated. The Court stated that its earlier tests were too formalistic and that for Due Process purposes, it would be more appropriate to not focus on physical presence, but to instead look at whether the company's contacts with the state make it reasonable for the state to require the company to collect use tax. In *Quill*, the Court stated that if an out-of-state business purposefully avails itself of the benefits of an economic market in the state, it need not have a physical presence in the state to be subject to tax collection requirements in the state.

Despite the Court's relaxation of the due process physical presence requirement, the Court stated that North Dakota's enforcement of the tax against Quill was an unconstitutional burden on interstate commerce in violation of the Commerce Clause. However, the Court pointed out that because the Constitution gives Congress the right to regulate interstate commerce, Congress could provide a mechanism to allow states to collect sales and use tax from an interstate mail-order business that was not physically present in the state, without violating the Commerce Clause.

What Is Considered Sufficient Physical Presence?

The answer to this question depends on the law of each state because some states have specifically excluded some types of presence from creating sales tax obligations. For example, some states exclude presence at trade shows for a limited number of days from creating sales tax obligations in the state. Also, rulings and statutes vary from state to state as to how much physical presence is necessary for sales tax nexus and whether any particular activity is considered physical presence.

Aggressiveness: States will lean towards finding sales tax nexus when facts indicate some type of physical presence. For example, the Maryland Comptroller's website for helping vendors know if they have sales tax collection obligations in Maryland states:

> "Under Maryland law, out-of-state vendors must register with the Maryland comptroller and file Maryland sales and use tax returns if the vendor shows a nexus connection by:
>
> - Permanently or temporarily maintaining, occupying, or using any office, sales or sample room, or distribution, storage, warehouse, or other place for the sale of tangible personal property or a taxable service directly or indirectly through an agent or subsidiary (Tax-General Article, Section 11-701(b)(2)(i));
> - Having an agent, canvasser, representative, salesman, or solicitor operating in the state for the purpose of delivering, selling, or taking orders for tangible personal property or a taxable service (Section 11-701(b)(2)(ii)); or
> - Entering the state on a regular basis to provide service or repair for tangible personal property (Section 11-701(b)(2)(iii)).
>
> "The Comptroller's Office interprets Section 11-701(b)(2), including sub-paragraph (iii), as broadly as is permitted under the United States Constitution. It is our position that the U.S. Constitution does not require an out-of-state vendor to have a substantial physical presence in the taxing state for the state to require that vendor to collect sales and use tax. All that is required is for the out-of-state vendor to demonstrate more than a "slightest presence" in the taxing state. . . .

[45] *National Bellas Hess v. Dept. of Revenue of Illinois*, 1 ILR 853, 386 U.S. 753 (1967).

> "We will examine all relevant information in making a determination, including advertising materials and promotional literature, representations made to prospective customers before sale, whether the vendor routinely employs service or repair personnel or regularly contracts for such services or repairs, and the vendor's description of its business operations as contained in business documents and submissions to government agencies in the vendor's home state."[46]

Legislatures in several states have either enacted or considered law changes to broaden the state's sales tax nexus reach. These so-called "affiliate nexus" or "Amazon nexus" statutes are discussed later in this section.

Following are examples of state rulings as well as a few key rulings of the U.S. Supreme Court (such as *Tyler Pipe* and *Scripto*). A ruling in one state cannot be applied in a different state. Also, it is important to check state law for the latest statutes, regulations and rulings.

Diskettes: In the *Quill* case, the Court noted that despite the fact that Quill licensed software to some of its customers in North Dakota to aid in placing orders, Quill's interests in the software did not affect the analysis under the due process clause issue nor did it constitute substantial nexus as required by the commerce clause. Neither died the existence of a few floppy diskettes in North Dakota create nexus. The Court noted that the government "concedes that the existence in North Dakota of a few floppy diskettes to which Quill holds title seems a slender thread upon which to base nexus" (footnote 8).[47]

Website: A 2000 ruling by the Virginia Department of Taxation (P.D. 00-53; 4/14/00), held that under Virginia law, a taxpayer did not have nexus in the state if its only presence is the use of computer servers to host websites. The taxpayer, a dealer of car parts, had a webpage that allowed customers to view and order products. The taxpayer had no physical presence in Virginia, but was contemplating using a "managed hosting" service or a "co-location hosting" service that would give the taxpayer server access in Virginia. Under both arrangements, servers would be exclusively dedicated to the taxpayer's website. The Tax Department held that the taxpayer met the definition of a "dealer," but did not find that nexus (physical presence) existed where the only presence was use of a server to create or maintain a website. The Department also noted that this holding conformed to the Internet Tax Freedom Act prohibition against discriminatory taxes. Finally, the ruling noted that Virginia buyers of car parts are subject to use tax, unless the purchase was exempt.

Credit cards: In *J.C. Penney National Bank v. Johnson, Commissioner of Revenue State Of Tennessee*, No. 96-276-1 (Tenn Ch Ct, Oct. 16, 1998), a franchise and excise tax case, the court found that the issuing and use of over 17,000 JCPNB credit cards in the state was "considerably more than the few diskettes at issue in *Quill* and [did] not constitute a 'slight presence.' " The court also found the cards to be tangible physical property because the contract between JCPNB and customers referred to the cards as the personal property of JCPNB. The court found that the cards created a sufficient nexus with Tennessee for tax purposes. The court also noted that it was relying on JCPNB's reliance on activities of its related agents in the state to determine if the "substantial nexus" factor of the *Complete Auto Transit* was satisfied. The court noted (footnote 2) that it did not interpret *Quill* as meaning that the physical presence requirement should be extended to other types of state taxes.

However, in December 1999, the Tennessee Court of Appeals overturned the lower court decision. In *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert denied*, 531 U.S. 927 (2000), the court agreed with the lower court that JCPNB had sufficient business connections with the State to satisfy Due Process considerations. However, under the Commerce Clause, more—"substantial nexus," is needed. The court first noted that the *Quill* decision guidance on "substantial presence" could be applied to a franchise and excise tax situation even though *Quill* involved a use tax. As to the tangible nature of the credit cards, the court emphasized that the cards, as physical property were worthless. Instead, their value was derived from the rights they represent. The accounts the cards represent were located in Delaware and not subject to Tennessee tax.

Software: Some states treat software as tangible personal property (see discussion of *South Central Bell* case later). A 1998 Texas ruling relied on a provision of Texas law treating tangible personal property as including a computer program to find that a remote seller had a physical presence in Texas because it was licensing software to customers there. This ruling by an Administrative Law Judge (Hearing 36,237; 7/21/98) involved a Minnesota company that during the audit period had about 42 customers in Texas. The taxpayer's contacts with customers were primarily by phone and mail and all software was shipped to the customers by common carrier. Taxpayer had no

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[46] Comptroller of Maryland, "Nexus Information for Sales and Use Tax," http://business.marylandtaxes.com/taxinfo/salesanduse/nexus.asp.

[47] *Quill Corp. v. North Dakota*, 2 ILR 242, 504 U.S. 298, fn. 1 (1992).

offices or employees in Texas. The Texas Tax Division assessed sales tax upon the taxpayer finding that it was present in Texas due to the fact that its software was in Texas.

The taxpayer argued that its physical presence in Texas was less than what was found in the *Quill* case. Taxpayer also argued that it was licensing software rather than leasing or selling property to customers. Thus, its customers were obtaining information (rather than physical property). The judge stated that for taxpayer to rely successfully upon *Quill*, it would have to show that it had similar facts. The judge agreed with the Tax Division that the situations were not similar. Quill sold property to customers while taxpayer licensed tangible personal property to customers. Thus, the nature of the transactions were not the same. The judge agreed with the Tax Division that taxpayer was physically present in Texas due to its computer programs located in the state. The judge also noted that leases and licenses are "conceptually similar" in that money is paid for use of property without transfer of title.

Presence from intangibles: In *Kmart Properties, Inc. v. Taxation and Revenue Dept*., No. 21, 140 (N.M. Ct. App., Nov. 30, 2001), use of a subsidiary's (KPI) trademark by the parent corporation (Kmart) was found to establish nexus and tax obligations in N.M. for KPI. In the Due Process clause analysis, the judge found that KPI purposefully directed its efforts towards N.M. residents and availed itself of N.M. markets by licensing its trademarks to Kmart in N.M. With respect to the Commerce Clause, the trial judge stated: "I have little difficulty determining that the contractual relationship between KPI and Kmart under the License Agreement creates the requisite physical presence required to subject KPI to New Mexico's taxing jurisdiction under the Commerce Clause. As noted in the Court's discussion in *Scripto* [362 U.S. 208 (1960)], the fact that KPI does not use its own employees to utilize its trademarks to generate sales to New Mexico residents, to enhance the associated value of its trademarks by utilizing them as a marketing tool, and to generate a stream of royalty income for itself should not be given constitutional significance. The License Agreement, with its attendant obligations upon Kmart to protect and enhance the value of KPI's trademarks, creates a contractual relationship between the parties in which Kmart uses the trademarks and their associated goodwill as a marketing tool to continuously solicit New Mexico residents to purchase merchandise associated with the trademarks, thereby creating the very income stream New Mexico seeks to tax. Kmart's relationship to KPI, particularly in light of the requirements of trademark law which render the trademarks inseparable from the goodwill of the business they are associated with, places Kmart in the same position as the salesmen in *Scripto* and the independent salesmen in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S.Ct. 2810 (1987). Kmart is contractually obligated to do the very things which establish, maintain and enhance the market for KPI's trademarks in New Mexico in order to generate a revenue stream for KPI derived from those marketing activities. These contractual obligations give KPI a presence in New Mexico which goes far beyond those of *Bellas Hess* and *Quill Corporation*, whose only contacts with the taxing states were by mail and common carrier." [footnote omitted]

The decision was upheld on appeal to the New Mexico Court of Appeals. That court also noted that the physical presence requirement provided by the U.S. Supreme Court with respect to sales and use taxes in the *Quill* decision did not apply to income tax cases. The court also noted that its holding did not mean that Kmart or any of its employees were the agent of KPI. For purposes of establishing Commerce Clause nexus, the representatives creating nexus need not have legal authority to bind the taxpayer.

Office not engaged in sales: In *National Geographic Society v. Cal. Bd. of Equalization*, 430 U.S. 555 (1977), the Court held that the presence of two advertising offices in California was sufficient to create nexus for National Geographic in California, even though the California offices were not involved with the product sales activity. The Court found the offices constituted a substantial presence in the taxing state.

Employee visits: In *Orvis v. Tax Appeals Tribunal of the State of New York* and *Vermont Information Processing, Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. Ct. App. 1995), *cert. denied*, 516 U.S. 989 (1995), the court overruled the lower court of New York which had held that 12 trips by employees into the state during 3 years did not constitute substantial physical presence to make the company subject to the collection of use tax (*Matter of Orvis Co. v. Tax Appeals*, 204 A.D.2d 916 (N.Y. App. Div. 1994)). The appellate court found that the lower court had not properly interpreted the *Quill* decision: "Quill simply cannot be read as equating a substantial physical presence of the vendor in the taxing State with the substantial nexus prong of the *Complete Auto* test, as the Appellate Division's [lower court's] interpretation would require." The court also noted: "While a physical presence of the vendor is required, it need not be substantial. Rather, it must be demonstrably more than a "slightest presence" (see, *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551). And it may be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf."

In the companion case involving another out-of-state retailer whose employees made occasional trips into New York to assist customers, the court of appeals also found that sufficient nexus was established to require the company to collect the New York sales and use tax. This taxpayer sold software and hardware to beverage distributors in New York and elsewhere. Although most orders were shipped into New York by third parties, employees of the taxpayer did visit customers in New York to assist with software use. The taxpayer also told prospective customers that it could visit to assist with software installation and troubleshooting. The court found that such practices "significantly contributed to [taxpayer's] ability to establish and maintain a market for the computer hardware and software it sold in New York. [Taxpayer's] activities in New York were, thus, definite and of greater significance than merely a slightest presence . . ."

Arizona Dept. of Revenue v. Care Computer Systems, Inc., 1 CA-TX 98-0003 (7/25/00), *rev'g Dept. of Revenue v. Care Computer Systems*, No. TX 95-00642, 4/8/97 (where the Arizona Superior Court had agreed with the Arizona Board of Tax Appeals (Dkt. No. 1049-93-S (4/4/95)), involved a business that sold and leased computers, licensed software, and provided computer training to nursing homes throughout the U.S. CCS had no offices or regular business presence in Arizona, and none of its employees lived there. CCS had one salesperson visit Arizona during the year, about 21 days of customer training, about 180 transactions totaling approximately $385,000 of income over a 4-year period, and owned two computers it was leasing to a customer in Arizona. All customer contracts were approved at CCS's home office in Washington and all items were shipped from that location either by common carrier or U.S. mail, with terms F.O.B. origin. The Arizona Board of Tax Appeals and Arizona Superior Court held that CCS did not have a substantial nexus in Arizona and thus, Arizona could not impose the transaction privilege tax on CCS. However, the Court of Appeals reversed these decisions.

The court quoted from the *Tyler Pipe* case (483 U.S. 232 (1987)) where the U.S. Supreme Court stated: "The crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." While noting that CCS's activity in Arizona was of "relatively low volume," the court noted it was more than existed in *Arizona Dept. of Revenue v. O'Connor*, 963 P.2d 279 (Ariz. App. Ct. 1997), where the vendor was found to have nexus in Arizona. For example, in the 1997 case, the vendor had only one customer in Arizona and did not own any property in Arizona. In contrast, CCS had many customers and owned the property it was leasing to Arizona customers.

A dissenting judge primarily disagreed with the approach of finding nexus based on similar cases. "The best the court can do is conclude by comparative analysis that, if the attenuated circumstances of *O'Connor* meet that standard, so must the equally attenuated circumstances of this case. And so, validating the taxation of one attenuated transaction after another after another, the courts erode the general standard of substantial nexus into something very insubstantial indeed." The dissenting judge also suggested that the majority did not follow the ADOR regulation because they broadened the meaning of "maintaining a place of business within Arizona" by considering current Commerce Clause cases, which the judge felt made the regulation irrelevant.

L.L. Bean, Inc. v. Commonwealth of Pennsylvania, 516 A.2d 820 (Pa. Comw. Ct. 1986), involved a taxpayer that had no offices in Pennsylvania. Bean did sell returned merchandise to V.F. Corporation that then sold the items to its customers. However, the Bean trademark was defaced prior to shipping by Bean, and VF set the prices and received no commission or fees from Bean. VF posted signs notifying customers that the merchandise was not guaranteed by Bean. Bean employees made three trips to VF (in Pennsylvania) at VF's request to discuss ways of improving the sales of items to VF and to suggest ways of displaying certain merchandise. The court held that L.L. Bean did not have a presence in Pennsylvania for sales and use tax purposes. The court did not find that VF acted as a representative of Bean in that Bean exhibited no control over VF, did not set VF prices and granted no special discounts to VF.

Connection to maintaining a market: In *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232 (1987), the court stated: "As the Washington Supreme Court determined, 'the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.' 105 Wash. 2d, at 323, 715 P.2d, at 126. The court found this standard was satisfied because Tyler's sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interests . . . .' *Id*., at 321, 715 P.2d, at 125. We agree that the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler." [482 U.S. 232, 250-252]

Whether or not activities are significantly associated with the taxpayer's ability to establish and maintain a market in the state is not a simple determination. While sales agents and employees are likely to be significantly

associated with the ability to maintain a market, what about a company located in the state hired to perform advertising for the taxpayer? What about an independent repair company the taxpayer contracts with to service warranties on products the taxpayer has sold to customers in the state? The nature of the relationship is also important—is the third party an agent or representative? Some state statutes or regulations specify the type of arrangements or activities that might be deemed to create sales tax nexus (also see later discussion on "affiliate nexus").

Can "ability to establish and maintain a market" be equated to "solicitation or orders" as used in P.L. 86-272? If so, there is some guidance as to the meaning of that term. For example, in *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1991), the Court held:

> "In addition to any speech or conduct that explicitly or implicitly proposes a sale, "solicitation of orders" as used in §381(a) covers those activities that are *entirely ancillary* to requests for purchases—those that serve no independent business function apart from their connection to the soliciting of orders. The statutory phrase should not be interpreted narrowly to cover only actual requests for purchases or the actions that are absolutely essential to making those requests, but includes the entire process associated with inviting an order. Thus, providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. On the other hand, the statutory phrase should not be interpreted broadly to include all activities that are routinely, or even closely, associated with solicitation or customarily performed by salesmen. Those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force are not covered. For example, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force."

Following the reasoning of the *Wrigley* and *Tyler Pipe* cases, repair work performed in the state might not be sufficient presence because it does not relate to solicitation or maintaining a market. However, see MTC Bulletin 95-1, discussed later. Also, if the repairs were performed in a facility owned by the taxpayer, sufficient physical presence would likely exist for tax purposes. If a company's only presence in a state is to have an employee attend a board of directors meeting or a training seminar, it will probably not be considered substantial nexus for sales and use tax purposes.

Non-employee sales: Scripto, Inc. v. Carson, 362 U.S. 207 (1960), involved a taxpayer located in Georgia that had no property or operations in Florida. Taxpayer did, though, have ten commissioned salespeople (contractors) in Florida. The court held that such continuous solicitation in Florida was sufficient to constitute "substantial nexus" such that Scripto was obligated to collect Florida use tax on its sales in that state. Also, the court did not find that the legal distinction between an employee and an independent contractor affected its conclusion. "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance. . . . The test is simply the nature and extent of the activities of [Scripto] in Florida." (Also see *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232 (1987).)

The type of nexus established by the use of third parties to assist a taxpayer with sales, as in the *Scripto* case, is sometimes referred to as "attributional nexus."

Solicitation assistance: In re The Ohio Table Pad Co., DTA No. 815122 (NY State Tax Appeals Tribunal, 1999), raised the issue as to how much a contractor needs to do for a company in order to cause the company to be considered physically present in a state for sales and use tax purposes. Ohio Table Pad (TP) did not have any facilities or employees in New York. TP was notified by the New York tax authority that it may have sales tax exposure when it was discovered that TP filed a 1099 with the federal government for a New York worker. TP had an arrangement with contractors in New York. One such individual represented a few different furniture manufacturers, including TP. The representative would help TP identify potential furniture stores in New York who might want to be distributors of TP's products. The representative only passed the names along to TP, it did not do any actual solicitation.

The court agreed with the administrative law judge that the activities of the representatives constituted solicitation because it involved invitation or orders and activities ancillary to requesting purchases. "[T]hese activities constitute speech or conduct that implicitly invites an order and is, therefore, solicitation (see, Matter of Stainless, Inc., supra [wherein we adopted the flexible and practical meaning of solicitation from the United States Supreme Court in *Wisconsin Dept. of Rev. v. Wrigley Co.* (supra) which held that any speech or conduct which implicitly invites an order constitutes solicitation, as in the instance where a salesman extols the virtues of his company's product to the retailer of a competitive brand])."

Advertising: Generally, a third party relationship with an advertiser in a state will not create nexus. For example, *JS&A Group, Inc. v. SBE* (Cal. Ct. App. 1997, A075021; unpublished), involved sales of product via mail order and television, telephone and magazine ads. JS&A had no offices or employees in California. In finding that JS&A did not have sales tax nexus, the court noted:

> "We see no analogy between Scripto's relationship with a fleet of salespersons continually soliciting on its behalf within the state, taking orders and receiving commission based upon their sales and who acted as the functional equivalent of a local sales force, and JS&A's contractual relationship with broadcasters and cable operators to air advertisements. The broadcasters and cable operators did not solicit or accept orders on behalf of JS&A. Nor did they collect payments, distribute product, or receive any commission or other compensation based upon sales they made on behalf of JS&A, because they made none. Instead, as part of their own business operations, i.e., airing programming and commercial advertisements, they aired commercials for JS&A, as one of many clients, and received payment for the commercial air time. They were engaged in their business of advertising, which by its nature, has the incidental effect of informing potential customers about the products available, which may in turn lead to more business for the entities that purchase such air time. The fact that a broadcast or cable operator contracts to air a commercial that promotes a product does not convert the broadcaster into an agent, or sales representative of the out-of-state retailer who purchases air time."

In *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954), the court noted the "wide gulf between" traveling sales agents visiting a state and actively soliciting sales "and the occasional delivery of goods sold at an out-of-state store with no solicitation other than the incidental effects of general advertising."

In ruling TSB-A-08(36)S (8/08), G, a seller of jewelry via television and the Internet inquired as to whether its relationships with television and other advertisers and cable operators might create nexus in NY. G had no physical presence in NY. The Department of Taxation and Finance stated: "If an out-of-state seller merely advertises on satellite and cable television stations in New York State, this activity would not by itself create nexus with New York State. Contractual relationships for the purchase of airtime or advertising of the kind described by Petitioner with STP, Procurer, and the cable operators also do not appear by themselves to give an out-of-state seller the physical presence in New York that would require it to register for sales tax purposes or collect sales tax on its sales. This presumes that STP, Procurer, and the cable operators have no economic interests or stake in Petitioner's sales and their relationships with Petitioner are strictly related to the sale of advertising and airtime in arm's length transactions." However, the Department would not conclusively rule that G had no sales and use tax nexus. "A determination as to whether an out-of-state seller has nexus with New York, however, depends on all the facts and circumstances of a case. It is beyond the scope of this Opinion to conclusively determine whether Petitioner has nexus with New York."

Third party repair services: In December 1995, the Multistate Tax Commission (MTC) issued Bulletin 95-1 which holds that a computer company's provision of in-state repair services by a third party creates nexus for the computer company for both sales and income tax purposes. Per the MTC, the repair services are not de minimis activities, but instead represent "regular or systematic activities in furtherance of the seller's business, such as solicitation of sales or provision of services." "The provision of in-state repair services provided by a direct marketing computer company as part of the company's standard warranty or as an option that can be separately purchased and as an advertised part of the company's sales contributes significantly to the company's ability to establish and maintain its market for computer hardware sales in the State. As in *Tyler Pipe*, these in-state activities, which develop goodwill and increased market share, are no less important or beneficial to the out-of-state direct marketing computer company because they are performed by an independent third party repair service."

Note: In 1996, both the California Franchise Tax Board and Board of Equalization withdrew their support of Bulletin 95-1.[48] Reasons for the withdrawal appeared to include faulty legal analysis regarding nexus in 95-1 and failure to follow the Administrative Procedures Act.

Consider the nature of the arrangement: In *Dell Catalog Sales v. Commissioner, Department of Revenue Services*, 834 A.2d 812, 48 Conn. Supp. 170 (Conn. Super. Ct. 2003), Dell Catalog Sales was found *not* to have nexus in Connecticut from its relationship with BancTec which provided services to Dell's customers. Dell Catalog has not presence in the state. Its customers may purchase a service contract from BancTec. Dell typically sold the service contract at the time it sold the computer and contracts could not be purchased from Dell without also buying

[48] "California FTB Pulls Out of MTC Bulletin 95-1," 96 STN 180-2.

a computer. About 75% of customers also purchased a service contract. Dell collected sales tax on the service contract, but not on the computer and remitted the tax to the state. The "the terms of the Service Contract Sales Brokerage Agreements provided that Dell Catalog Sales would act as BancTec's agent and broker in marketing BancTec's service contracts, and Dell entities would provide certain technical assistance to BancTec in connection with BancTec's service contracts, in exchange for the contract commission." Dell received about 90% of the service contract revenue because it provided the bulk of the services via the phone through Dell Tech Support outside of the state. The court noted that this situation indicated that "BancTec's effort in going on-site in Connecticut to service the consumer's computer had to be minimal."

Dell Catalog was registered to do business in Texas, Florida, Kentucky and Nevada, but the Connecticut Tax Commissioner registered Dell (involuntarily) to do business in Connecticut. The Commissioner argued, based on *Scripto* (362 U.S. 207 (1960)), that Dell owed use tax on computer sales in the state because BancTec was its representative in the state. The court noted that the Commissioner's position was also supported by the Multistate Tax Commission's (MTC) Nexus Program Bulletin 95-1.

The court noted: "Although it appears that BancTec was operating in Connecticut on Dell's behalf, in fact the parties have stipulated that BancTec was an independent computer service provider throughout the United States, and that on-site service was performed solely by BancTec or its subcontractors. (Joint Stipulation of Facts, ¶¶ 35-36.) his stipulation of the parties negates the claim of the Commissioner that BancTec was the agent of the plaintiff in Connecticut. By stipulating that BancTec was an independent service provider, the Commissioner acknowledged that Dell had no right to direct and control the work of BancTec. *Beckenstein v. Potter & Carrier, Inc.,* 191 Conn. 120, 132-33, 464 A.2d 6 (Conn. 1983). We also find credible the testimony of Michael Burns, vice president of sales and marketing of BancTec that servicing computers was their expertise and that Dell did not control or interfere in BancTec's dealings with the customer. This lack of control by Dell substantiates the stipulation of the parties that BancTec was not an agent for Dell."

Further, "We note that Dell provides service to the consumer under the terms of the service contract only by telephone in Texas, and BancTec, for its part, performs only on-site service to the consumer in Connecticut. We further note that Dell markets and sells the service contract to its own customer at the time that it sells the customer a computer; that Dell sets the price of the contract to the consumer; that Dell earns a substantial portion of the cost of the contract; and that Dell performs a substantial part of the service required under the terms of the service contract. Although Dell's name does not appear on the service contract as a contracting party, Dell is an integral part and a major ingredient in the performance of the contract. Cases dealing with the issue of whether the use of independent service representatives provides the in-state physical contacts required to establish nexus by an out-of state seller focus on the extent of the activities of the in-state independent service representative. In *Scripto*, ten independent service representatives conducting continuous local solicitation in Florida and forwarding the orders to the out-of-state seller for acceptance of the orders was sufficient nexus for the state of Florida to require the out-of-state seller to collect a state use tax upon the sale of the goods shipped to customers in Florida. *Scripto v. Carson, supra*, 362 U.S. 211-212. In *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 251, 107 S.Ct. 2810 (1987), the U.S. Supreme Court held that having resident sales representatives in the taxing jurisdiction to establish and maintain the seller's market constituted physical contacts that established a nexus sufficient to impose a business and occupation tax on sales upon the out-of-state seller. The Tyler court stated: "[T]he crucial factor governing nexus is whether the activities performed [in Washington] on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Id*., 250-251. The Tyler case was a direct tax case, not a sales and use tax case, but we see the principle of nexus associated with the extent of the in-state activity to apply with equal force to cases involving sales and use taxes." The court also discussed *In re the Appeal of Intercard*, 270 Kan. 346, 14 P.3d 1111 (Kan. 2000), where the court found 11 visits to the state to not create a substantial nexus in the state.

Thus, the court found that Dell Catalog did not have sales tax nexus in the state. "The missing ingredient in determining whether BancTec's on-site service established nexus in Connecticut as a representative of Dell would be the frequency, if any, of the number of on-site service calls."

However, in 2006, a Louisiana court took a different interpretation and found that Dell did have substantial nexus in the state for sales and use tax purposes due to its arrangement with BancTec. In *State of Louisiana and Secretary of the Dept. of Revenue and Taxation v. Dell Int'l, Inc., et al*, 2006 ILRC 1233, 922 So.2d 1257 (La. Ct. App. 2006), the appeals court reversed the trial court decision to find that Dell did have sufficient connection through a third party acting on its behalf in the state to create physical presence for sales and use tax purposes. Dell itself has no facilities or employees in Louisiana (L). Its customers in L order products via the Internet or catalogs

with orders accepted in Texas and products shipped from either Texas or Tennessee by common carrier or the U.S. Postal Service. Dell had a contract with BancTec (B) for B to provide on-site service for Dell products in L. B does not work exclusively for Dell, but also had repair contracts with other computer providers.

Dell designed the repair service program and copyrighted it. Customers bought the service contracts at the time they purchased a Dell product or after the purchase. The service was emphasized in Dell's marketing literature. B employees were trained by Dell and Dell told B, based on calls Dell received from its customers, when to service a customer's machine. Dell set the service prices and paid B based on the number of on-site service calls it had. Dell also provides all of the service parts to B. However, the service contracts themselves were between a Dell customer and B. Yet, if B did not perform to Dell's standards, Dell had the right to hire a different third party to handle the service. The court noted: "The record establishes that Dell through BancTec is clearly in control of the on-site computer repairs."

L's tax agency sought payment from Dell for use tax and income and franchise taxes, plus interest and penalties. Only the use tax claim survived to trial. The tax agency argued that Dell had a physical presence in L through its repair agent, B. Dell countered that B was not an agent, but an independent party performing work under contracts between customers and B and that B was not acting on behalf of Dell. To support its case, Dell submitted various affidavits and documents including the decision of a Connecticut court (48 Conn. Supp. 170, 834 A.2d 812 (Conn. Super. Ct. 2003)) that found that the arrangement did not cause Dell to have a physical presence in that state. The court noted though that the decision states that the "court's finding was based primarily on the lack of evidence in the record to establish the focus and extent of the activities of BankTec's independent service representatives in Connecticut, particularly evidence regarding the frequency or number of the on-site services actually performed in Connecticut."

In finding that Dell did have a physical presence in L through B, the court referred to the old U.S. Supreme Court decisions of *Scripto* (362 U.S. 207 (1960)) and *Tyler Pipe* (483 U.S. 232 (1987)), as well as a L case, *Quantex* (809 So.2d 246 (La. Ct. App. 2000)). The court noted that unlike in *Quantex*, the present case provides "both documentary evidence and deposition testimony detailing the contractual relationship between Dell and BancTec as well as the nature and extent of the services provided by BancTec and most significantly, evidence regarding the significance of BancTec's services on Dell's 'ability to establish and maintain a market in Louisiana.' "

The court questioned the semantics of terms such as "agent," "broker" and "on behalf of" seeking to look at the substance of the arrangements. The court noted that "the trial court and Dell both ignore the Supreme Court's admonition in *Scripto*, that the 'contractual tagging' of a third party as an independent contractor or salesman is simply insufficient to change the function of the third party 'nor bears on its effectiveness in securing a substantial flow of goods into [the state].' 362 U.S. at 211. The nature and extent of the activities (*Scripto*, 362 U.S. at 211) and whether those activities are significantly associated with the taxpayer's ability to establish and maintain a market in this state (*Tyler Pipe Industries, Inc.*, 483 U.S. at p. 250; *Quantex*, 809 So.2d 252) are the determinative factors of whether Dell's contractual dealings with BancTec constitute a sufficient physical nexus for the purpose of justifying the imposition of a use tax." The court found Dell's involvement in all parts of the contractual arrangement to be significant from writing the contracts, to requiring customers to call Dell first, training B's employees and providing initial diagnosis and scripts for B's employees. Also, Dell includes the availability of on-site service in its advertising. Dell also hired a third party to determine how satisfied customers were with B and could terminate the arrangement with B if B didn't meet Dell's expectations.

Dell argued that it was not legally obligated to provide repair services. Thus, when B provides the services, it is not acting on behalf of Dell. The court noted that the contractual "tag" of being a non-agent to avoid taxation in the state was forbidden by the U.S. Supreme Court per *Scripto* and *Tyler Pipe*. The court also noted that without the arrangement for B to provide services, it would have been difficult for Dell to establish and maintain a market in L. The court referred to the following excerpt from CEO Michael Dell's book—*Direct from Dell: Strategies that Revolutionized an Industry*:

> "Pretty early on in the company's life, we concluded that we wanted to earn a reputation for providing *great customer service,* as well as great products. . . . What was really important was sustaining loyalty among customers and employees, and that could only be derived from *having the highest level of service* and very high-performing products. . . .
>
> From the very beginning, we saw *a huge opportunity to provide extraordinary service* where our competitors saw none—and *designated it as one of the company's early objectives.* In 1986, *we offered the very first program in our industry for on-site service as a kind of "house call" service for sick computers.* If your

computer had a problem, you didn't have to go anywhere; we came to you—to your business, house, or hotel room. . . . What the competition initially assumed would be a disadvantage for us *turned out to be a massive advantage.*"

The court concluded: "The trier of fact could clearly find for the purpose of taxation that Dell hid behind the fact that it hired a third party to provide this service in state or tag that third party as "independent" to destroy nexus with this state which is contrary to law and to the mandates and admonitions of the Supreme Court of the United States."

A dissenting judge noted that B did not solicit sales for Dell but instead only provided services to Dell customers who purchased an optional service contract from B. This judge found that the optional service contract, Dell's efforts in ensuring quality control, and its insistence that B did not disparage Dell when providing services, did "not rise to the level of activities sufficient to find that BancTec was acting on behalf of Dell." This judge also did not put much credence in an un-sworn statement from a mass marketed book.

Delivery: Comptroller of the Treasury v. Furnitureland South, Inc., C-97-37872 OC (Md. Cir. Ct. 1999) involved a situation where the court found that both Furnitureland (F) and the company that delivered its furniture (R) were subject to use tax collection obligations in Maryland. While F sold furniture in all 50 states, it only had physical facilities in North Carolina. F sent no unsolicited promotional materials into Maryland. Most customers relied on F to make delivery arrangements. Prior to 1991, F made deliveries in North Carolina and other East Coast locations, but decided to have another company handle deliveries in the future. One reason for the change was to avoid use tax collection obligations in other states. F obtained advice from its tax advisors as to how to avoid use tax collection obligations. The result was that a separate delivery company was formed which never had executives or shareholders in common with F. F loaned funds to R for formation and sold and assigned trucks to it. F also made many of the delivery arrangements for R. Not until 1998 did R have customers other than F. In addition to delivering furniture to Maryland customers, R sometimes set-up and repaired furniture for F. R also sometimes picked up furniture in Maryland for F to repair. R also kept certain items on the trucks, such as bed slats, to sell to customers when needed. Most R trucks displayed F advertising.

The court determined that under Maryland law, both F and R met the definition of a "vendor"—R directly, and F through R, acting as an agent of F. Since F advertised delivery and set-up, its relationship with R was crucial to its operations. The court also applied the four-part test of *Complete Auto Transit*, 2 ILR 50, 97 S.Ct. 1076 (1977), to determine that there was no Commerce Clause problem with finding that both F and R were subject to use tax collection in Maryland. The frequency of R's contacts on F's behalf in Maryland satisfied the requirement that the tax be applied to an activity with a substantial nexus in the taxing state. The court did not find that R was a "common carrier," but was more of a personalized delivery service. R even charged F less than it charged other customers, in addition to providing services (set-up and repair) not commonly provided by a common carrier. The court found the second prong of the test—fair apportionment of the tax, to also be satisfied. The tax was internally consistent because Maryland was only seeking to have F and R collect the tax. The tax was externally consistent because Maryland exempts property from tax if it was paid to another state. The third prong was also satisfied—the tax does not discriminate against interstate commerce. Finally, the court found the tax to be fairly related to services provided by Maryland—fire protection, roads and schools for customers, and roads for R and F.

In May 2001, the Court of Appeals of Maryland dismissed the case for failure to have used and exhausted the administrative remedies required under the law for resolving tax disputes. Instead of seeking a declaratory judgment and injunction to require F to pay taxes, the court noted that the Comptroller could have brought an enforcement action in Circuit Court.

Same facts, different rulings among the states: There have been a few cases over the years where a seller with no business location, property, or employees in a state had contacts with individuals in a state who assisted with sales in some way. The most common fact pattern involved use of teachers to help an out-of-state bookseller obtain orders from children from a book catalog. The cases are split as to whether the teachers were agents of the seller such that substantial nexus existed to require the vendor to have to collect use tax from its customers. A few of these cases are summarized below.

Scholastic Book Clubs, Inc. v. State Board of Equalization, 207 Cal.App.3d 734, 255 Cal.Rptr. 77 (Cal. Ct. App., 1989)—Scholastic (S) had no physical presence or employees in California, yet was assessed use tax because the SBE found that S's use of teachers and librarians to solicit book orders created sufficient nexus with California. S periodically mailed catalogs to teachers and librarians who previously placed orders or requested catalogs. S also mailed catalogs to unnamed teachers ("3rd grade teacher at . . ."). Participating teachers distribute the order sheets,

collect payment, and distribute orders to students for S. Teachers and librarians can earn "bonus points" from participating in the ordering process.

The court relied on California R&T §6203 defining 'retailer engaged in business in this state' as including "any retailer having any representative, agent, salesman, canvasser, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, or the taking of orders for any tangible personal property." The court stated that even though the teachers were not obligated to act, once they do, they are under S's authority (because they were not under anyone else's authority for the activity). Also, a written agreement is not needed to establish an agency relationship, but can instead be implied based on conduct and circumstances. Finally, S ratified the acts by accepting the orders.

The court found that the relationship between S and the teachers was similar to that in *Scripto* (discussed earlier) and that the teachers did more than the jobbers in *Scripto* because they collected payment and distributed the merchandise to the customers. The court stated that S was "exploiting or enjoying the benefit of California's schools and employees to obtain sales." Thus, sufficient nexus was found to allow California to impose use tax collection responsibility on S.

In a later ruling the SBE held that when bonus points were awarded to classrooms, rather than for personal use by teachers, S was not liable to collect sales tax.[49]

In *Scholastic Book Clubs, Inc.*, 920 P.2d 947 (Kan. 1996), with a similar fact pattern to the California case, the court also concluded that S had a sales and use tax obligation. S had argued that the teachers were acting on behalf of the students, rather than on behalf of S and that no agency relationship existed with the teachers because there was no expressed or implied contractual agreement. In addition, S argued that the teachers do not act under its authority because S denied entering into a relationship with the teachers. The Kansas tax agency argued that S both directs the teachers to act and accepts the benefits of their efforts and provides them bonus points for their services thereby establishing an agency relationship. The court found that an implied agency can exist from a party's words, conduct or other circumstances and that denial by the alleged principal is not sufficient to disprove an agency relationship. The court ruled that the teachers were acting under S's authority once the teachers begin to sell S's books and S accepted the orders. The court also found "substantial nexus" as required by the *Quill* decision (see earlier discussion), based on Kansas agency and tax law. The court also relied on the 1989 California decision involving S. In contrast, the court found that *Pledger v. Troll Book Clubs, Inc.*, 871 S.W.2d 389 (Ark. 1994) which held that a bookseller had no nexus in the state was different because agency law in Arkansas differed from that in Kansas.[50]

In *Scholastic Book Clubs, Inc v. Reagan Farr, Commissioner of Revenue, State of Tennessee*, No. 09-587-II (2012), the court found that S had nexus for sales tax collection purposes. S argued that teachers were not its agents but instead acted on behalf of the students to help them place orders. However, the court held that the issue was not dependent on whether the teachers were agents of S because it was enough that S had connections in Tennessee by its use of schools and teachers to facilitate sales in the state. Per the court, S "created a de facto marketing and distribution mechanism within Tennessee's schools and utilizing Tennessee teachers to sell books to school children and their parents." The court also noted that the "safe harbor" of the Commerce Clause only applies where the vendor's connection with customers is by common carrier or U.S. mail. That safe harbor did not apply to S because it had other connections in Tennessee.

In contrast, at least three cases with facts similar to the California and Kansas cases, found that the taxpayer did not have substantial nexus with the state and thus, the state could not impose use tax collection responsibilities on the taxpayer. The Connecticut case described below is a good example of the confusion that can exist in knowing when a vendor has a taxable presence. The trial court found that the vendor did not have nexus in Connecticut, but on appeal, the court found that the vendor did have sales tax nexus.

Pledger v. Troll Book Clubs, Inc., 871 S.W.2d 389 (Ark. 1994), involved a New Jersey company that had no business location, property or employees in Arkansas. The bookselling arrangement was similar to that of Scholastic Books described earlier. The court found that the teachers were not agents of Troll. Under Arkansas law, an agency relationship can only be found if the agent is authorized to perform for and bind the principal and the principal has

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[49] In the Matter of the Petition for Redetermination of Scholastic Book Clubs, Inc. under the Sales and Use Tax Law, memo opinion (1999), http://www.boe.ca.gov/legal/pdf/1999Scholastic.pdf.

[50] Similarly, see *House of Lloyd v. Commonwealth of Pennsylvania*, 684 A.2d 213 (Pa. 1996), where nexus was found in a situation involving distributors of the taxpayer's products in the state.

the right to control the agent. The court found that the 1989 *Scholastic Book* case decided in California was distinguishable because it was decided prior to the *Quill* decision and California agency law differed from that in Arkansas. California law allows an agency relationship to be implied retroactively by ratification, while Arkansas does not. A dissenting judge stated that once a teacher sends in an order, a contract has been formed between the teacher and Troll and a contract of agency exists.

In *Scholastic Book Clubs, Inc. v. State of Michigan, Dept. of Treasury*, 567 N.W.2d 692 (Mich. Ct. App. 1997), the court held that "the use of teachers, without more, does not establish a substantial nexus with, or physical presence in, this state." The court found that the teachers were not S's agents under Michigan law, primarily because the teachers have no authority to bind S and the teachers are under no obligation to participate in S's program. The court analogized the teachers to parents who order items for their children. Thus, the court concluded that S had no use tax collection obligation in Michigan.

A similar result to the Michigan case was reached in Connecticut in *Scholastic Book Clubs v. Commissioner*, Docket CV 07 4013027S (Conn. Super. Ct. 2009), rev'd SC 18425 (Conn. Sup. Ct. 2012). However, on appeal, the court found that the teachers were "representatives" of the vendor in Connecticut, making Scholastic obligated to collect sales tax. The Connecticut statute referred to a vendor having either agents or representatives in the state. Thus, the court held that there need not be a legal agency relationship between Scholastic and the teachers to fall under the statute. The court also did not agree that the teachers were really customers acting in the role of parents helping children place an order. The court stated: "it is the effect of the in-state providers' participation in fostering the out-of-state retailer's goal of selling its products, not the providers' motivation, with which the statute is concerned. The statute contains no reference to the motivation that may inform a providers' conduct but simply requires that the retailer have a "representative" who is "operating" in the state for the specified purposes."

The court also stated: "the terms "customer" and "representative" are not mutually exclusive. Although the teachers may be customers when they purchase books from the plaintiff and participate in the bonus point system to obtain additional materials, this should not obscure the fact that their *principal* function is to serve as the exclusive vehicle for selling the plaintiff's products to their students. Accordingly, the teachers' status as customers does not mean that they cannot also serve as the plaintiff's representatives."

The court observed that the teachers "serve as the exclusive channel through which the plaintiff markets, sells and delivers its products to Connecticut schoolchildren." Due to the role the teachers played in enabling sales for Scholastic, the court found both per the statute and U.S. Supreme Court interpretations of "substantial nexus" (*Scripto, Tyler Pipe* and *Quill*, discussed earlier), Scholastic had sales tax nexus in Connecticut.

Affiliate Nexus

The growth of e-commerce and its reality that vendors can have customers in all jurisdictions but physical presence in only a few, has increased the use tax gap in states and local jurisdictions. States have taken several actions to try to change this situation, including trying to get Congress to use its Commerce Clause powers to overturn the *Quill* decision. Another tactic taken by state legislatures is to modify statutes to find some relationship an e-commerce vendor might have with a person or entity in the state and deem it to constitute nexus.

This section summarizes some key cases on how sales tax nexus determinations work for related entities and two key legislative approaches states have taken to have an in-state "affiliate" create nexus for a remote vendor.

Longstanding case law on nexus and affiliates: In *Current, Inc. v. SBE*, 24 Cal.App.4th 382, 29 Cal.Rptr.2d 407 (Cal. Ct. App. 1994), the court held that a remote seller could not be treated as having nexus due to the physical presence of a parent corporation where the corporations were separate and distinct entities. In similar cases, courts have "relied upon the fundamental principle of corporate law that the parent corporation and its subsidiary are to be treated as separate and distinct legal persons in the absence of a showing that corporate assets have been intermingled, that the formalities of separate corporate procedure have been ignored, or where the corporation is inadequately financed."

Similarly, see *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), *cert. denied*, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (Ohio 1995), and *Bloomingdale's v. Dept. of Revenue*, 567 A.2d 773 (1989), *aff'd without opinion* 591 A.2d 1047 (Pa. 1991), *cert. denied*, 504 U.S. 955 (1992).

In *Bloomingdale's*, *supra*, Pennsylvania tried to get Bloomingdale's By Mail, Ltd. (By Mail) to collect use tax from catalog sales delivered into the state. By Mail was formed as a wholly-owned subsidiary of Federated Department Stores, Inc. Federated is a Delaware corporation with headquarters in Ohio and with stores (Bloomingdale's) in Pennsylvania. By Mail was a New York corporation with officers and directors in New York,

Ohio, and Connecticut. It operated its nationwide mail order business from Virginia and a fulfillment center in Connecticut. Customer orders were received at one of these locations and shipped to the customer by U.S. mail or common carrier. By Mail customers could pay by various credit cards including a Bloomingdale's card. Customers wanting to return merchandise, did so to By Mail. By Mail had customers in Pennsylvania but did not collect use tax from them because By Mail did not have a physical presence in that state.

The Pennsylvania Department of Revenue argued that By Mail had sufficient nexus with the state to enable the state to impose use tax collection obligations. State arguments included: i) there were at least two instances where By Mail customers were allowed to return merchandise to a Bloomingdale's department store, ii) By Mail and Bloomingdale's use the same advertising themes and motifs, and iii) By Mail's separate corporate existence from Bloomingdale's department stores was a mere legal formality which should not control constitutional considerations, but should be treated as an agency relationship, such as in the *Scripto* case. The court discredited each of these arguments as follows: i) the two merchandise returns were "aberrations from normal practice," ii) similar advertising themes is not enough to constitute nexus, and iii) By Mail does not have agents acting on its behalf in Pennsylvania, as Scripto did by using independent contractors to solicit sales for the company.

Additional affiliate rulings: Illinois Department of Revenue General Information Letter ST 00-0043-GIL involved a parent and subsidiary corporation engaged in retail operations that were separate and distinct from each other. The subsidiary, ABC, was a mail order company with operations located only in State 1 and State 2. ABC solicited sales via catalogs and its website. The parent company, XYZ, had several locations in the U.S., including Illinois. While ABC's retail activities were "totally autonomous" from those of XYZ, ABC did pay XYZ for providing accounting and computer services to it. The fees charged were at arm's length. The services were provided in States 1 and 2. Sometimes, ABC purchased products from XYZ, but again, an arm's length price was charged. ABC did not distribute any of its catalogs in XYZ retail establishments and customers could not contact ABC through XYZ's retail establishments. XYZ sought a ruling from the Department of Revenue because it was considering placing ads in ABC" mail order catalogs, for an arm's length charge, and wanted to know if this would create nexus for ABC in Illinois. Based on *Quill*, the DOR ruled that XYZ's ads in ABC's catalogs would not create sales and use tax nexus for ABC in Illinois under an "agency, affiliate or other theory."

In contrast, in Letter Ruling 99-1 of the Massachusetts Dept. of Revenue (1/6/99),[51] the relationship between a television station and an out-of-state vendor was found to create a physical presence for the vendor. C was a nationwide mail order business with no property or employees in Massachusetts. C used television infomercials as the primary technique to sell its products. In Massachusetts, C advertised its products via a cable television station owned by a subsidiary of C. About 83% of the station's broadcasting time was devoted to C. The DOR found that the presence of the station and its activities in Massachusetts caused C to be present there and subject to sales tax collection. Per the DOR, the station's activities were "significantly associated" with C's ability to establish and maintain a market in Massachusetts. The DOR distinguished affiliate cases, such as *SFA Folio* (discussed above), in that its conclusion was not based on the ownership between C and the subsidiary, but the significance of the sub's operations to C's ability to sell.

The DOR concluded: "While we agree that a non-Massachusetts vendor generally will not create nexus with the Commonwealth under the standard set out in *Quill* by advertising in a local newspaper or on a local television station, we conclude that the unusual facts of this case compel a different outcome. We rule that Corporation has nexus with Massachusetts and, thus, a Massachusetts use tax collection responsibility in connection with its sales of goods to Massachusetts customers. Two facts form the basis for our ruling: (1) the physical presence of W__-TV in the Commonwealth and (2) the fact that W__-TV performs extensive activities on behalf of Corporation (over 80 percent of its total broadcast hours) that are significantly associated with Corporation's ability to establish and maintain a market in Massachusetts. Together, they create Commerce Clause nexus for Corporation. *See Scripto* and *Tyler Pipe*."

Selected cases involving Internet booksellers: In 2003 in the *Matter of the Petition for Redetermination under the Sales and Use Tax Law of Borders Online, Inc.* (SC OHA 97-638364), the California Board of Equalization found that because Borders accepted returns of purchases from Borders.com, nexus existed. The statement was found on-line in July 1999, but was removed in August 1999. The Board found such activities to be an integral part of the selling process (people are more likely to buy online if they can return to a store) and that Borders.com had a

[51] Available at http://www.mass.gov/dor/businesses/help-and-resources/legal-library/letter-rulings/letter-rulings-by-years/1995-1999-rulings/letter-ruling-99-1-electronic-retailers.html.

physical presence in California (through the in-state affiliate). The appeal was heard and decided by the First Appellate District in May 2005 and affirmed.

Borders Online was formed in 2001 as a Delaware corporation, headquartered in Michigan, to be Internet Company for Borders (it is a successor in interest to Borders Online, Inc.). Online and Borders are affiliated corporations owned by the same corporation. Most likely, one of the reasons why Online was set up as a separate corporation was to limit the number of states in which it would have to collect sales tax, based on such precedent as *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), *cert. denied*, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (Ohio 1995), and *Bloomingdale's v. Dept. of Revenue*, 567 A.2d 773 (1989), *aff'd without opinion* 591 A.2d 1047 (Pa. 1991), *cert. denied*, 504 U.S. 955 (1992). Online had no employees or property in CA.

In 1998 and 1999, Online sold over $1.5 million of merchandise over the Internet to CA consumers. Its website noted that goods could be returned to any Borders (physical) store. Borders did not charge Online for this service. This note was removed from Online's website on 8/11/99. Borders also included a notation on its sales receipts to "visit us online at www.borders.com."

Issues before the court were (1) whether Border's activities were "for the purpose of selling" Online's goods, and (2) whether Online had sufficient presence in the state, through Borders, to justify that it was required to collect sales and use tax.

The court agreed with the SBE that since Borders only handled returns for Online per the terms on Online's website, it was acting as Online's authorized agent. A formal arrangement is not needed because an agency relationship can be implied based on conduct and circumstances and no written agreement is needed.

The handling of returns for Online caused Borders to be "selling" for purposes of §6203(c)(2), because it was an integral part of getting customers to buy online. Online argued that it was not allowed to produce evidence that Border's reason for taking the returns was unrelated to encouraging sales. No evidence was produced when required and the court noted that even if the return policy provided some benefit to Borders (for example, it got a customer into their store), it could have still induce Online customers to buy from Online.

Online noted that unlike the situations in *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232 (1987) and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), Borders was not actually making any sales for Online. The court viewed that perspective as too narrow noting that per *Tyler Pipe* one is to look at whether the activities of the retailer's in-state people are "significantly associated with [its] ability to establish and maintain a market in [the] state for the sales."

The court did not find the returns policy here similar to SFA Folio Collection where the store took returns from the catalog operation under its own policy and for its benefit.

Query: Is this holding a proper interpretation under CA R&T §6203(c)(2)? R&T §6203(a) provides that "every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state, not exempted . . . shall . . . collect the tax from the purchaser." R&T §6203(c)(2) provides that "retailer engaged in business in this state" includes "any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property." Clearly, Online is a retailer. Also, noting on its website that Borders will handle returns appears to make it an agent or representative, but was Borders "selling" for Online?

The court stated "The Board appears to have thoroughly considered the meaning of the term, and its reasoning that the act of 'selling' encompasses offering other inducements to purchase is consistent with at least one later pronouncement. (Board's Boarder Opn., *supra*, Cal. Tax Rptr. (CCH) ¶ 403-191 at p. 29.974; *In the Matter of the Petn. For Redetermination Under the Sales and Use Tax Law of Barnes & Noble.Com* (Sept. 12, 2002) [2000-2003 Transfer Binder], 11 ILR 846, Cal Tax Rptr (CCH) ¶ 403-325, pp. 30,447, 30,450 [bookstore's distribution of discount coupon on behalf of affiliated Internet retailer was integral to selling efforts and thus constituted 'selling'].)"

There was no evidence of whether sales occurred at Online due to the return policy. Is an offer to handle a return the same sales inducement as providing a coupon (which in Barnes & Noble.Com, the Board found to be more than advertising)? Does "selling" mean offering inducements to sales, or actually making sales, as was done in *Scripto* (independent contractors taking orders) and *Scholastic* (see earlier discussion of teachers taking orders and collecting payment for the bookseller)? Of course, those cases were looking at the in-state person's actions and

relationship with the out-of-state retailer to determine if an agency relationship existed, not whether "selling" was involved (because taking orders is unquestionably selling).

Does R&T §6203 need to be modified again to be clearer? Should it say "selling or inducing or promoting sales" rather than just "selling"? Of course, given the 2005 *Borders Online* decision, there would appear to be no need to clarify it other than to avoid litigation in the future. Such a change would appear to be permissible within the Due Process and Commerce Clause given that §6203 requires the physical presence of an agent or representative in the state. Also, this new language would tie to maintaining a market in the state as required by the U.S. Supreme Court (In *Tyler Pipe*, *supra*, the Court stated: "The crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.")

In *Matter of Barnes & Noble.com* (Case ID 89872; 9/02), the California Board of Equalization found that the retail store's distribution of discount coupons to its customers for credit when they bought books online created an agency and nexus. (This position was overturned on appeal, see discussion following this summary of the Board's determination). BN.com also paid to have its logo printed on shopping bags used in the retail store. The retail store's distribution of the shopping bag with the discount coupon inside "served as a public statement that Booksellers had the authority to distribute the coupons on petitioner's behalf." The Board stated that the coupon distribution was not "mere advertising" and neither was "the use of the employees of an authorized in-state representative to make sales solicitations by manual transmission of coupons."

In *Barnesandnoble.com v. BOE*, 2007 ILRC 2893, CGC-06-456465 (Cal. Sup. Ct. SF, 10/11/07), the court reversed the earlier decision to find that BN did not have nexus for sales and use tax purposes in California. BN operated as a Delaware LLC. BN is owned 40% by Barnes & Noble, Inc. (B&N), 40% by Bertelsmann AG, and 20% by barnesandnoble.com, inc., a publicly-traded corporation. BN operates as a separate legal entity and has offices at a different location than B&N and its affiliates and subsidiaries. BN has separate and independent management from B&N. Booksellers (B), a wholly-owned subsidiary of B&N, operates retail stores in the US. The only connection between BN and B was including BN's coupons in shopping bags used by B. B and BN did not share employees, inventory, facilities, management or any information. B's stores did not take returns of BN merchandise and provided no "unique or preferential services to [BN's] customers" and did not refer customers to BN.

From mid-November 1999 through mid-December 1999, B's shopping bags included coupons for a $5 discount for online purchases from BN of $25 or more. The bags had B's logo on one side and BN's logo on the other side. BN paid to have the coupons printed and the extra cost of having its logo on the shopping bags.

In September 2001, the BOE issued a memorandum decision in Borders Online where it indicated that it interpreted that "selling" as used in R&T §6203(c) to mean "inclusive of all activities that are an integral part of making sales." The BOE used this same interpretation for B and BN to find that use of the coupons was an integral part of making sales thus making BN a "retailer engaged in business" in California with "substantial nexus" as required by the commerce clause due to B being its representative or agent in California.

The court did not find any difference between the terms "agent" and "representative" (both used in §6203). It also did not find similarities between BN's situation and the two cases the BOE cited as support of the existence of an agency relationship between B and BN. In *Borders Online LLC v. State Bd. of Equalization,* 18 ILR 10, 129 Cal.App.4th 1179 (2005), the two corporations involved were wholly-owned subsidiaries of the same parent corporation. They also had overlapping boards of directors and corporate officers. Borders stores provided "unique and preferential services" to Online's customers such as returns of merchandise on favorable terms. Borders employees also solicited sales for Online.

The court distinguished the BN situation in that while B&N and BN had two directors in common as well as the same chairman, the court found that B and BN shared no officers or directors. The court also did not find that B&N had "actual control" over BN and B. "Thus, the fact that [BN] and [B] are sister corporations does not support a finding that [B] was [BN's] agent."

The BOE also relied on *Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 7 Cal.App.3d 734 (1989). In this case school employees provided various services to enable Scholastic, which had no physical presence in California, to sell books in California. Per the court: "This is a far cry from the passive distribution of coupons."

Per the court: "The concept of agency requires something significantly more than simply passing out information at somebody else's request. An essential element is that the agent (or representative) must have the authority to bind the principal, authority held neither by [B&N] retail stores nor the hypothetical person on the street corner handbag

out promotional material. [B] had no input in creating the coupon program. [B] had no authority to adjust the terms of the coupons or to redeem them. [B] could not accept returns of books purchased from [BN] with the coupons. [B] did not solicit sales and could not accept orders for [BN]. [B] had no authority to accept anything from customers that would be passed on to [BN]. With regards to [BN], [B] could do nothing but pass out the coupons created and distributed by [BN]. [B] could not speak for or bind [BN] on any subject whatsoever. Thus, the Court finds that [B] was not [BN's] agent for the purposes of RTC §6203."

The court also noted that the fact that B and BN had similar names does not make B the agent of BN because there was no evidence that B could bind BN. "Finally, the Board argued that [B] gave [BN] preferential treatment because [B] did not pass out coupons from any company other than [BN]. The evidence only shows that [B] did not pass out coupons from other companies during the tax period. There is no evidence that [B] did not pass out coupons from other companies during another time period or that [B] would not offer this service to any other company. In any event, even if this were only a one-time operation, that would not alter the agency analysis."

While recognizing that the term "selling" as used in R&T §6203 had been modified by the BOE's ruling in Borders, it was not relevant since B was found not be an agent of BN. Per the court: "Because the Board's statutory interpretation of "selling" has been conclusively adopted as law in Borders Online, the Court of Appeal's definition of that term now controls the outcome of this case. Accordingly, the interpretation of that term, as first applied by the Board in its memorandum opinion, is now a matter of settled decisional law. But "selling" activity in California would subject [BN] to the Board's jurisdiction only if carried out by [BN's] "agent," which, as explained above, it was not."

Thus, BN was not subject to sales and use tax collection in California as it had no physical presence in the state.

Despite winning the case, the 10-Q (pp. 26-27) for the quarter ending August 2, 2008 for Barnes & Noble, Inc. indicates that in May 2008, the BOE and B&N entered a settlement agreement to resolve all disputes between BN and California. Apparently, the BOE had filed an appeal. The $17.7 million assessment was canceled and the BOE waived any claims for tax, interest and penalties through November 1, 2005 which is the date when BN began to voluntarily collect sales tax in California. As part of the settlement, BN agreed to pay $9 million.

In 2007, in a case with similar facts, a district court in Louisiana (L) found that BarnesandNoble.com (Online) did not have nexus in the state (*St. Tammany Parish Tax Collector v. BarnesandNoble.com*, 22 ILR 615, 481 F.Supp.2d 575, No. 05-5695 (E.D. La., 03/22/07). The facts indicated that Online had no physical presence in L and that goods purchased online were delivered to L customers via common carriers. From January 2001 to October 2003, Barnes & Noble, Inc. owned 40% of Online and then through May 2004, owned 80% of Online through a wholly-owned subsidiary. Thereafter, BN owned 100% of Online through B&N Holding Corp., a wholly-owned subsidiary. Despite being owned by the same parent, BN and Online did not share management, employees, offices or other business elements. BN did operate stores in L including in St. Tammany Parish. The Tax Collector of St. Tammany Parish, where BN operated a store, sued Online for failure to collect sales and use taxes from its customers in the parish.

The court noted that to be subject to sales tax and within the Commerce Clause, L must show that Online's activity had a substantial nexus with the state, the tax was fairly apportioned, the tax did not discriminate against interstate commerce, and that it was fairly related to the services provided by the state (the *Complete Auto Transit* standards (2 ILR 50, 430 U.S. 274, 279 (1977)). At issue in the case was only the substantial nexus standard. The court noted two tests for substantial nexus: (1) physical presence as called for by the *Quill* decision (2 ILR 242, 504 U.S. 298 (1992)) and (2) attributional nexus as articulated in *Scripto* (362 U.S. 207 (1960)) and *Tyler Pipe* (483 U.S. 232 (1987)). The court then went through the five business relationship factors that L argued proved that Online had substantial nexus for sales tax purposes.

1. Common membership program where customers of BN and Online received a discount on items purchased. Members paid a fee and Online received part of that revenue. BN and Online shared the database generated from the cards.

2. BN sold gift cards that could be used either in a store or with Online. Revenue was earned only by selling gift cards or accepting a gift card as payment. Neither BN nor Online derived revenue from sales made by other retailers participating in the program.

3. Online earned revenue via commissions for merchandise ordered at BN stores but shipped directly to customers.

4. BN and Online engaged in cross-promotional advertising. For example, Online's website included a store locator function. BN promoted Online via the gift card and membership programs. BN employees only provided information about Online if asked by customers.

5. BN gave preferential treatment for returns of items purchased from Online. Evidence indicated that BN stores would take returns from other stores including Online and non-BN stores, at the store manager's discretion.

Considering the above factors, the court found that Online did not have substantial nexus with Parish. It did not find that BN marketed Online's products. "The existence of a close corporate relationship between companies and a common corporate name does not mean that the physical presence of one is imputed to the other. *See, e.g., SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220, 229-31 & 233-34 (1991) (refusing to impute nexus from bricks-and-mortar retailer to mail-order retailer when the retailers were separate corporate entities owned by the same parent company, sharing some directors and officers, using the same trademarks and logos, selling similar merchandise, and sharing financial and market information); *Bloomingdale's By Mail, Ltd. v. Pennsylvania*, 130 Pa. Cmwlth. 190, 198 (1989) (holding that affiliation alone was insufficient to create nexus); *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St.3d 119, 122-23 (Ohio 1995) (rejecting unitary business entity argument that would impute nexus to affiliated, out-of-state retailer); *Current, Inc. v. State Board of Equalization,* 24 Cal.App.4th 382, 391 (Cal. App. 1st Dist. 1994) (holding that nexus could not be imputed between companies that did not have integrated operations or management and were organized as separate and distinct entities). Booksellers and Online were formally separate corporate entities that were wholly owned by the same parent company for only part of the period in issue. The two companies clearly shared a common name and brand identity under the "Barnes & Noble" banner, but there was no overlap between the companies' management or directors. There is no allegation that the companies intermingled assets or that they were underfinanced. And to the extent the companies may have shared financial or market data, that fact is not of independent significance. The companies did not hold themselves out as the same entity. Thus, the Court finds that attributional nexus does not apply merely by virtue of the affiliation between the companies."

The court also found that BN's activities performed on behalf of Online were not sufficient to treat BN as serving as a marketing presence for Online in the Parish. Unlike in *Scripto*, BN never took an order for Online and did not provide facilities to enable customers to place an order with Online. In addition, the gift card and membership program did not lead to nexus as they did not produce revenue for Online "by virtue of sales made or orders taken by the entity that is physically present in the Parish. That Online may have derived a benefit from [BN's] advertising of the program is not sufficient to impute its presence to Online." The court noted that in *SFA Folio Collections*, the mail-order retailers distributed their catalogs to local stores to be given to customers. The court found that situation to be a stronger case for a showing of nexus than what existed with Online, but that SFA Folios did not find nexus to exist. Finally, the court did not find the return practice to rise to the level of activity in *Scripto* or *Tyler Pipe* where contractors made sales on behalf of the out-of-state retailer. Neither was it comparable to the in-state sales support found in such cases as *Scholastic Book Clubs*, 207 Cal.App.3d 734.

With facts similar to the California and Louisiana cases, the New Mexico Department of Revenue found that the online retailer did not have substantial nexus for gross receipts tax purposes.[52]

Potential advantages of planned structuring: A Technical Assistance Advisory issued in West Virginia in December 1999 illustrates the potential benefits of use of a separate entity to conduct certain operations within a state. In TAA 99-002, Corporation (C) was engaged in sales of various products over the Internet. C had no property or employees in West Virginia. C was considering forming Contact Company (CC) as a wholly-owned subsidiary to respond to inquiries from customers and potential customers who do not reside in West Virginia, but elsewhere on the east coast. CC would obtain its own facilities in West Virginia and charge an arm's length fee to provide customer support to C. Technology would be used to ensure that any request or contact from a West Virginia customer of C would not be handled by CC. C sought advice from the W.V. taxing agency as to whether the existence of CC would cause C to become subject to sales and use tax collection in West Virginia.

The taxing agency concluded that C did not meet the definition of a "vendor" under W.V. law because CC will not be selling any tangible personal property or providing services to W.V. customers of C.

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[52] Letter ID NO. #L1806543104**;** http://www.tax.newmexico.gov/Public%20Decision%20and%20Order%20Document%20Library/11-10.doc.

Caution: Tax laws in every state need to be reviewed as they may differ from state to state and case law continues to evolve and state legislatures tend to be aggressive in enacting laws that make it more likely that a company with any connection to someone in the state will create nexus. Also consider the conflicting nexus cases cited earlier.

Legislative Actions and Proposals to Address Affiliate Nexus

In the first few years of e-commerce, some "bricks and mortar" vendors ventured into the e-commerce arena by first establishing a separate legal entity to handle the online activities. Per the holdings in SFA Folios and other cases summarized earlier, the nexus of the online entity would not automatically be attributed to the in-state entity. This is the fact pattern litigated in California and Louisiana involving Barnes & Noble and its online entity (summarized above). In such a situation, if a person purchased a book from a Barnes & Noble store, he was charged sales tax. If he instead purchased the book from bn.com (assuming he did not live in a state where bn.com had a physical presence), he was not charged sales tax, but would instead have to self assess use tax.

This arrangement caught the attention of both state officials and main street retailers. While state tax agencies could look for an agency or similar relationship between the in-state store and online entity (as California did with two booksellers), several states took a more proactive stance and enacted legislation to specify that certain ownership relationships and similar sales arrangements created nexus ("affiliate" nexus). States continue to introduce proposals to enact such laws.

In 2001, Arkansas enacted affiliate nexus legislation (Act 922, HB 1440). In 2003, similar legislation passed in Alabama (H.B. 650). Kansas, Louisiana, Minnesota and New York have similar rules.

While state statutes on affiliate nexus vary, the approach used in Alabama provides a good example of what the states' goals are in enacting such legislation. The text follows:

Alabama R&T §40-23-190, *Conditions for Remote Entity Nexus*

> "(a) An out-of-state vendor has substantial nexus with this State for the collection of both state and local use tax if:
>
> (1) the out-of-state vendor and an in-state business maintaining one or more locations within this State are related parties; and
>
> (2) the out-of-state vendor and the in-state business use an identical or substantially similar name, tradename, trademark, or goodwill, to develop, promote, or maintain sales, or the in-state business and the out-of-state vendor pay for each other's services in whole or in part contingent upon the volume or value of sales, or the in-state business and the out-of-state vendor share a common business plan or substantially coordinate their business plans, or the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market.
>
> (b) Two entities are related parties under this section if one of the entities meets at least one of the following tests with respect to the other entity:
>
> (1) one or both entities is a corporation, and one entity and any party related to that entity in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of Section 318 of the Internal Revenue Code owns directly, indirectly, beneficially, or constructively at least 50 percent of the value of the corporation's outstanding stock;
>
> (2) one or both entities is a limited liability company, partnership, estate, or trust and any member, partner or beneficiary, and the limited liability company, partnership, estate, or trust and its members, partners or beneficiaries own directly, indirectly, beneficially, or constructively, in the aggregate, at least 50 percent of the profits, or capital, or stock, or value of the other entity or both entities; or
>
> (3) an individual stockholder and the members of the stockholder's family (as defined in Section 318 of the Internal Revenue Code) owns directly, indirectly, beneficially, or constructively, in the aggregate, at least 50 percent of the value of both entities' outstanding stock."

In 2001, Nevada expanded its definition of "retailer maintaining a place of business in this State" at §372.728 of its Sales and Use Tax Act by adding the words italicized in the following excerpt:[53]

> "A retailer soliciting orders for tangible personal property through a system for shopping by means of telecommunication or television, using toll-free telephone numbers, which is intended by the retailer to be broadcast by cable television or other means of broadcasting to persons located in this state *or through a website on the Internet or other electronic means of communication to provide solicitations to persons in this state."* [§372.728(4)]

In April 2008, New York enacted a new approach to reach a different type of "affiliate."[54] This legislation broadened the definition of "vendor" for sales tax purposes to include (NY Tax Law §1101):

> "a person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods ending on the last day of February, May, August, and November. This presumption may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the united states constitution during the four quarterly periods in question."

The legislature was aware that some e-commerce vendors make arrangements with website owners (often called "affiliates" or "associates") whereby if the affiliate places a link on their website directing people to the vendor's website, the affiliate will potentially receive compensation. The compensation might be a fixed amount per clicks or it might be a commission based on any purchase the visitor makes if the visitor reached the vendor's website by starting with the "affiliate's" website. The commission fee arrangement led the legislature to presume that the affiliate might solicit sales in order to increase its commissions and that could cause the vendor to have sales tax nexus. Presumably, the legislature created a rebuttable presumption to allow vendors the opportunity to prove that the affiliates were only engaged in advertising and not solicitation of sales.

Soon after enactment of the New York legislation, the Department issued two rulings to help vendors comply with the law including its rebuttable presumption. Ruling TSB-M-08(3)S (5/8/08) explains the new rule, distinguishes paying a commission to an affiliate versus paying per clicks, and explains how to rebut the presumption. Ruling TSB-M-08(3.1)S (6/30/08) provides additional information on how to rebut the presumption.

Two e-commerce vendors (Amazon and Overstock.com) subject to the New York law filed lawsuits challenging the constitutionality of the provision. Aside from the lawsuit, these vendors reacted to the New York law differently. Amazon began to collect sales tax in New York and Overstock cancelled its arrangements with New York affiliates making it no longer subject to the expanded definition of "vendor." The New York legislation also included a limited amnesty provision for vendors who started to collect tax per the new legislation.

The New York Supreme Court issued a ruling on the litigation in January 2009. The court dismissed the claims for failure to state a cause of action because it found that the vendors would not prevail in finding that the law was unconstitutional. In the ruling, the court stated:[55]

> "There is a "reasonably high degree of probability" that New York businesspeople and entities desirous of raising money that are compensated for referring customers who ultimately make purchases will solicit business from those with whom they are familiar and encourage sales. It is also highly probable that New York residents will more likely than not have ties to other New York residents and it is not irrational to

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[53] Nevada Assembly Bill No. 445, Chapter 364, June 6, 2001.

[54] For more information see New York State Department of Taxation and Finance, "Business Taxpayer Answer Center," http://nystax.custhelp.com/app/answers/detail/a_id/2421/~/chapter-57-of-the-laws-of-2008-included-amendments-to-the-tax-law-that-revised. The Department also has a summary at http://www.tax.ny.gov/pdf/stats/sumprovisions/summary_of_2008_09_tax_provisions.pdf (page 10 - 11).

[55] *Amazon.Com v. New York State Dept of Taxation and Finance*, 26 ILR 442, 23 Misc.3d 418, 877 N.Y.S.2d 842, 2009 N.Y. Slip Op. 29007 (1/12/09); also the *Overstock* opinion.

presume that at least some of them will actively solicit business for the remote seller from within the State from others within the State."

An appeals decision was issued in November 2010, also the constitutionality of the legislation, but allowing further discovery on the taxpayer claims.[56]

Subsequent to the New York Supreme Court ruling favorably for the state in January 2009, several other states introduced similar legislation. At March 2012, seven other states had enacted legislation. The changes are mostly similar to the New York legislation except that two states (Illinois and Connecticut) did not include a rebuttable presumption and some states had a sales threshold lower than $10,000.

For more information on the affiliate nexus approach of New York and other states and the issues involved, see the author's website on the topic (http://www.cob.sjsu.edu/nellen_a/affiliate_nexus.html). The website includes links to legislation, litigation and articles on the topic.[57]

Observations on Sales and Use Tax Nexus

1. *Due Process Issues May Remain*—While the *Quill* decision would seem to indicate that only Commerce Clause issues remain with respect to whether states may impose sales tax collection obligations on remote vendors, differences between e-commerce and mail order likely make this a false illusion. In the past few years, there have been several cases regarding whether it was "fair" to subject certain persons to the laws of particular jurisdictions where they had no physical presence. Several of these cases involved trademark infringement. These cases indicate that just having a website is not enough to find jurisdiction within due process constraints. Instead, "something more" is required to show that a person purposefully directed its activities to the jurisdiction.[58]

A 2007 non-tax case in Illinois indicates a change in thinking regarding when a person or entity has a connection with a state such that it can be subject to its rules without the state violating the Due Process clause of the U.S. Constitution. In *Howard v. Missouri Bone and Joint Center*, Ill. App. Ct., 2007 (Ill. App. Ct., 5th Dist.), the court found that it was not relevant whether an entity's website was interactive in determining whether the website owner had purposefully directed activity toward the state (contrary to *Zippo Manufacturing Co. v. Zippo Dot Com, Inc.*, 2 ILR 286, 952 F.Supp. 1119 (W.D. Pa. 1997). The court found the interactive website to be no different from a phone or mail communication, which is not enough to find personal jurisdiction over the one initiating the communication. "Virtually every corporate defendant maintains some type of website, and that virtual presence does not indicate a deliberate intention to enter the market." Instead, one must check to see if the defendant maintains continuous and systematic business contacts in the state.

In *Ginsburg v. Dinicola*, 2007 ILRC 2057, 2007 WL 1673533, Civil Action No. 06-11509-RWZ (D. Mass. 2007), the court held that the defendant's one sale to a customer in Massachusetts via eBay did not fall under the state's long-arm statute for the state to impose its jurisdiction over the New York defendant. The court referred to other cases involving sales on eBay noting that the mechanics of the system, particularly it selecting the high bidder, reduced the seller's contacts with the state (the "choice of the highest bidder is beyond the control of the seller"). A single transaction did not rise to the level of "sufficient minimum contacts" with the state. Because the defendant did not fall under the state's long arm statute, the court did not address a due process analysis.

In situations where a person makes no deliberate or repeated contact with the state, jurisdiction might not be found. Consider an example where a vendor uses a website to sell regionalized merchandise (such as something related to a college or sports team in the area) yet anyone can order a product from the site. Has the vendor purposefully directed its activities to residents of every state? How many sales outside of the region would be necessary for a state not located in the region to make the vendor comply with state tax laws? Or, is setting up a website, that does not prohibit customers in any particular state, constitute purposefully directing activities to

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[56] *Amazon.com v. New York Department of Taxation and Finance*, *Overstock.com v. New York Department of Taxation and Finance*, 30 ILR 625, 913 N.Y.S.2d 129, 2010 N.Y. Slip Op. 07823 (2010).

[57] Also see Nellen, "From Website Links to Collection Points," Cal Tax Network, Nov. 2011, http://www.21stcenturytaxation.com/uploads/CABar_TaxNewsletter-Nov2011_AffiliateNexus.pdf; BNA, Tax Management Multistate Tax Report, "California's Delay in Online Collection Law Sets Stage For Federal Solution, With or Without Streamlined System," Vo1. 18, No. 11, 11/25/11; and Nellen, "Creating More Sales Tax Collectors, *AICPA Tax Insider*, 7/14/11, http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2011/Tax/Sales_Tax_Collectors.jsp.

[58] See *Cybersell, Inc. v. Cybersell, Inc.*, 3 ILR 215, 130 F.3d 414 (9th Cir. 1997), and *Millennium Enterprises v. Millennium Music*, 2 ILR 410, 33 F.Supp.2d 907, Civ. No. 98-1058-AA (D. Or. 1999).

Internet users in all states? These are some of the questions that remain in the e-commerce environment and for which Congress cannot address under the Due Process Clause.

2. *Commerce Clause and Congressional Action*—While in the *Quill* decision, the Supreme Court reminded everyone that Congress could address the Commerce Clause issue that prohibits states from making remote vendors collect sales tax it is unlikely that Congress will do so without significant changes first being made to simplify state sales tax systems. Subjecting multistate vendors to sales tax collection in potentially over 6,000 taxing jurisdictions would impede interstate commerce. The Streamlined Sales and Use Tax project (discussed later) has simplified tax compliance and administration in adopting states.

3. *Will Nexus Guidelines Help?*—P.L. 86-272 (9/14/59) has provided certainty to many multistate businesses with respect to whether they are subject to income states in states in which they have sales of tangible personal property. A similar approach could be applied with respect to sales tax nexus which could address issues of how much physical presence establishes nexus and when a third party relationship constitutes nexus. While guidelines will be helpful to vendors by providing certainty, they will not address the concern of state and local governments in collecting use tax from buyers (when a seller does not have nexus) given the difficulty of collecting it directly from consumers.

4. *Global considerations*—At the international level, the tax equivalent of nexus is permanent establishment (PE). That is, generally, a foreign country may not subject a vendor to income taxation unless it has a physical presence in the country. The OECD is has been working clarifying what constitute a PE in the e-commerce realm.[59]

Drop Shipments

The e-commerce model may result in more types of drop shipping arrangements as some Internet businesses reduce costs by having products shipped directly from the unrelated supplier to the customer. A drop shipment occurs when a business (B) has an unrelated supplier (DS) deliver goods directly to the business's customer (C). This type of business operation is one advocated as a way to make money via the Internet. An Internet search on the topic will produce various articles on this business strategy. Few of these websites note anything about the tax considerations for the seller although issues exist. For example, does the business have inventory even if they don't have possession of goods? The answer to this question is relevant in determining the proper tax accounting methods and recordkeeping for the business. Who is responsible for the collection of sales tax from customers and whose physical presence is relevant (the business's or the drop shipper's) in determining if there is nexus? The inventory issue is discussed later and the sales tax issue is discussed here.

A drop shipment, in effect, involves two sales: (1) from DS to B, and (2) from B to C. The tax treatment of these transactions can differ from state to state. The rules of California are explained below to provide an overview to possible tax consequences and interpretations and to illustrate the confusion that might arise in dealing with the rules.

California Revenue & Taxation Code §6007 provides: "A 'retail sale' or 'sale at retail' means a sale for any purpose other than resale in the regular course of business in the form of tangible personal property. When tangible personal property is delivered by an owner or former owner thereof, or by a factor or agent of that owner, former owner, or factor to a consumer or to a person for redelivery to a consumer, pursuant to a retail sale made by a retailer not engaged in business in this state, the person making the delivery shall be deemed the retailer of that property. He or she shall include the retail selling price of the property in his or her gross receipts or sales price."[60] Thus, the California supplier (drop shipper) delivering product to a remote retailer's California customer will have to collect the sales tax (unless it is a sale for resale or B is engaged in business in California). CA Regulation 1706 provides that the drop shipper is to report and pay sales tax based on the retail selling price of the tangible personal property paid by the California consumer to the business.

If B is an out-of-state entity not engaged in business in California, even though it looks like DS is selling to B, if C is a California entity, DS must collect sales tax from C (unless it obtains a resale certificate from C; a resale certificate from B is of no relevance).[61] If DS is engaged in business in California (per R&T §6203) it is the retailer

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[59] See, for example, "OECD releases a discussion draft on the definition of "permanent establishment" in the OECD Model Tax Convention," 10/12/11, http://www.oecd.org/document/51/0,3746,en_2649_33747_48836787_1_1_1_1,00.html.

[60] R&T §6007 was found to be constitutional. See *Lyon Metal Products, Inc. v. State Board of Equalization*, 58 Cal.App.4th 906, 68 Cal.Rptr.2d 285 (Cal. Ct. App. 1997).

[61] CA Annotation 475.0028 (12/14/93).

under §6007 and required to collect the sales and use tax from the California customer. If DS is an out-of-state supplier not engaged in business in California, it is not required to collect tax from the California customer; instead, the customer must self-report the use tax.[62]

When DS is responsible for collecting sales tax from C, how does it know what sales price B is charging the customer? California Regulation 1706 provides that DS may assume that the sales price is its selling price to B with a 10% mark-up. If S has proof that the mark-up should be less, it may use less than 10%.

Confusion regarding 3-party arrangements for sale of products can result due to not knowing who is "engaged in business" in the state where the customers are located (who has nexus). Confusion can also result in knowing whether the transaction is indeed a drop shipment arrangement. In a 2005 case, *In re Valley Media, Inc.,*[63] the court found that an arrangement was not a drop shipment because DS did not deliver goods to customers in Massachusetts. Thus, DS was not responsible for collecting tax from the Massachusetts customers. DS did business in California and had arrangements with Internet retailers who advertised DS's products. The retailers had arrangements with DS that it would ship products directly to Massachusetts customers. There was no contractual arrangement between DS and the customers. The shipment terms were F.O.B. DS's shipping facility in California. Thus, delivery took place when DS put the good into the hands of the common carrier at its place of business in California. Thus, the court held that DS's drop shipped products were delivered to the retailers in California rather than to the retailers' customers in Massachusetts. Since DS did not "deliver" goods in Massachusetts, it did not make a "sale at retail" and was not responsible for sales tax on such products.

It is important to note that the language of the drop shipment statute in Massachusetts was not exactly the same as that in California because the Massachusetts statute included the words "the *delivery in the commonwealth* of tangible personal property."

Occasional Sales

Generally, a seller making only "occasional" or "isolated" sales does not have to collect sales and use taxes. For example, in California, Revenue & Taxation Code §6367 provides: "There are exempted from the taxes imposed by this part the gross receipts from occasional sales of tangible personal property and the storage, use, or other consumption in this state of tangible personal property, the transfer of which to the purchaser is an occasional sale." R&T §6006.5(a) provides that an occasional sale includes "A sale of property not held or used by a seller in the course of activities for which he or she is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state, provided that the sale is not one of a series of sales sufficient in number, scope, and character to constitute an activity for which he or she is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state."

California Reg. §1595 further provides: "Generally, a person who makes three or more sales for substantial amounts in a period of 12 months is required to hold a seller's permit regardless of whether the sales are at retail or are for resale. Each sale of the person during the 12 months period is included in determining whether that person is required to hold a permit, or would be required to hold a permit if the activities were conducted entirely inside this state. Thus, a sale occurring outside California, whether at retail or for resale, is included, even though it would not be subject to California sales tax. A person who makes a substantial number of sales for relatively small amounts is also required to hold a seller's permit."

The Internet led to the creation of various auction sites where both businesses and private individuals can sell items. States might review their occasional sales rules to see if they need modification if they desire to provide a broader exemption for individuals using sites, such as eBay. Alternatively, states that do not want to modify their existing rules will need to undertake educational efforts with individual taxpayers to be sure they know when they must register as a retailer and how to collect and remit sales and use taxes.

As part of the standard questions for income tax return preparation, practitioners should consider asking individual clients if they sold anything online to determine if they should be registering for sales tax collection.

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[62] CA Annotation 495.0849 (6/18/97).

[63] *In re Valley Media, Inc.*, 2004 ILRC 3265, Case No. 01-11353, 2004 Bankr. LEXIS 2061 (D. Del. Bankr., Dec. 29, 2004), *aff'd* 2007 U.S. App. Lexis 4189 (3d Cir. 2007).

Sourcing

> "A sale of goods is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed. We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future." *Oklahoma Tax Com'n. v. Jefferson Lines, Inc.*, 1 ILR 857, 115 S.Ct. 1331, 1339 (1995).

Generally, sales and use taxes are collected for the jurisdiction of the destination of the goods. However, for intangibles, some states call for some type of proration of the tax based on where the intangible or service will be used. For example, the District of Columbia tax regulations provide:

> "Information services performed or delivered outside of the District for use within other jurisdictions, as well as for use within the District shall be subject to a prorated share of the District use tax; Provided, that no sales tax was required to be paid on that prorated share to the other jurisdiction. Information services sold and delivered by the vendor to locations outside of the District shall be exempt from the sales tax."[64]

Sourcing issues exist mostly for intangibles and services. If a business were to purchase five computers from a vendor in Michigan for delivery and use in five different states, the determination of the sales and use tax liability in each state generally poses no problem. However, if the business were instead to purchase software from a Michigan company for delivery to a server in California that would be accessed by the buyer's employees in four other states, issues would arise as to where sales and use tax should be assessed.

A 2012 New York State Department of Taxation and Finance ruling (TSB-A-12(3)S (2/27/12)) noted that taxable access to an online database should be "based on the portion of the receipt attributable to the employee users located in New York" if a customer's employees use the software and database both in and outside of New York.

The laws of any state in which a business may have nexus should be consulted to determine how sales tax should be sourced for items used in more than one jurisdiction.

Origin versus Destination Basis for Assessing Sales and Use Taxes

Another sourcing issue that primarily arises in discussions of proposals to change the sales and use tax system is whether sales should be sourced (taxed) at the destination or the origin. Some of the relevant issues include:

- Would nexus issues be simplified by imposing sales taxes based on the location of the seller, rather than the buyer? The European Union discussed moving towards such a system. The OECD, however, recommends that the destination approach should be used for consumption taxes.
- Some commentators have suggested that an origin basis be used for assessing sales tax on services provided over the Internet, such as the provision of information. This position is supported by its simplicity (relative to trying to determine the location of all customers) and the *Jefferson Lines* case (see above).[65] Use of different sourcing systems for goods purchased at physical stores versus over the Internet would not result in a tax neutral system. That is, a customer might prefer to purchase clothes from an e-commerce vendor in Oregon (no sales tax) rather than from a store located in her neighborhood.
- What would be the impact on distribution of sales tax revenues? States with more customers than businesses would experience a loss of revenues.
- How would tax competition be impacted? Would new companies locate in sales tax haven states, such as Oregon? Would existing companies set up new corporations to operate e-commerce operations in sales tax havens? Would state and local governments lower their sales tax rates in order to attract businesses, in what economists refer to as a "race to the bottom?"
- Would problems exist in determining the situs of sales made by companies with multiple locations, particularly where it is difficult to identify where the sale occurred, such as for software sold via the Internet?

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[64] District of Columbia Regulation §475.9.

[65] Arthur Angstreich, James R. Fisher, and Eric J. Miethke, "*Jefferson Lines* as Ticket to Cyberspace? Taxing Electronic Commerce Services," *Tax Notes,* July 27, 1998, page 499. Also see Terry Ryan and Eric Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma," *State Tax Notes*, 98 STN 192-23 (10/5/98).

Arguments in favor of a destination approach:

- Results in less competition among taxing jurisdictions to attract businesses. That is, jurisdictions would not be fighting for sales offices and retail stores.
- Is in line with the direction of the OECD.
- Is in line with the fact that the sales tax is a consumption tax because the tax would fall in the jurisdiction where the consumption occurs.
- Since the buyer pays the tax, it enables the buyer to pay a tax in the jurisdiction where he lives and votes.
- Avoids issues that could exist under an origin approach in determining the origin of a sale when individuals and equipment in multiple locations were involved in transacting the sale.
- Results in neutrality regarding customer-buying decisions because all purchases would be subject to the same tax implications.

Arguments in favor of an origin approach:

- Is in line with treatment of the seller as the liable party because would enable vendors to just use the sales tax rules of the state in which they are located.
- Would be simpler for vendors because they would only have to deal with the rules of one state (assuming they just have one location).
- Buyer privacy could be better maintained.

Tangible or Intangible

Another tax issue that can arise in the sales and use tax context that is particularly relevant to Internet transactions is the meaning of the terms "tangible" and "intangible." State statutes and case law continue to evolve in this area. Described below are a sampling of cases and actions in this area. The Internet taxation debate may require a definition of these terms, unless all states expand their sales and use tax to cover intangibles. Alternatively, the terms could be rendered less important if a neutrality approach is taken under which all transactions of a particular type are subject to tax regardless of the distribution means or form. For example, some states subject all off-the-shelf (canned) software to sales tax regardless of how it was transferred. Thus, such a rule is neutral because a consumer's decision on how to acquire the software (via modem or on a diskette or use in the "cloud") is not affected by the tax law.

South Central Bell Telephone v. Barthelemy[66]—The Louisiana court held that both custom and non-custom software, whether transferred by disk or by modem, was tangible personal property and subject to sales and use tax in New Orleans. Support for this conclusion included: software constitutes goods under the UCC; software is "part of the physical world;" software is "knowledge recorded in a physical form;" the object of the transaction was to "obtain recorded knowledge stored in some sort of physical form that Bell's computers could use;" and "software, recorded in physical form, becomes inextricably intertwined with, or part and parcel of the corporeal object upon which it is recorded, be that a disk, tape, hard drive, or other device."[67] The court noted that although Louisiana's sales tax regulation distinguished canned from custom software, "it has been observed that this distinction departs entirely from the general Louisiana property law concepts applicable for making the tangible versus intangible distinction."[68]

Some states, such as Vermont,[69] treat software transferred electronically, such as downloaded from the Internet, as tangible property. In contrast, a few states, such as California and South Carolina, treat software transferred electronically as non-taxable intangible property. [70]

Dept. of Revenue, State of Florida v. Quotron Systems, Inc.[71]—The Florida Department of Revenue assessed Quotron approximately $3.8 million for unpaid sales tax, interest and penalties for a 4-year audit period. Quotron, in

66 *South Central Bell Telephone v. Barthelemy*, 643 So.2d 1240 (La. 1994).

67 *Id*. at 1244, 1245 and 1247.

68 *Id*. at 1249.

69 Vermont Department of Taxes, Technical Bulletin 54, 4/11/11, and 32 V.S.A. §9701(7).

70 California Regulation 1502(f) and South Carolina Revenue Ruling #12-1 (3/20/12).

71 *Dept. of Revenue, State of Florida v. Quotron Systems, Inc.*, 615 So.2d 774 (Fla. 1993).

the business of transmitting financial data to customers, such as banks and stock brokerage firms, only "sold" data by electronic means. If a customer printed the data, there was no additional charge and Quotron would not know of the printing. Customers only had access to the video display terminal, not to Quotron's central processing unit (CPU). Quotron charged only for use of the data. Thus, a customer using its own display terminals would pay similarly to one who used Quotron's terminals. During the short time period that Florida had in place a sales tax on services, Quotron paid the tax.

The Dept. of Revenue argued that Quotron owed sales tax on its transmission of electronic data because transmission of electronic images was a sale of tangible personal property; such images were perceptible to the senses. The court disagreed and held that Quotron was not liable for sales tax. The court noted that the images on the screen were not capable of being either touched or possessed because they were only of a transient nature. Thus, the court could not find that the images were tangible personal property subject to sales tax.

May Broadcasting Co. v. Nebraska Dept. of Revenue[72]—The Nebraska court held that syndicated programs purchased by a broadcaster were tangible property and therefore subject to sales and use tax. The programs were either delivered to May Broadcasting (MB) by satellite and then stored on tape by MB, or delivered to MB on videotape or film. MB was not allowed to make additional copies and could only show the programs in accordance with the license agreements. The issues before the court were, 1) whether a transfer of intangibles was present for which no sales or use tax was owed, and 2) whether a sale for resale was involved for which sales or use tax was not owed.

In holding that tangible property was involved, the court noted that an electronic signal could be stored, whereas an intangible item could not be stored. In addition, the court noted that the transmission method, was not relevant in determining whether use tax applied. The court also did not agree with MB's second argument that no sales or use tax was owed because a sale for resale was involved. The court noted that what was acquired was not the same thing that was provided to MB's customers (advertisers). Also, the distributor agreements prohibited MB from reselling the tapes.

Cloud Transactions

Cloud computing transactions where customers access software or databases on a vendor's computer have raised issues in most states as to whether the transaction is subject to sales tax. A state's tax law may not be clear as to whether it applies to a cloud computing transaction. Also, the nature of the transaction, such as acquisition of software versus use of software, may lead to different tax results. Following are a few samples of state rulings on cloud computing transactions.[73]

A 2009 New York ruling (TSB-A-09(33)S (8/13/09) found that software accessed on a vendor's server was subject to sales tax. Per the ruling:

> "Petitioner's charges for use of its "On-Demand TMS System" are receipts from the sale of prewritten computer software. TMS consists of software that resides on Petitioner's server, which its customers access via the Internet. Petitioner refers to itself as an "application service provider," which it describes as a business organization that offers software application capabilities from centralized data centers, usually through the Internet. Prewritten computer software is included within the definition of tangible personal property, "regardless of the medium by means of which such software is conveyed to the purchaser." Tax Law §1101(b)(6). The sale of prewritten computer software is subject to tax as the sale of tangible personal property. See Tax Law §§1101 (b)(6); 1105(a)."

Indiana Department of State Revenue's Revenue Ruling 2009-03 ST (3/30/09) held that hosted software was subject to sales tax. The software was accessed by customers via the Internet and allowed the customers to update patient information.

A 2012 ruling in South Carolina observed that while the transfer of software electronically to a customer's computer was not subject to sales tax, use of the software on an Application Service Provider's website was subject to sales tax.[74] Thus, it is important to review the law in any state in which a customer is located or where a customer

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[72] *May Broadcasting Co. v. John Boehm, Tax Comm'r and Nebraska Dept. of Revenue*, 490 N.W.2d 203 (Neb. 1992).

[73] For more information on state treatment of cloud computing transactions, see Gregory, Roll and Boeckel, "Cloud Computing Emerges as a Tax Conundrum as States Seek to Squeeze 'New Paradigm' Into Old Ways of Thinking," BNA Tax Management, *Multistate Tax Report*, Vol. 18, No. 12 (12/23/11).

[74] South Carolina Revenue Ruling #12-1 (3/20/12).

might be using software or the "cloud" as well as the nature of the transaction to determine if cloud computing charges are subject to a state's sales tax law.

Complexity of the Sales and Use Tax

Multiple Sets of Rules: While the foundation of the sales tax used by the states is similar, one needs to refer to state sales tax systems using a plural reference because there are so many differences in the operation of each state sales tax. In addition, many local governments have sales tax systems that employ different rates and compliance features than the state's system. A few states allow their local governments to administer and impose their own sales tax, which results in multiple sets of rules and forms within the single state. Thus, there is no single sales tax in the U.S., but instead there are hundreds of sales tax systems. Some of the differences in state sales taxes are listed below.

1. *Rates*—State-level sales and use tax rates vary from 4% to 7.25%.[75]

2. *The Tax Base*—The types of consumption that are subject to sales and use taxes vary among the states. For example, the number and types of services taxed by the states vary tremendously—Hawaii, New Mexico, and South Dakota tax over 140 types of services, while seven states tax fewer than 20 types of services (states without a sales tax have been omitted from this count).[76]

Many states exempt food, even more exempt prescription drugs. A few also exempt non-prescription drugs. A few states, such as Illinois, tax all of these items, but at a much lower rate than the rate for other taxable items.[77]

3. *Jurisdiction to Tax*—Court cases arise yearly that address the issue as to how much physical presence is needed in order for a state to impose sales and use tax collection obligations on a vendor. This question has not been addressed consistently by the courts. For example, a New York case held that 12 trips into the state by an out-of-state vendor over three years constituted a sufficient presence for the vendor to be subject to tax collection obligations.[78] On the other hand, an Arizona case held that one employee visit to the state, about 21 days of customer training, about 180 transactions totaling approximately $385,000 of income over a 4-year period, and ownership of two computers being leased to an Arizona customer did not cause the company to be present in the state or subject to tax collection obligations.[79] However, this ruling was overturned on appeal.[80]

4. *Tax Administration*—Generally, each state has its own set of tax forms and instructions. In addition, each state has its own tax administration agency and auditors. Some efforts have been made to provide for uniformity though. For example, a few years ago, the Multistate Tax Commission (MTC) created a *Uniform Sales & Use Tax Certificate—Multijurisdiction*, which has been adopted by over 30 states.[81] This form is a uniform certificate to be used by customers who purchase goods for resale. The MTC also provides joint audits for businesses with nexus in ten or more states who request the service.

Various state tax agencies and associations have been working on uniformity projects over the past few years. However, typically, not all states are involved in or ultimately adopt the recommendations. For example, at March 2012, 24 of 44 states had adopted the Streamlined Sales and Use Tax Agreement.[82]

Frequency of Changes: Another complexity of the U.S. sales tax systems is the frequency of changes to the rules and rates of each of the over 6,000 jurisdictions that assess sales and use taxes.[83] Changes include to rates, definitions, base, exemptions and procedures.

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75 See information from Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/vendors.pdf.

76 Federation of Tax Administrators, Sales Taxation of Services, http://www.taxadmin.org/fta/pub/services/services.html.

77 Data provided by the Federation of Tax Administrators at http://www.taxadmin.org/fta/rate/sales.pdf.

78 *Orvis v. Tax Appeals Tribunal of the State of New York* and *Vermont Information Processing, Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. Ct. App. 1995), *cert. denied*, 516 U.S. 989 (1995), discussed earlier.

79 *Care Computer Systems, Inv. v. Arizona Dept. of Revenue*, Dkt. No. 1049-93-S (Apr. 4, 1995).

80 *Arizona Dept. of Revenue v. Care Computer Systems, Inc.*, 1 CA-TX 98-0003 (July 25, 2000).

81 See http://www.mtc.gov/Resources.aspx?id=1594.

82 See http://www.streamlinedsalestax.org/index.php?page=faqs.

83 While there are over 6,000 jurisdictions that can assess a sales tax, the rules of most local jurisdictions are the same as the state in which they are located. Thus, there are not over 6,000 sets of sales and use tax rules.

In addition, hundreds of legislative proposals are offered every year by states to make modifications to the state's sales tax rules. Many of these proposals call for new exemptions that might cover such diverse items as equipment used by manufacturers or gumballs.[84]

Problems of Collecting the Use Tax: With respect to tax collection activities, the U.S. faces a different picture than do countries in the European Union. As noted in a November 1999 Inland Revenue report:

> "Being comprehensive in its nature, VAT is sufficiently robust to capture the vast majority of e-commerce transactions in its existing form. This is different from the complex web of sales taxes in the United States of America, which currently fail to tax many out-of-state sales."[85]

State and local governments face great challenges in collecting sales tax on sales made from remote vendors (see earlier discussions). While a few states have made some effort to collect the use tax from its consumers, most have made no real effort to do so. In fact, most U.S. consumers have no understanding of the concept of a use tax or of their obligation to remit it. Thus, when a state or local government does make some effort to collect it, such as by adding a line to the state income tax from for the use tax,[86] individuals tend to assume that it is a new tax (rather than one that has been around for several decades).

State and Local Government Concerns

A significant concern of state and local governments regarding the sales and use tax and the Internet is the growth in the number of remote vendors. Since a remote vendor, by definition, does not have a physical presence in the state, the governments must rely on the unreliable system of having buyers self-assess the use tax (with the compliance concern being primarily with individual consumers, not with businesses).

Also, e-commerce makes it easy for many businesses to have a customer base without a bricks-and-mortar location. The vendor or service provider may even be a sole proprietor operating out of their home. While this is great for enabling more individuals to operate small businesses, it adds to the number of sales where sales tax is not collected by the vendor. With low levels of use tax compliance, state and local governments lose sales and use tax dollars.

Apparently, some vendors may be greatly simplifying their tax compliance requirements by making all sales in their capacity as a remote vendor. A review of vendors selling used items on one website indicated a few sellers who stated they ship from State X, but will not ship *to* State X. This vendor thus avoids all sales tax collection requirements.

In addition, customers can fairly easily search online for their desired product from a vendor who will not charge sales tax, thus adding to the statistics of uncollected sales and use tax (assuming the buyer does not self assess the use tax).

Sales Tax Simplification Efforts

The *Quill* decision and the increase in remote vendors caused by the Internet, has led states and state organizations to explore ways to simplify the sales and use tax. The most significant simplification project of the past few years is the Streamlined Sales and Use Tax Agreement (SSUTA), initiated by some states in 2000. An overview to this project is provided here.

The SSUTA was established to simplify and modernize state sales and use tax systems in order to reduce the burden on companies of collecting the taxes. The model tax agreement of the SSUTA contains uniform definitions, allowance of one state rate per state, one local rate for each local jurisdiction, state level tax administration for the state and local taxes, a requirement that all local jurisdictions in the state have the same tax base, uniform sourcing rules, uniform audit procedures and state funding of the technological models provided for in the agreement.

A state must conform its sales and use tax rules to that called for in the model agreement and have a "certificate of compliance" to be part of the interstate Streamlined Sales and Use Tax Agreement (SSUTA). A Governing Board made up of a representative from each member state interprets the Agreement, amends it and issues resolutions.

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[84] SF 3752 introduced in the Minnesota legislature in 2000 would exempt gumballs from sales tax, including those sold in gumball machines.

[85] Inland Revenue, *Electronic Commerce: The UK's Taxation Agenda*, November 1999.

[86] A few states, such as California, Connecticut, Idaho, Indiana, Kentucky, Maine, and Wisconsin, have a line on the individual income tax form for reporting of use tax on mail order and similar purchases.

As of March 2012, 24 of 44 states had approved the SSUTA.[87]

States may need to make significant changes in their existing sales tax rules to be part of the SSUTA.

The members of the Streamlines Sales Tax Governing Board, made up of states that have adopted the SSUTA, hope that Congress will enact legislation to reverse the *Quill* decision for SSUTA states. Since 2000, a few bills have been introduced in Congress, but as of March 2012, none have been enacted. However, as of March 2012, three different bills have been introduced to allow states that have taken certain actions to collect sales tax from remote vendors. Legislative proposals to reverse the Quill decision usually include a de minimis rule to exempt small vendors. The small seller exemption though challenges the touted simplification. Also, unless states exempt purchases from small businesses from use tax, buyers would still need to self-assess use tax.

The three bills introduced in the 112th Congress are:

- The Main Street Fairness Act (H.R. 2701 and S. 1452 (112th Congress)) proposes that to the extent the SSUTA meets specified simplification standards, adopting states may collect sales tax from remote sellers. There is an exemption for small sellers. Similar versions have been introduced in prior sessions of Congress including H.R. 5660 (111th Congress) and H.R. 3396 (110th Congress).
- The Marketplace Equity Act of 2011 (H.R. 3179 (112th Congress)), is similar to the Main Street Fairness approach but includes the possibility of a single rate per state. It includes a small seller exception "for remote sellers with gross annual receipts in the preceding calendar year from remote sales of items, services, and other products in the United States not exceeding $1,000,000 (or such greater amount as determined by the State involved) or in the State not exceeding 4100,000 (or such greater amount as determined by the State)."
- The Marketplace Fairness Act (S. 1832 (112th Congress) allows both states that have adopted the SSUTA and those who have not, but who modify their sales tax to meet the simplifications specified in S. 1832 to collect from remote vendors. Small sellers, defined as having gross annual receipts for remote sales in the U.S. in the prior year in excess of $500,000, are exempt. As it is likely that some states, such as California are not going to join the SSUTA with its one-vote-per-state Governing Board, S. 1832 allows for a broader solution to the issue of collecting sales/use tax on out-of-state sales. Amazon has indicated that it supports this legislation.[88]

A hearing was held by the House Judiciary Committee on the sales tax collection issue and possible legislative proposals on November 30, 2011.[89]

Advantages of the SSUTA

- It provides certainty and simplification to retailers by having uniform rules among the states.
- It provides technological solutions to simplify the assessment and collection process.
- It may provide for compensation to vendors to partially compensate them for collecting the tax.
- If Congress reverses the *Quill* decision for SSUTA adopting states, it will bring greater equity to all vendors by making more items subject to sales tax rather than leaving some items subject to the risk of use tax assessment by consumers.

Disadvantages of the SSTP

- Uncollected use tax is not as high as some estimates have indicated. States can do more to collect use tax and more online retailers are establishing a physical presence in more states because consumers want this (for example, they want to be able to return items purchased online to a physical store nearby).
- Problems with the SSUTA, such as each member state gets just one vote. Thus, California with its large population and market, would have a small voice in interpreting and changing the SSUTA.
- A major simplification—one rate per state, is missing because local jurisdictions are allowed to set their own rate.

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87 For additional information on the SSUTA, see http://www.streamlinedsalestax.org/.

88 "Amazon Strongly Supports Enactment of Enzi-Durbin-Alexander Federal Online Sales Tax Bill," 11/9/11, http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=1628503&highlight=.

89 House Judiciary Committee, http://judiciary.house.gov/hearings/hear_11302011_2.html.

- It does not address the problem that led to the *Quill* decision—states wanting remote vendors to collect sales tax. The SSUTA hopes that Congress will step in and solve this problem for adopting states, but there is no guarantee of this. However, if Congress steps in, such as with S. 1832 (discussed above), that exempts retailers with $500,000 or less of remote taxable sales and allows non-SSUTA states that adopt certain simplifications to collect from remote vendors, states may likely have a reduced incentive to adopt the SSUTA.
- Many states will need to change their sourcing rules which for many retailers will result in a more complicated system. For example, in California, if a retailer has only one business location, it only has to apply the rate of the city in which it resides. Under the SSUTA, it would have to apply the rates of the cities where goods were delivered (destination approach rather than origin approach). If only a single rate were allowed in a state though, this problem would be lessened, although the retailers would still be required to note where goods were delivered so the state could be sure the collected tax went to the correct local jurisdiction. However, there would be winners and losers among local jurisdictions under the new tax sourcing/allocation scheme.
- Exemptions are still allowed if it is a separately defined category under the SSUTA. Thus, retailers will still need to track exemptions by state.

Federal and State Income Tax Issues

Introduction

While most of the focus on Internet taxation issues is on sales and use tax, there are a few income tax issues at the state and federal levels. Several of these issues and their background are explained in this section.

State Income Tax Nexus

The rules for when a business has nexus for state income tax purposes are different than sales and use tax purposes. This is because of a 1959 federal law (P.L. 86-272) that provided guidance on when a business could be subject to income tax in a state. That rule only applies for income taxes and for sales of tangible personal property so it might not apply to all e-commerce businesses since some are service providers or sell intangible property. The other difference is that some state courts have found that the *Quill* physical presence standard (discussed earlier) does not apply to income taxes. These two differences are briefly described next. The specific statutes, regulations, and tax agency guidance should be reviewed in any state in which a business has customers, employees, representatives or property to determine if there is potential income tax liability.

P.L. 86-272: When a state seeks to impose an income tax on a multistate business, it faces the same constitutional constraints as exist for sales tax purposes. However, with respect to income taxes applied to sales of tangible personal property, Congress exercised its authority under the Commerce Clause to provide minimum standards that must be met for a state to impose a net income tax on the operations of a remote vendor by enacting Public Law 86-272 in 1959. This law prohibits a state from taxing a foreign corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved, filled, and shipped from outside the state.

In *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1991), the Court stated that "solicitation" for purposes of P.L. 86-272 included activities ancillary to purchase requests. That is, if the activity only occurred because of the solicitation of orders, it was part of the solicitation and thus a "protected" activity under P.L. 86-272. In *Wrigley*, the Court held that providing a car and a stock of free samples to salesmen was part of solicitation of orders. However, not all activities of salesmen are protected. If they perform an activity that does not relate to solicitation and one that the company would have performed regardless of having a salesforce, it is not considered "solicitation" and is not protected under P.L. 86-272.

P.L. 86-272 is of more limited use today due to the increased sales of intangible property and services that are not covered by this law. With the expected increase in the delivery of digitized products over the Internet, P.L. 86-272 will become even less useful. When P.L. 86-272 does not apply, a state's ability to assess income taxes upon a remote vendor depends on whether such imposition is within the standards of the Due Process and Commerce Clauses. Generally, the same nexus analysis is applied as for sales tax purposes. However, in *Geoffrey, Inc. v. South Carolina Tax Commission*, the court held that G had the minimum connection with the state to be subject to tax there even though the only connection involved intangible property (thus, no physical presence). "We reject Geoffrey's claim that its intangible assets are located exclusively in Delaware. Accordingly, we find that Geoffrey's

purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State."[90]

Subsequent to the *Geoffrey* case, several state courts and legislatures have adopted an "economic nexus" approach for income tax purposes rather than a physical presence standard (discussed below).

Unlike sales tax, income tax on multistate operations is apportioned among the states.

Economic Nexus

An example of "economic nexus" definition from Michigan for its corporate income tax follows:

"What are the nexus standards under the CIT? Answer:

> A taxpayer, other than an insurance company, has nexus with Michigan and is subject to the tax imposed under the CIT if (a) the taxpayer has a physical presence in this state for more than one day in a tax year, (b) the taxpayer actively solicits sales in this state and has gross receipts of $350,000 or more sourced to Michigan, or (c) the taxpayer has an ownership interest or a beneficial interest in a flow-through entity, directly, or indirectly through one or more other flow-through entities, that has nexus in Michigan. MCL 206.621(1). . . .
>
> Active solicitation includes, but is not limited to, solicitation through: (1) the use of mail, telephone, and e-mail; (2) advertising, including print, radio, internet, television, and other media, and; (3) maintenance of an internet site over or through which sales transactions occur with persons within Michigan.
>
> Examples of active solicitation include: sending mail order catalogs; sending credit applications; maintaining an internet site offering online shopping, services, or subscriptions, and; soliciting through media advertising, including internet advertisements."[91]

In *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App., Dec. 7, 2004), The Limited, an Ohio corporation, had several wholly-owned, non-domiciliary subsidiary corporations of the Limited, Inc. (the "Limited"). The Limited and its related entities had about 130 locations in NC. Several years after creating trademarks, L incorporated the subsidiaries in question (S) in Delaware as trademark holding companies and assigned certain trademarks to each. S then licensed the trademarks to the Limited and its related entities, collecting a fee for doing so. S had no employees or office space in NC. S did not file tax returns in NC. At issue was whether S was "doing business" in NC and whether the Commerce Clause would allow NC to assess income tax on S. "Doing business" means that some economic gain results from operations in the state.

"[B]y providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements. *See Geoffrey, Inc. v. South Carolina Tax Commission,* 437 S.E.2d 13, 18 (S.C. 1993) (upholding a tax imposed on that portion of a non-domiciliary trademark holding company's income derived from the use of its trademarks and trade names within South Carolina by a related retail company). The protection of North Carolina's marketplace by the State provides the *quid pro quo* for which the State can expect a return. We hold the taxpayers were "doing business in this State;" therefore, the State did not exceed its authority by imposing franchise taxes."

S also argued that because they had no physical presence in NC, it had no "substantial nexus" with the State. In *Complete Auto Transit* (2 ILR 50, 430 U.S. 274, 279 (1977), the U.S. Supreme Court held that "a tax challenged on Commerce Clause grounds will be upheld where it "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." Per *Quill* (504 U.S. at 313): "The second and third parts of [the *Complete Auto*] analysis . . . prohibit taxes that pass an unfair share of the tax burden onto interstate commerce. The first and fourth prongs . . . limit the reach of the state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." S asserts that the first prong and *Quill* require a physical presence in the state in order for S to owe income and franchise taxes. The court disagreed.

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[90] *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, 17 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993).

[91] Michigan Department of Taxes, "Frequently Asked Questions – Corporate Income Tax," FAQ 5, http://www.michigan.gov/taxes/0,4676,7-238-59682-267980—F,00.html.

The court's rationale for not viewing *Quill's* physical presence requirement as applying to all taxes:

- The "tone" of the Court in *Quill* did not indicate the physical presence test should apply to all taxes.
- There are differences between sales and income taxes. A taxpayer becomes the state's tax collector under a sales tax. Courts have held that a non-resident need not be located in a state to be subject to income tax, but could have property or other means of generating income from the state.

"[W]e hold that under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause. *Accord Geoffrey*, 437 S.E.2d at 18 (holding that "by licensing intangibles [to Toys R Us, an affiliated operating store,] for use in [South Carolina] and deriving income from their use [t]here, Geoffrey ha[d] a substantial nexus with South Carolina"); *Kmart*, at 15 (holding that "the use of KPI's [the wholly-owned trademark holding company licensor] marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishe[d] a sufficient nexus between that income and the legitimate interests of the state and justifie[d] the imposition of a state income tax")."

In *Lanco, Inc. v. Director, Division of Taxation*, No. A-3285-03T1 (N.J. App. Div. 2005), cert denied 6/18/07 (Dkt. 06-1236), the court reversed the lower court decision to find that the *Quill* decision only applies to sales and use tax matters. Lanco licensed trademarks and similar intangibles to a related retailer in New Jersey—Lane Bryant. Lanco had no physical property in New Jersey. The "minimum contacts" and fairness considerations of the Due Process clause were not at issue. Instead, the "substantial nexus" consideration of the Commerce Clause was.

The Director argued that "there is no principled reason why the Commerce Clause should require a corporation's physical presence to justify State taxation . . . provided the State can establish that the corporation derives significant benefits from the continued and deliberate economic activity in the taxing State." The Director also noted that Quill's connection with customers was via the U.S. mail or common carrier whereas Lanco's connection with its customer (Lane Bryant) was a long-term contractual one designed to increase Lane Bryant's sales and the parties were affiliated corporations. The Director noted that there is an increased burden to NJ from such increased retail sales activity relative to Quill mailing catalogs and products to customers.

The appellate court agreed with the Director that *Quill* was inapplicable to the case. The court referred to the *Geoffrey* case, as well as the North Carolina case of *A&F Trademark* (see above).

Other cases that have ruled that economic nexus standard applies when P.L. 86-272 is inapplicable include:

- *Tax Comm'r of the State of West Virginia v. MBNA America Bank*, 640 S.E.2d 226 (2006), cert denied 6/18/07 (Dkt. 06-1228)
- *MBNA America Bank v. Indiana Dept. of Revenue* (Case No. 49T10-0506-TA-53, 10/08)
- *KFC Corporation v. Iowa Dept. of Revenue* (No. 09-1032, 12/10), cert denied No. 10-1340 (10/3/11)

Several state legislatures have also modified their income tax statutes to follow an economic nexus standard when P.L. 86-272 does not apply.[92]

Audit Trails, Compliance and Unreported Income

The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concerns for the Internal Revenue Service and state tax agencies as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed. In a speech entitled, "Tax Administration in a Global Era," then (former) Treasury Secretary Summers stated:

> "The Internet provides new ways for tax administrations, such as the IRS, to improve the ease and transparency of tax collection. But new technology also raises certain problems. In a world where cyber-transactions are growing at a rapid pace, tax administrations face the challenge of adapting existing tax systems to an economy that increasingly ignores physical borders.
>
> In such a world, it will be easier for companies to avoid tax collectors by operating worldwide through web-sites based in jurisdictions that are unwilling to share taxpayer information."[93]

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[92] For a list of state activity regarding use of economic nexus standard for income tax, see author's economic nexus website at http://www.cob.sjsu.edu/nellen_a/TaxReform/economic_nexus.htm.

[93] From a speech to the 34th General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.

An example of use of technology to illegally reduce tax obligations is "zappers." Zappers are installed in cash registers to easily allow retailers to have some sales "zapped" from the records.[94] In 2012, Utah enacted legislation prohibiting the sale, purchase, installation, transfer, use or possession of "automated sales suppression device or phantomware, making the offense a felony.[95]

A 2004 report by the Treasury Inspector General for the Commissioner of the Small Business/Self-Employee (SB/SE) Division includes a focus on unreported income from e-commerce. The IRS first studied compliance issues with e-commerce businesses in 2000 and found an income tax gap of about $6.2 million for 1997. That gap estimate was based on 426 commercial websites (retailers, wholesalers, services, ISPs, and adult entertainment) that were examined. The most significant cause of the gap was understatement of income. The IRS also found that about 10% of the owners of the websites were non-filers of 1997 returns and 12% of the owners could not be identified to determine whether a return had been filed. A study by the SB/SE Division of the IRS in 2004 derived an estimate of a tax gap of $1 billion potentially, just for small businesses doing business on the Internet.[96]

To address the compliance concerns it found, the SB/SE Division created e-commerce compliance units within its reporting group and another within its taxpayer education and communication functions to aid in educating taxpayers. In recent years, the IRS has provided some information on its website regarding e-commerce, as well as in some of its audit guides for revenue agents. For example, see:

- Tax Tips – E-Business & E-Commerce http://www.irs.gov/businesses/small/industries/article/0,,id=209314,00.html
- Tax Consequences of Virtual World Transactions http://www.irs.gov/businesses/small/article/0,,id=215593,00.html
- IRS Audit Techniques Guide on hobby v. business http://www.irs.gov/businesses/small/article/0,,id=208400,00.html

The Internet and social media may enable tax agencies greater opportunities for finding taxpayers and understanding their activities.[97]

Why confusion exists? There are many reasons why compliance problems exist, particularly for small e-commerce firms. First, some of the transactions do not neatly fit into existing tax rules, but these are primarily state issues, not federal income tax ones. Some may think that the IRS can't find e-commerce sites or track sales. Some may have misinterpreted the Internet Tax Freedom Act to think that e-commerce is not subject to tax. Also, there are a variety of websites and books available on starting and growing Internet businesses that may not focus sufficiently on the tax considerations. Some of the books may be misleading to some business owners due to certain language—such as "loopholes," used in the title or narratives.

Untaxed Gains

Online auction sites that enable sellers to reach a worldwide market produce a much better marketplace than selling stuff through local classified ads or yard sales. Also, a look at some of the auction sites indicates sales of some significant items not usually found at garage sales, such as collectibles. This improved marketplace likely leads to more sales and more sales where the seller produces a gain rather than a loss. Unlike the sales of stock, no Form 1099 is produced for these sales and it is likely that many go unreported.[98]

The cost of auditing these transactions likely outweighs the possible tax collected. Also, any proposal to require online auction houses to issue 1099s is unlikely and many items sold likely produce an unusable personal loss. However, this is an area where greater educational efforts may improve compliance. It is likely that many individual sellers do not even think about reporting gains from the sale of personal items. Such educational efforts could be in

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[94] See Holeywell, "In An Uphill Battle, States Fight Tax 'Zappers'," *Governing*, 8/25/11, http://www.governing.com/blogs/view/uphill-battle-states-fight-tax-zappers.html.

[95] HB 96 (3/15/12), http://le.utah.gov/~2012/bills/hbillenr/hb0096.pdf.

[96] Final Audit Report—The Internal Revenue Service Is Making Progress in Addressing Compliance Among Small Businesses Engaged in Electronic Commerce (Audit #200330036), Ref. No. 2005-30-010, Nov. 2004; available at http://www.treasury.gov/tigta/auditreports/2005reports/200530010fr.html.

[97] "Is 'Friending' in your Future? Better Pay Your Taxes First," *Wall Street Journal,* 8/27/09.

[98] If the seller allows customers to pay by credit card, or by PayPal and has more than 200 transactions in a year totaling over $20,000, the seller will be issued a Form 1099-K; see IRC Section 6050W and regulations.

the form of instructions on tax forms and publications and ads placed on Internet sites by the IRS and state tax agencies.

As part of the standard questions for income tax return preparation, practitioners should consider asking individual clients if they sold anything online at a gain.

What Is Inventory?

Inventory rules represent another area where the rules were written for the industrial era, rather than the information era. Businesses and tax practitioners are likely to encounter businesses engaged in new ways of delivering items to customers (particularly digitized products) and new types of intermediaries assisting in matching buyers and sellers where issues will arise as to whether the intermediary is subject to the inventory and accrual accounting rules.

Example 1: Ostrich Software is a sole proprietorship that develops and transfers educational software. OS only sells to customers via the Internet—both the software and payment (by credit card) are transferred via the phone lines. The software is not customized, but is off-the-shelf type software. OS expenses its software development costs under §174 and Rev. Proc. 2000-50 and has no §263A costs. Is OS required to use the accrual method of accounting? Is it subject to §471 on the premise that it is selling "something"? If the software is considered inventory, is it de minimis?

Under Reg. §1.471-1, a taxpayer must account for inventory if the production, purchase or sale of merchandise is an income-producing factor. In *Wilkinson-Beane, Inc. v. Comm'r*, 420 F.2d 352 (1st Cir. 1970), the court held that "merchandise" is something held for sale. Arguably, ABC has something held for sale and thus, has merchandise for §471 purposes. That same case interpreted "income-producing factor" as measured by cost of the merchandise purchased during the year divided by the gross receipts for the year. In *Wilkinson-Beane* the percentage was about 15% which the court found to constitute an income-producing factor. It is not clear how to do this income-producing factor ratio (which has been used in many court decisions subsequent to the *Wilkinson-Beane* decision), where there is no "cost" for the numerator. However, since the software represents ABC's entire production of gross receipts, it is likely to be viewed as an income-producing factor under any common sense interpretation.[99]

This fact pattern illustrates how the tax law has not kept up with transactions involving software.

Example 2: Business X facilitates the sale of guitars by making arrangements with various wholesalers to list their guitars on X's website. The wholesalers set the prices. X does not maintain any inventories of guitars. Instead, when a visitor to X's website makes a purchase, it is directed to the appropriate wholesaler who ships the product directly to the customer. X does take title to the guitars at the time they are shipped from the wholesaler. Customers pay via credit card before a guitar is shipped and based on the recordkeeping customers believe that X is the seller. X earns income by the commission set by the wholesalers for each guitar. X remits the commissions to wholesalers monthly. The sale terms posted on the website indicate that X handles the ordering, shipping and billing, but is not handling the product. Instead, the wholesalers are the true sellers of the guitars. Thus, X has no control over the quality of the products and warranties are only available if provided by the wholesaler.

Is X required to account for inventories and use the accrual method of accounting? If a business is only receiving a commission and does not have title to the goods (even if momentary) and does not have the benefits and burdens of ownership, generally, inventory accounting is not required.[100]

If X can be viewed as primarily a service provider, some post-*Wilkinson Beane* cases offer support for X not accounting for inventory. Two of these cases are:

- *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. 211 (2000)—The court held that a provider of concrete foundations and walkways did not have to account for inventory or use the accrual method. The majority viewed RACMP as primarily a service provider and under various laws, including the UCC, was treated as operating under contracts for labor, not for the sale of personal property. The liquid concrete used by RACMP was viewed as a supply because it was used up in providing services to customers. Also, since

[99] If ABC's average annual gross receipts are $10 million or less, it may use the cash method and ignore §471 under Rev. Proc. 2002-28.

[100] *Addison Distribution, Inc., et al. v. Comm'r*, T.C. Memo 1998-289; *Epic Metals Corp & Subs v. Comm'r*, T.C. Memo 1984-322; TAM 8510003.

liquid concrete can't be stored it cannot be considered as "held for sale."[101] The majority also viewed the sand and rock used by RACMP as a supply, rather than inventory, noting that such items lost their "separate identity to become an integral and inseparable part of the real property in the construction activity" just as chemotherapy drugs lost their identity separate from that of the patient (referring to *Osteopathic Medical Oncology and Hematology P.C. v. Commissioner*, 113 T.C. 376 (1999)[102]). Also, customers did not want to buy materials from RACMP, thus RACMP was not a merchant.

Dissenting judges noted that while RACMP was in a service-oriented business, it did produce a product, such as a walkway. They also noted that there is no requirement that materials be held for a certain period of time in order to be considered inventory. They also distinguished the *Osteopathic* case where calling the items a supply was clearer because "no product resulted from the administration of drugs into patient's bodies." Finally, dissenting judges noted that the majority's conclusion would lead to wrong results for other businesses that primarily provided services, such as restaurants and dot.com companies that provide the service of being able to shop at home.

- *Edward G. Smith v. Comm'r,* T.C. Memo. 2000-353—The court found that a business that installed flooring materials (carpet, tile, etc.) was not selling merchandise. The taxpayer did purchase and store the materials needed for each job and customers were charged a markup on the cost of the materials. The court noted that this practice was due to the need to manage the project and that the markup was to cover taxpayer's services of storing and inspecting the materials. Per the court, "Smith Floors' practice of purchasing the flooring materials for a particular job is incidental and secondary to Smith Floors' provision of flooring installation services." Also, "Smith Floors is inherently a service provider. Smith Floors' stock in trade is its expertise in installing flooring materials in a variety of unique applications and petitioner's skill and craftsmanship in hand-cutting and incorporating specialized designs into flooring materials. The companies contracting with Smith Floors are primarily interested in the firm's labor and contractual skills."

In situations where it is not clear whether a taxpayer has inventory or if inventory accounting rules are applicable, the facts and circumstances must be carefully evaluated including any written agreements. In addition, cases should be reviewed from *Wilkinson-Beane* to the present.

In Notice 2009-25, the IRS requested public comment on whether the guidance on the IRC Section 263A uniform capitalization rules should be modified due to changes in the retail industry "due to advancements in technology and service innovations." No changes have yet been made.

IRC §355 and E-Commerce Activities

In Rev. Rul. 2003-38, 2003-17 I.R.B. 811, the IRS ruled that an expansion, rather than a new business resulted when a retail shoe store created a website to sell shoes. While selling shoes on the Internet requires some additional knowledge relative to selling in a store, it also requires use of the taxpayer's existing experience. In addition, the website's success would depend upon taxpayer's goodwill.

Transfers of Domain Names

Typically, a business or individual obtains a domain name by registering with a registrar and paying a nominal fee (perhaps $6 to $8). Other times, a business may acquire a domain name that has already been registered by someone else.[103] Some of these purchases have been quite newsworthy due to the dollar amount involved. For example, in January 2000, the name "loans.com" sold at auction for a reported $3 million and in November 1999, the name "business.com" sold for $7.5 million.[104] These types of situations may raise the tax question for the buyer of how to treat the acquisition costs, and for the seller as to how to characterize the gain. Large amounts may also be allocated to a domain name when a taxpayer acquires another business in a taxable acquisition.

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[101] The majority also relied on *Galedrige Constr*., Inc., T.C. Memo. 1997-240, which held that a contractor of asphalt pavements did not have inventory due to the ephemeral nature of emulsified asphalt.

[102] Similarly, see *Mid-Del Therapeutic Center, Inc.*, T.C. Memo. 2000-130. In April 2000, the Service issued Action on Decision 2000-05 acquiescing, in result only, to the *Osteopathic* case (acq. 2000-23 I.R.B. 1149).

[103] Domain names are also traded on the web, such as on eBay.

[104] The Associated Press, "Loans.com Domain Name Sells for $3 Million," *New York Times*, Technology Section, January 31, 2000.

Some non-tax cases are useful to gain an appreciation of the nature of the asset involved. In *Panavision Int'l v. Toeppen*,[105] T, an Illinois resident, had registered the domain name panavision.com and posted a picture of Pana, Illinois at the site. When P notified T that Panavision was a registered trademark, T tried to sell the name to P. P brought action against T in California on the basis that T had violated the Federal Trademark Dilution Act of 1995 and similar California law. The District Court held for P and T appealed. The Ninth Circuit affirmed. T's argument that California had no jurisdiction over him failed.

The court noted that where the only presence is through a website, jurisdiction would only likely be found if there was "something more to indicate that the defendant purposefully (albeit electronically) directed his activity in a substantial way to the forum state." The court found that T had directed his activity (trying to obtain money from P) to California where P is headquartered. The court also stated that while T's burden of litigating in California is significant, it was not so great such as to deprive him of due process. The district court had even stated that due to fax machines and discount travel, litigating in California was not constitutionally unreasonable. The court also found with respect to the trademark dilution issue, T did make commercial use of the mark because he was in the business of registering trademarks as domain names and then selling them to their rightful owners.

In contrast, in *K.C.P.L., Inc. v. Nash*,[106] the court held that New York did not have jurisdiction over an individual. While the plaintiff referred to the defendant as a cyber-pirate, the court noted that the defendant did not compare to Toeppen. Toeppen had registered over 100 domain names most of which were trademarks of others, while Nash had only registered four with just one of them a trademark, although the court noted it was not a famous one. Thus, the court could not find that Nash had transacted business in New York. The court also noted that the long-arm statute of California was not as restrictive as that of New York.

Nature of the Asset for the Buyer: When a domain name is acquired by paying a nominal registration fee, the tax question is whether that fee can be currently expensed or must be capitalized. In *Surety Insurance Company of California*,[107] the taxpayer had to pay annual license fees to various states in order to operate its business. Taxpayer treated the fees as current deductions and the Service argued that they were capital expenditures. The court agreed with the Service finding that the expenditures were really for acquiring the right to conduct a surety business in a specific state. The court also noted that state law allowed the certificates to be renewed annually provided the company had complied with all rules and regulations and paid the annual fee. Thus, "the license is realistically not intended nor limited to a single year where petitioner complies with state law."

Does a nominal fee need to be amortized? Arguably not. As stated in a 1982 Tax Court memorandum decision: "While we do not attempt to establish a rule of thumb as to what constitutes a small expenditure, we hold that the $90 at issue here may be deducted currently rather than amortized over its useful life."[108]

What about domain names purchased from existing holders for more than nominal amounts or taxable business acquisitions where a significant portion of the purchase price is allocated to a domain name? Is the domain name an IRC Section 197 intangible for purposes of determining the amortizable life? If not, then the Section 167 regulations should be reviewed to determine if the asset is amortizable. Under Reg. §1.167(a)-3(b), a safe harbor rule provides that where there is no statutory life, no possibility of estimating the life with reasonableness, no prohibition on amortization, and it is not an intangible described in Reg. §1.263(a)-4(c) acquired from another person, the intangible asset will have a 15-year life. Reg. §1.263(a)-4(c) lists a variety of intangibles including those specifically covered under Section 197 and ones specifically excluded from Section 197. The intent in reading this provision seems to be that Section 197 already provides a rule for particular intangible assets and new regulations did not need to do the same. However, there is broad language at the start of that subsection that provides that the listed intangibles are just examples of intangibles acquired from another party. Thus it appears that any intangible acquired from another party cannot benefit from the 15-year safe harbor even if it is not a Section 197 intangible. Thus, if it is determined that a domain name falls outside of Section 197, it can only be amortized if it is to be used for a limited period and the length of that period can be estimated with reasonable accuracy. Given that a business would usually intend to use a domain name for an indeterminable period of time, it would be a better result for a domain purchased from another party at a significant cost to be a Section 197 intangible with a 15 year life.

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105 *Panavision Int'l v. Toeppen*, 1 ILR 699, 141 F.3d 1316 (9th Cir. 1998).

106 *K.C.P.L., Inc. v. Nash*, 1 ILR 804, 1998 U.S. Dist. LEXIS 18464 (S.D.N.Y. 1998).

107 *Surety Insurance Company of California v. Comm'r*, TC Memo. 1980-70.

108 *Kohen v. Comm'r*, T.C. Memo. 1982-625 dealing with a bar application fee. Similarly, see *Sharon v. Comm'r,* 66 T.C. 515, 527 (1976), *aff'd* 591 F.2d 1273 (9th Cir. 1978), *cert. denied* 442 U.S. 941 (1979).

Possible categories of §197 intangibles which a purchased domain name used in a trade or business or held for investment might fall within seem to be:

1. "customer-based intangibles" and "any similar item" [§197(d)(1)(C)(iv) and (vi)]

2. "any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof" [§197(d)(1)(D)]

3. "any franchise, trademark, or trade name" [§197(d)(1)(F)]

Each of these possibilities is discussed next.

(1) IRC Section 197(d)(2)(A) defined "customer-based intangible" as "composition of market, market share, and any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers." Reg. §1.197-2(b)(6) further provides that a customer-based intangible includes "customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular customer, a mortgage servicing contract, an investment management contract or other relationship with customer involving the future provision of goods or services." Arguably, if someone owns, for example, the URL tires.com, there is value in it because they can establish a website with that URL and generate advertising revenues by selling space on that site to tire companies wanting to list their URL and company information. If generation of advertising dollars is what causes the acquired domain name to have value, it seems to meet the definition of a Section 197 intangible, assuming the URL and the revenue generating possibilities can be viewed as a single asset. If the domain name does not have value from providing goods or services to customers, other possible Section 197 categories should be considered.

(2) A license, permit, or other government-granted right can be a Section 197 intangible even if it has an indefinite term or can be renewed indefinitely. Reg. §1.197-2(b)(8) includes the following examples of assets that fall within this Section 197 category: liquor license, taxicab medallion, airport landing right, regulated airline route, television broadcasting license. Oversight and management of IP space on the Internet is under the direction of a non-profit organization called ICANN. According to its website:

"The Internet Corporation for Assigned Names and Numbers (ICANN) is an internationally organized, non-profit corporation that has responsibility for Internet Protocol (IP) address space allocation, protocol identifier assignment, generic (gTLD) and country code (ccTLD) Top-Level Domain name system management, and root server system management functions. These services were originally performed under U.S. Government contract by the Internet Assigned Numbers Authority (IANA) and other entities. ICANN now performs the IANA function.

"As a private-public partnership, ICANN is dedicated to preserving the operational stability of the Internet; to promoting competition; to achieving broad representation of global Internet communities; and to developing policy appropriate to its mission through bottom-up, consensus-based processes."[109]

Is ICANN a government agency? The U.S. Department of Commerce played a role in setting up ICANN. Does that make it a government agency? One commentator has stated that the Department of Commerce is the source of ICANN's powers.[110] The matter is not clear since ICANN is a non-profit organization rather than a government agency even though it was established under government authority.

(3) Reg. §1.197-2(b)(1) defines a trademark as including "any word, name, symbol, or device, or any combination thereof, adopted and used to identify goods or services and distinguish them from those provided by others. . . . A trademark or trade name includes any trademark or trade name arising under statute or applicable common law, and any similar right granted by contract." Is a domain name a "similar right granted by contract?" While domain names and trademarks appear to share some similarities, there are also some differences. Both domain names and trademarks serve to identify a business and may have distinctive characteristics. However, the purpose of a domain name is to represent a series of numbers to locate a website. Domain names are only unique in terms of identifying a website; they do not have any

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[109] See http://archive.icann.org/tr/english.html.

[110] A. Michael Froomkin, "Wrong turn in cyberspace: using ICANN to route around the APA and the Constitution," 50 *Duke Law Journal*, 17, 71 (Oct 2000); available at http://www.law.duke.edu/shell/cite.pl?50+Duke+L.+J.+17. The call for establishment of a non-profit organization to manage the domain name system is explained in a policy paper of the Department of Commerce, docket number 980212036-8146-02; available at http://www.ntia.doc.gov/ntiahome/domainname/6_5_98dns.htm.

distinctive shape, color, font, etc. Also, unlike a trademark, domain name can be issued as long as no one else has registered it,[111] there is no need to show that it will be used in commerce. Also, some words that can be registered as domain names, such as loans.com, cannot be trademarks because they are common words.

A 2000 article suggested that a domain name derives its value from two key sources: 1) the name's association with a company or product (such as "Amazon.com"), and 2) inherent value that is not part of the trademark value, but the value from registration of the name (such as "drugs.com"). The author posited that the value associated with the company or product can be treated as a trademark under Section 197, but that the inherent value cannot be treated as such.[112] If the government agrees with this interpretation, might the inherent value be a customer-based intangible since the likely hope for the asset (and what give it value) is that it will generate revenue, such as from advertising?

Conclusion: Depending on the facts and circumstances of the domain name and its intended purpose (what causes it to have value such that purchase price is allocated to it), a domain name might be a Section 197 intangible. Given the intent of Section 197 to simplify identification, allocation of purchase price, and determination of an amortizable life, it seems that Congress would have wanted a domain name to be a Section 197 intangible. But, given the existing language that doesn't clearly bring it in, taxpayers will need to make their case for such treatment. In the meantime, this is an area greatly in need of guidance from Congress or the IRS.

Characterization of Gain for the Seller: With respect to the seller, the domain name is not a capital asset if held by someone who is in the business of buying and selling domain names (as in the *Toeppen* case). That is, the asset likely falls within Section 1221(a)(1) as property held primarily for sale to customers in the ordinary course of a trade or business. If a domain name was purchased for investment and the level of activity does not rise to the level of a trade or business,[113] then it must be determined if the name is a copyright, artistic composition, or similar property under Section 1221(a)(3). Per Reg. §1.1221-1(c)(1), "similar property" refers to something that is eligible for copyright protection. The issue then falls under copyright law. Generally, words and phrases are not copyrightable because they do not have the minimal level of creativity.[114] But, if the owner's purpose of obtaining the domain name was the creativity of the name, might it be copyrightable? Resolution of this issue will likely first come from copyright cases, rather than tax cases.

If the domain name meets the definition of a trademark, Section 1253(a) provides that if the transferor retains any significant power, right, or continuing interest in the trademark, the transfer is not treated as a sale or exchange of a capital asset.

Transfer of Software

E-commerce has expanded and accelerated the various innovative ways that software can be transferred to and used by customers. For example, there has been a trend for so-called ASP arrangements and cloud computing arrangements. ASP refers to *application service provider*. ASPs host software on servers that can be accessed by customers, usually through a rental or lease arrangement, sometimes with an option to buy. The key advantage to users is ease of access and maintenance of the software. The myriad of ways that software can be transferred raises tax issues as to the nature of the revenue (royalty, sale of goods, service, etc.). The nature of the revenue is important for the following tax reasons:

(1) Character of the resulting income: If the transferred item is a capital asset that is sold, capital gain will result; if it is not a capital asset, or is licensed or constitutes service income, ordinary income will result. It is also important (for both parties) to distinguish what has been transferred—an intangible (such as a copyright) or a copyrighted item. For certain transfers of a patent, special capital gain treatment of Section 1235, *Sale or exchange of patents,* may be available to the transferor.

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[111] The Anticybersquatting Consumer Protection Act (P.L. 106-113, 11/29/99) which amends the trademark statute (15 U.S.C. §1125(d)) may deter individuals from registering domain names intended to be similar to trademarks.

[112] David Hardesty, "Taxation of Internet Domain Names – Can They Be Shoehorned into the 15-Year Amortization Rules?" *Journal of Taxation*, December 2000.

[113] There are several dealer versus investor cases under §1221(1), such as *Drummond v. Comm'r*, T.C. Memo 1997-71 and *Guardian Ind. v. Comm'r*, 97 T.C. 308 (1991), *aff'd without published opinion* 21 F.3d 427 (6th Cir. 1994).

[114] See *CMM Cable Rep., Inc. v. Ocean Coast Properties, Inc.*, 97 F.3d 1504 (1st Cir. 1996), *Salinger v. Random House, Inc.*, 811 F.2d 90 (2d Cir. 1987), and cases cited therein.

(2) Timing of income recognition: If the transferred item is licensed, income is likely earned by an accrual basis taxpayer ratably over the license period; if the item is sold, income is recognized upon sale, unless the installment method applies.

(3) Passive versus active income: Under some tax provisions, royalty income from licensing can produce adverse tax consequences, such as personal holding company status, passive investment income of an S corporation, or possibly constitute income from a passive activity under Section 469.

(4) Various foreign provisions: Sourcing—royalty income is generally sourced where the property is used, while sale of goods income is sourced per the residence of the seller. Also relevant for foreign tax purposes, withholding on royalties, and per the regulations under Reg. §1.861-18 (explained later)—sale versus license versus services can be relevant under Sections 367, 404A, 482, 551, 679, 842, 845, 1057, and 1059A.

Sale versus Lease versus License: In Revenue Ruling 55-540,[115] the IRS held that whether a transaction is a lease or a sale depends on the intent of the parties as evidenced by the terms of the transaction. A transaction will most likely be classified as a sale if one or more of the following conditions are present:

a) A portion of each periodic payment made by the customer is specifically to acquire an equity interest in the property.

b) The customer will acquire title to the property once they make a stated amount of payments.

c) The total amount to be paid by the customer for a relatively short period of use is an "inordinately" large proportion of the total amount to be paid to obtain title to the property.

d) The periodic payments materially exceed the fair rental value.

e) The agreement includes a purchase option that allows the customer to obtain the property for a nominal amount relative to the total amount of periodic payments to be made.

f) A portion of each periodic payment made by the customer is designated as interest.

A transaction may be classified as a sale even if title does not transfer, provided at least one of the above factors is present.

In *Grodt & McKay Realty v. Comm'r*, 77 T.C. 1221 (1981), 8 factors were found to be relevant in distinguishing a lease from a sale:

(i) Whether legal title passes;

(ii) How the parties treat the transaction;

(iii) Whether an equity was acquired in the property;

(iv) Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;

(v) Whether the right of possession is vested in the purchaser;

(vi) Which party pays the property taxes;

(vii) Which party bears the risk of loss or damage to the property; and

(viii) Which party receives the profits from the operation and sale of the property.

A sale is generally considered to be a transfer of title, or transfer of benefits and burdens of ownership where the seller gives up all substantial rights.

Reg. §1.861-18 (T.D. 8785; 10/2/98) on the classification of revenues from transactions involving computer programs under certain international provisions of the Code may also be helpful in providing factors to distinguish between, sales, licenses and leases. These regulations enable taxpayers to categorize transactions involving computer programs as being either: sales, licenses, leases, the provision of services, the provision of know-how, or some combination of these transactions. The regulations *only* apply for purposes of IRC Sections 861 through 999, 367, 404A, 482, 551, 679, 1059A, 1441 through 1465, 1491 through 1494, 842 and 845 (to the extent involving a foreign person) and for transfers to foreign trusts not covered by Section 679.[116]

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[115] Rev. Rul. 55-540, 1955-2 C.B. 39. Also see Rev. Rul. 75-21, 1975-1 C.B. 715.

[116] Reg. §1.861-18(a)(1).

The chart below summarizes the six types of transactions described in the regulations. The regulations contain 18 examples to help illustrate their application; these examples are referenced in the chart.

Transaction	Regulation §1.861-18
Transfer where transferee (TE) acquires one or more of the following rights: (i) to make copies of CP to distribute to the public by sale or other transfer of ownership, or by rental, lease or lending; (ii) to prepare derivative CP based upon the copyrighted CP; (iii) to make a public performance of the CP; or (iv) to publicly display the CP. CP = computer program[117]	Transfer of © rights, that is either: (1) a sale or exchange of property (©)—if, based on the facts and circumstances, all substantial rights in the © have been transferred (per the principles of §1222 and §1235, as well as case law (even cases not specifically addressing §1222 and §1235)); [Income to be sourced per §865(a), (c), (d), (e), or (h) as appropriate.] [Example 5] or (2) a license of a © generating royalty income—if not all substantial rights have been transferred. [Income to be sourced per §861(a)(4) or §862(a)(4) as appropriate.] [Examples 6 and 8] © = copyright
TE acquires copy of CP, but does not acquire any of the rights (i)—(iv) listed above (or only acquires a de minimis grant of such rights), and either no services or a de minimis amount of services are involved, or a de minimis amount of know-how is involved.	Transfer of copyrighted article,[118] that is either: (3) a sale or exchange of a copyrighted article if the benefits and burdens of ownership have been transferred; [Income to be sourced per §861(a)(6), §862(a)(6) §863, §865(a), (b), (c), or (e), as appropriate.] [Examples 1, 2, 7, 9, 10, 11, 13, 14, 17, and 18] or (4) a lease of a copyrighted article (generating rental income), if insufficient benefits and burdens of ownership have been transferred. [Income to be sourced per §861(a)(4) or §862(a)(4), as appropriate.] [Examples 3, 4, and 12]
Provision of services for the development or modification of a CP. Provision of services is to be distinguished from other transactions by considering "all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties." [§1.861-18(d)]	(5) Provision of services. [Example 15]

[117] Per §1.861-18(a)(3), a computer program is defined as a "set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result." A computer program includes "any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program."

[118] Per §1.861-18(c)(3), "copyrighted article" includes "a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium."

Provision of information with respect to a CP that: 1) relates to computer programming techniques; 2) is furnished under conditions preventing unauthorized disclosure; and 3) is considered property subject to trade secret protection.	(6) Provision of know-how relating to computer programming techniques. [Example 16]
Transaction involving more than one category above.	Treat as separate transactions, with appropriate provisions applied to each transaction. "However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction."[119]

Software and the Special Manufacturing Deduction of IRC Section 199: The issue of how to classify revenue from certain software transactions is also relevant under IRC Section 199, *Income attributable to domestic production activities*. The American Jobs Creation Act of 2004 (P.L. 108-357, Sec. 102) created an incentive for manufacturers at IRC Section 199, effective for tax years beginning after December 31, 2004. This new deduction replaced the FSC/ETI regime, yet applies to all manufacturers regardless of export activity. Manufacturers are broadly defined and can include software development.

A question that arose soon after enactment was whether software development receipts would qualify for the deduction if the software was not licensed or transferred, but was instead used by customers while on the provider's servers. The IRS did not view such revenue as derived from the lease, rental, license, sale, exchange or other disposition of software. This is a good illustration of the confusion that exists in classifying software transactions and how the Internet has added to the confusion due to the reality that it makes it easy to be able to transfer or use software in a variety of ways.

On July 21, 2005, the chairs of the congressional tax-writing committees sent a letter to Treasury suggesting that the online software position be reconsidered. The IRS also received several comments on this matter from practitioners and taxpayers. Some noted that online software receipts should fall under §199 if the substance of the transfer was that the taxpayer had distributed the functionality of the software to end users. Per the preamble to TD 9262 (5/06), comments received by the IRS suggested the following factors for consideration of understanding the substance of the online transaction: "(1) Whether an agreement exists, regardless of its form, between the computer software producer and the customer that gives the customer permission to use the computer software; (2) whether the use of computer software is merely incidental to the provision of a separate service or transaction; (3) whether the end user has made a payment to the computer software producer directly for the right to access and use the computer software's functionality, as opposed to a payment for a separate service or good in which the use of the underlying computer software is only incidental to the separate service or transaction; (4) whether the computer software producer holds itself out to the public as being in the computer software business; (5) whether the computer software producer uses alternate channels for distributing its computer software product or functionality other than through online access; and (6) whether a competitive marketplace exists for the same or similar computer software functionality that provides customers with alternative distribution choices in addition to online access. The commentators explained that this proposed list of factors was not exhaustive and there could be other relevant factors. The commentators suggested that no single factor should control and that failure to satisfy one or more factors should not necessarily result in gross receipts derived from online access to computer software being non-DPGR [domestic production gross receipts]."

The temporary regulations did not follow the suggestions of commentators. Instead, "as a matter of administrative convenience," the regulations provided two exceptions that would allow receipts from online use of software to be treated as derived from the lease, rental, license, sale, exchange, or other disposition of software. Per the preamble to the regulations:

> "The first exception applies to a taxpayer that derives gross receipts from providing computer software to customers for the customers' direct use while connected to the Internet (online software) and also derives gross receipts from the lease, rental, license, sale, exchange, or other disposition to customers that are unrelated persons of computer software that has been provided to such customers affixed to a tangible

[119] Reg. §1.861-18(b)(2).

medium or by allowing them to download the computer software from the Internet. The second exception applies if a taxpayer that derives gross receipts from providing online software and an unrelated person derives on a regular and ongoing basis in the unrelated person's business gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software to its customers affixed to a tangible medium or by allowing its customers to download the substantially identical computer software from the Internet."

"The temporary regulations define substantially identical software as computer software that, from a customer's perspective, has the same functional result as the online software and has a significant overlap of features or purpose with the online software. To avoid controversy between taxpayers and the IRS, the temporary regulations provide a safe harbor under which all computer software games are deemed to be substantially identical software.

"If a taxpayer's provision of computer software for online use meets the requirements set forth in the temporary regulations, then an allocation of gross receipts between DPGR and non-DPGR will be necessary if, as part of the same transaction, the taxpayer derives gross receipts other than from providing computer software to a customer for the customer's direct use while connected to the Internet. For example, if in connection with providing computer software to a customer for the customer's direct use while connected to the Internet, a taxpayer also provides a service such as storing its customers' data or providing telephone support, then the taxpayer must allocate its gross receipts between DPGR and non-DPGR using any reasonable method."

The IRS noted that this treatment of software under §199 is only for §199 purposes and cannot be used to classify software transactions for purposes of "character, timing, or source." Final regulations (TD 9317, 3/20/07) follow the temporary regulations. Two examples from Treas. Reg. 1.199-3(i)(6) follow:

"*Example 1*. L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under paragraph (i)(6)(ii) of this section, gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non-DPGR. [domestic production gross receipts]"

"Example 4. O produces tax preparation computer software within the United States. O derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are unrelated persons of O's computer software that has been affixed to a compact disc as well as from the sale to customers of O's computer software that customers have downloaded from the Internet. O also derives gross receipts from providing customers access to the computer software for the customers' direct use while connected to the Internet. The computer software sold on compact disc or by download has only minor or immaterial differences from the online software, and O does not provide any other goods or services in connection with the online software. Under paragraph (i)(6)(iii)(A) of this section, O's gross receipts derived from providing access to the online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met)."

Website Development Costs

The proper tax treatment of website development costs has become a longstanding one now. Website development may include such activities as creating content and a strategy for how the site fits into sales and advertising goals, developing software, using templates to assemble content into HTML format, testing, redesign, and updating of content. The website may be only for internal use (intranet) or also for external use. The sponsor's purpose in creating the site may be solely for advertising, or the site may constitute the company's primary business operation, for example, soliciting sales from customers.

Website Development Activities and Relevant Tax Rules: The treatment of the costs to develop a website will depend on the nature of the activity. Common activities of website development and their likely tax treatment are described next.

Initial Planning: The treatment of costs incurred in deciding upon the purpose, content and use of a webpage, may vary depending on the particular circumstances for incurring the costs. If the costs are viewed as an integral part of the development costs, they likely should be treated in the same manner as such costs are treated. If the planning can be viewed as a separate activity, Reg. §1.263(a)-4 should be considered to determine if the costs

incurred should be capitalized. If the primary benefit is to current year activities, the costs should be deductible under §162.[120]

Software Development: Per Revenue Procedure 2000-50,[121] software development costs may be treated similarly to §174 expenditures thereby allowing the taxpayer to currently expense the costs or to elect to amortize them over 60 months. If instead of developing the software, a taxpayer purchases software designed by someone else, the taxpayer must capitalize the software. The definition of software used in Rev. Proc. 2000-50 ties to the definition in §197. Computer software is defined as "any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software." The term does not include any data or information base unless it is in the public domain and is incidental to the program. The term also does not include any costs of procedures external to the computer's operations.

Rev. Proc. 2000-50 provides that software development costs may be accounted for similarly to §174 expenditures thereby allowing the taxpayer (1) to currently expense the costs, or (2) to elect to amortize them over 60 months from the date the development is completed in accordance with rules similar to §174(b), or under the 167(f) depreciation rule (36 months) starting with the date the software is placed in service.

Rev. Proc. 2000-50 does not state that software development expenditures are per se R&E expenditures. Instead, it states that software development costs "in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of §174 as to warrant similar accounting treatment." This is particularly important for purposes of §41 because for software development activities to constitute "qualified research," such activities must meet the definition of R&E under §174 and Reg. §1.174-2 (a standard not required to be able to currently deduct software development costs under Rev. Proc. 2000-50).

Research and Experimentation (R&E): Section 174 allows for the current deduction of research or experimental expenditures incurred in connection with a trade or business.[122] The "in connection with" language differs from the §162 "carrying on" language. The U.S. Supreme Court has held that the "in connection with" language allows taxpayers to deduct R&E expenditures before they are carrying on a business.[123] However, the taxpayer must be engaged in a trade or business at some time—there must be some actual and honest objective of making a profit.[124]

Research and experimentation costs are defined as R&D costs incurred in the experimental or laboratory sense, for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[125] Uncertainty exists if information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. One is to look to the nature of the activity, not to the nature of the product or improvement being developed. R&E expenditures include costs of obtaining a patent, including attorney fees in making and perfecting the application. Quality control testing does not constitute R&E. However, the regulations clarify that "quality control testing does not include testing to determine if the design of the product is appropriate" (validation testing).[126]

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120 Revenue Ruling 2000-4, 2000-4 I.R.B. 331 (current deductibility of ISO certification costs); *Goodwyn Crockery Co*., 37 T.C. 355 (1961), PLR 7906011, Revenue Ruling 92-80, 1992-2 C.B. 57 (advertising, even if it creates goodwill, is deductible under §162); and *RJR Nabisco, Inc. v. Comm'r*, T.C. Memo 1998-252, nonacq. 1999-40 I.R.B. 2, AOD 1999-012.

121 Rev. Proc. 2000-50, 2000-52 I.R.B. 601 which replaces Rev. Proc. 69-21, 1969-2 C.B. 303.

122 If a taxpayer does not want to current expense its R&E expenditures, it may elect to instead capitalize them and then begin to amortize them when it first realizes benefits from the expenditures. The amortization period under §174(b) may be no shorter than 60 months. If the R&E results in an item that is depreciable under §167, that life is used. For example, if a software developer has capitalized its R&E (software development costs), the amortizable life is under §167(f)—36 months. See Reg. §1.167(a)-14(b)(1) and §1.174-4(a)(4).

123 *Snow v. Commissioner*, 416 U.S. 500 (1974).

124 *Brown v. Commissioner*, 58 T.C.M. (CCH) 850 (1989).

125 Reg. §1.174-2(a).

126 Reg. §1.174-2(a)(4).

Section 174 only applies to R&E expenditures if they are reasonable in amount under the circumstances. Generally, expenditures are reasonable in amount if the amount "would ordinarily be paid for like activities by like enterprises under like circumstances."[127] Depreciable property is not a §174 expenditure, but the depreciation on equipment used in R&E falls under §174.[128] A product includes "any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer it its trade or business as well as products to be held for sale, lease, or license."[129]

If the expenditures for developing a website meet the definition of R&E under §174 and the taxpayer has adopted the §174(a) expensing method, the costs are deductible. In order to potentially claim a research tax credit under §41 for the website development costs, such costs will have to meet the definition of R&E under §174 (in addition to other requirements under §41).[130]

Purchase of Software: If instead of developing the software, a taxpayer purchases software designed by someone else, the taxpayer must capitalize the software costs (assuming the software has a useful life exceeding one year). To determine if the software designed by a third party constitutes a §174 expenditures or should instead be treated as the acquisition of a software program, a determination must be made as to who was at risk for the development. If R&E expenditures are incurred in the creation of depreciable property by another person, they are only deductible under §174 if "made upon the taxpayer's order and at his risk."[131]

Creation of an HTML File from a Template: Various software programs exist that provide a template and software to enable someone to create an HTML file (webpage). It is unclear whether this type of activity constitutes software development. The file created with the program does not by itself enable a computer to do something. However, the file may also include some code created by the designer that does have some functionality on its own. If the creation of an HTML file from a template is not treated as software development or creation, then the costs to create this item must be examined under §162 and §263. Generally, under Reg. §1.263(a)-4, taxpayers must capitalize amounts paid to acquire or create an intangible, as well as amounts paid to create or enhance a separate and distinct intangible asset (as defined in the regulations). Otherwise, the costs should be expensed when incurred. If the costs are to be capitalized, the next issue would be to determine if the asset can be amortized under §167, §1,167-3(b) or §197. In addition to the costs of creating the file, related costs of planning what the site should look like should be included with the other costs of creating the site.[132]

Final regulations under §263(a) on capitalization of intangibles provide that amounts paid to develop software are not treated as amounts that create a separate and distinct intangible,[133] and software is not given as an example of a created intangible requiring capitalization.[134] On the other hand, acquired software is an example of an acquired intangible requiring capitalization.[135] Thus, under current guidance, once a taxpayer knows if they have developed software or acquired it, the guidance is clear. However, it is not clear as to what distinguishes purchased software from developed software particularly in situations where a taxpayer begins with a piece of software but makes

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127 Reg. §1.174-2(a)(6); based on I.R.C. §174(e) added by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, §7110, 103 Stat. 2106.

128 See §174(c) and Reg. §1.174-2(b)(1).

129 Reg. §1.174-2(a)(2).

130 §41(d)(1)(A) and *Norwest Corp., et al. v. Comm'r*, 110 T.C. 454 (1998).

131 See Treas. Reg. §1.174-2(b)(3) and TAM 9449003 (Aug. 25, 1994).

132 The question of whether use of a software program to create an HTML document constitutes software development is one in need of guidance. Attorney Douglas W. Schwartz has written an extensive analysis calling for the Treasury Department and IRS to issue a revenue procedure on the accounting treatment of website development and modification costs. Mr. Schwartz recommends that the government accept the premise that that website development costs are most closely analogized to software development costs. Taxpayers should be allowed a choice of two different accounting methods for such costs: 1) a pool-of-costs capitalization and 36-month capitalization or 2) a site-by-site capitalization and 36-month amortization method. These methods would operate similarly to those provided for package design costs (Rev. Proc. 97-37). See Douglas W. Schwartz, on behalf of the 2000 Washington, D.C. delegation co-sponsored by the Tax Sections of the Los Angeles County and California Bar Associations; "Tax Accounting for Costs of Developing or Modifying Internet Web Sites;" *The California Tax Lawyer*, Summer 2000.

133 Reg. §1.263(a)-4(b)(3)(iv).

134 Reg. §1.263(a)-4(d).

135 Reg. §1.263(a)-4(c)(1)(xiv).

significant modifications to it. The factors that distinguish acquired software from developed software are to be addressed in the future by the IRS.[136]

Continual Updating: The content of a webpage will most likely be updated frequently in order to provide useful information to visitors. These recurring costs do not provide a significant benefit beyond the current year and so, should be deducted under §162 as incurred.[137] Also, if the updating process involves training of employees, such costs should be deductible under §162 (and Reg. §1.263(a)-4).

Creation of an Asset with a Long Useful Life: As a general rule, no deduction is allowed for amounts paid for new buildings or permanent improvements or betterments that increase the value of any property. In addition, amounts spent to restore property or in making good the exhaustion thereof for which a depreciation allowance was taken are not currently deductible. Additional examples of capital expenditures include the cost of acquiring and constructing property, defending or perfecting title to property, commissions paid in purchasing securities, and the cost of goodwill in connection with acquiring assets of a going concern.[138] In 1992, the U.S. Supreme Court attempted to clarify the demarcation between ordinary and capital expenditures in the *Indopco* decision (503 U.S. 79 (1992)).

Per the Court, an expenditure need not create or enhance a separate and distinct additional asset to be capitalizable; other characteristics of an expenditure may indicate that it is a capital expenditure. "Although the mere presence of an incidental future benefit—"*some* future aspect"—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." Several revenue rulings were issued to help explain this ruling and final regulations were issued in 2004 at Reg. §1.263(a)-4.

If any costs incurred in developing a website do not fall under §174 or Rev. Proc. 2000-50 and create an intangible covered by Reg. §1.263(a)-4 they likely should be capitalized.

Creation of a New Trade or Business: Typically, creation of a website by a business will not constitute the creation of a new trade or business. If a business decides to create a website in order to serve customers, it has merely used a tool to reach customers for its existing trade or business. A website should be viewed as enabling the company "to carry on an old business in a new way."[139] Where a website is created as part of the creation of a new trade or business, such costs must be capitalized if they are of a nature that would have to be capitalized if incurred by an existing trade or business.[140] If such costs are otherwise deductible and are not §174 expenditures, they should be treated as §195 start-up expenditures.

Advertising: One function of many websites is to advertise the company's products and services. Generally, all advertising costs are deductible under §162 and Reg. §1.263(a)-4.

Activities of Governments and Industry Associations

Introduction

Since the mid-1990's there have been many different government and industry associations that have studied and reported on the tax implications of the Internet and e-commerce. These reports often suggested approaches the government should take to help the Internet grow and to be sure taxes did not impede its growth. The most extensive federal study was performed by a commission established by the Internet Tax Freedom Act enacted in 1998. The commission and its work are described here along with the moratorium that was also part of that Act. This is

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136 The proposed regulations that preceded TD 9107 suggested that future guidance would be in line with TAM 200236028 (6/4/02) and the simplifying conventions of the final §263(a) regulations; REG-125638-01, 2003-5 IRB 373, 383.

137 *Encyclopedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982) and TAM 9645002.

138 IRC §263(a), and Reg. §1.263(a)-1(a) and §1.263(a)-2.

139 *Colorado Springs National Bank v. U.S.*, 505 F.2d 1185 (10th Cir. 1974) where the court held that establishment of a credit card system by a bank was similar to its typical lending operations. "A new method is distinguishable from a new business." Similarly, see *NCNB Corp v. U.S.,* 684 F.2d 285 (4th Cir. 1982); and *First National Bank of South Carolina v. U.S.,* 558 F.2d 721 (4th Cir. 1977). In contrast, in TAM 9331001 (April 23, 1993), the IRS ruled that the activities involved in operating a retail store were substantially different from those of a manufacturer and distributor an thus, constituted a new line of business. Similarly, in *Cleveland Electric Illuminating Co. v. U.S.*, 7 Cl. Ct. 220 (Cl. Ct. 1985), the court held that a nuclear power plant operated by a utility was a new business relative to the utility's existing fossil fuel plant.

140 IRC §195(c)(1)(B).

followed by an overview of selected reports from governments and industry associations, as well as some federal legislative proposals relevant to Internet taxation.

Internet Tax Freedom Act and the Advisory Commission on E-Commerce

Basics: The Federal Internet Tax Freedom Act (ITFA, P.L. 105-277, 10/21/98) imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) on state and local taxes on Internet access, unless such tax was generally imposed and actually enforced before October 1, 1998.[141] This moratorium was extended to November 1, 2003 (P.L. 107-75; 11/28/01), to November 1, 2007 (P.L. 108-435; 12/3/04), and to November 1, 2014 (P.L. 110-108; 10/31/07). The moratorium also applies to multiple[142] or discriminatory taxes[143] on e-commerce.

The ITFA preserves state and local taxing authority to the extent the particular tax is not covered under the moratorium.

Legislation enacted along with the ITFA included a sense-of-Congress declaration that the Internet should be free of foreign tariffs, trade barriers, and other restrictions. This declaration set out the negotiating objectives for the U.S., which included accelerating growth of e-commerce by expanding market access opportunities for the exchange of goods, services, and digitized information. There was also a sense-of-Congress declaration that no new federal taxes should be imposed during the moratorium.

The original ITFA called for formation of a 19-member Advisory Commission on Electronic Commerce (ACEC). The members include 8 representatives of state and local governments (including one from a state with no sales tax and one from a state with no income tax), and 8 representatives from the e-commerce industry (including small business), telecommunications carriers, local retail businesses, and consumer groups. The ACEC was to conduct a thorough study of all levels of tax with respect to e-commerce, including considerations of all types of remote commerce, and report to Congress in April 2000. The ACEC report could contain legislative recommendations. Per the legislation that established the ACEC, "any recommendation agreed to by the Commission shall be tax and technologically neutral and apply to all forms of remote commerce. No finding or recommendation shall be included in the report unless agreed to by at least two-thirds of the members of the Commission serving at the time the finding or recommendation is made."

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[141] The following states fall under this exception: Connecticut (although repealed as of 7/1/01), Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Tennessee, Washington, and Wisconsin.

[142] A "multiple tax" is generally defined at §1104 of the ITFA as any tax imposed by a state or political subdivision of the state on "the same or essentially the same electronic commerce that is also subject to another tax imposed by another State or political subdivision thereof (whether or not at the same rate or on the same basis), without a credit (for example, a resale exemption certification for taxes paid in other jurisdictions." Multiple tax does not includes a sales or use tax imposed by a state and one or more or its political subdivisions on the same e-commerce or a tax on persons engaged in e-commerce which also may have been subject to a sales or use tax thereon.

[143] "Discriminatory tax" has a lengthy definition at §1104 of the ITFA. The definition uses two separate focal points for the definition, with satisfaction of either leading to a conclusion that a tax is discriminatory. The first focal point looks at the "fairness" or "neutrality" of the tax, while the second focal point labels a tax as discriminatory if applied based on an overly broad definition of nexus. More specifically, the definition of "discriminatory tax" per the ITFA language follows:

> "(A) any tax imposed by a State or political subdivision thereof on electronic commerce that— (i) 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; (ii) is not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means, unless the rate is lower as part of a phase-out of the tax over not more than a 5-year period; (iii) imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means; (iv) establishes a classification of Internet access service providers or online service providers for purposes of establishing a higher tax rate to be imposed on such providers than the tax rate generally applied to providers of similar information services delivered through other means." OR
>
> "(B) any tax imposed by a State or political subdivision thereof, if— (i) the sole ability to access a site on a remote seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation; or (ii) a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of— (I) the display of a remote seller's information or content on the out-of-State computer server of a provider of Internet access service or online services; or (II) the processing of orders through the out-of-State computer server of a provider of Internet access service or online services."

The duties of the Commission were quite broad as explained in the following excerpt from the ITFA.

"(g) Duties of the Commission—

(1) In general.—The Commission shall conduct a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate or international sales activities.

(2) Issues to be studied.—The Commission may include in the study under subsection (a)—

(A) an examination of—

(i) barriers imposed in foreign markets on United States providers of property, goods, services, or information engaged in electronic commerce and on United States providers of telecommunications services; and

(ii) how the imposition of such barriers will affect United States consumers, the competitiveness of United States citizens providing property, goods, services, or information in foreign markets, and the growth and maturing of the Internet;

(B) an examination of the collection and administration of consumption taxes on electronic commerce in other countries and the United States, and the impact of such collection on the global economy, including an examination of the relationship between the collection and administration of such taxes when the transaction uses the Internet and when it does not;

(C) an examination of the impact of the Internet and Internet access (particularly voice transmission) on the revenue base for taxes imposed under section 4251 of the Internal Revenue Code of 1986;

(D) an examination of model State legislation that—

(i) would provide uniform definitions of categories of property, goods, service, or information subject to or exempt from sales and use taxes; and

(ii) would ensure that Internet access services, online services, and communications and transactions using the Internet, Internet access service, or online services would be treated in a tax and technologically neutral manner relative to other forms of remote sales;

(E) an examination of the effects of taxation, including the absence of taxation, on all interstate sales transactions, including transactions using the Internet, on retail businesses and on State and local governments, which examination may include a review of the efforts of State and local governments to collect sales and use taxes owed on in-State purchases from out-of-State sellers; and

(F) the examination of ways to simplify Federal and State and local taxes imposed on the provision of telecommunications services.

(3) Effect on the communications act of 1934.—Nothing in this section shall include an examination of any fees or charges imposed by the Federal Communications Commission or States related to—

(A) obligations under the Communications Act of 1934 (47 U.S.C. 151 et seq.); or

(B) the implementation of the Telecommunications Act of 1996 (or of amendments made by that Act)."

The Commission would end with the filing of their report to Congress which was due April 21, 2000 (the report was actually submitted about a week early).

NOTE: A reading of the full text of the ITFA and related legislation is recommended.[144]

Rationale for the ITFA:

- To ensure fair and administrable rules exist so that growth of the Internet is not impeded.
- To avoid multiple taxation of transactions among states that might arise due to lack of clarity in existing rules which were not designed with the Internet in mind.
- Even though in 1998 most jurisdictions were not imposing the taxes subject to the moratorium, they could decide to later and it would be best to create the moratorium now, rather than later.

[144] See Public Laws enacting, modifying and extending the ITFA noted earlier, as well as 47 U.S.C. 151 note.

Opposing viewpoints:

- Imposes federal restrictions on state and local governments (federalism concerns).
- Reduces state and local tax revenues.
- "Provides unfair competition to main street businesses."[145]
- Would benefit wealthier consumers at the expense of lower-income consumers based on wider use of the Internet by more affluent consumers.[146]
- Would impede existing efforts of governments and industries to address e-commerce taxation issues.[147]
- "There is no objective evidence that state and local taxes are stifling the expansion of the Internet or electronic commerce in any way; both the Internet and electronic commerce are experiencing explosive growth."[148]
- A moratorium tends to create special interests who will seek a permanent moratorium.

Formation of the ACEC: Due to lack of a mechanism to ensure that the Commission would have the balanced number of government and industry members, it ended up with nine industry reps and only seven from government—a problem that delayed the work of the commission, cutting into its already short existence (18 months). On March 2, 1999, the U.S. Conference of Mayors and the National Association of Counties announced that they would file a lawsuit to prevent the ACEC from meeting prior to resolving the issues of its makeup. NACO urged state and local government organizations to join county officials and majors in forming a "State and Local Government Task Force on Fair and Equitable Taxation." The goal of this group was to make recommendations to Congress on simplifying state and local sales taxes so as to restore fairness between Main Street and remote sellers.[149] In March 1999, the Department of Justice announced that it would represent the ten defendants (all nine industry commissioners and Mr. Lebrun) because the Commission was serving a government function. Finally, in May 1999, the problem was resolved when Mr. Barksdale, CEO of Netscape (which was acquired by AOL) stepped down, enabling a government official to be appointed to balance the Commission. The lawsuits were then dropped and the first meeting was held on June 21-22, 1999 in Williamsburg, VA. Governor Gilmore was selected as the chair of the ACEC.

The members of the Commission were, in addition to representatives of Commerce Secretary Daley, Treasury Secretary Summers, and U.S. Trade Representative Barshefsky:

Industry	Government
C. Michael Armstrong, Chairman and CEO of AT&T	James Gilmore, Governor of Virginia
Grover Norquist, President of Americans for Tax Reform	Dean Andal, Vice-Chair, California State Board of Equalization
Richard Parsons, President of Time Warner	Paul Clinton Harris, Sr., Virginia Delegate
Robert Pittman, President and COO of AOL	Ron Kirk, Mayor of Dallas
David Pottruck, President & Co-CEO of Charles Schwab	Michael Leavitt, Governor of Utah
John Sidgmore, Vice-Chairman of MCI WorldCom	Eugene Lebrun, Partner in Lynn, Jackson, Shultz & Lebrun, P.C., and President of the National Conference of Commissioners on Uniform State Laws (NCCUSL)
Stanley Sokul, Independent Counsel for the Association for Interactive Media	Gary Locke, Governor of Washington
Ted Waitt, Chairman and CEO of Gateway 2000	Delna Jones, County Commissioner—Oregon

[145] View of Senator Graham who opposed S. 442 when voted upon by the Senate Finance Committee; see Senate Report 105-276 (7/30/98).

[146] Center on Budget and Policy Priorities, *A Federal "Moratorium" on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households*, May 1998. Available at http://www.cbpp.org/.

[147] *Id*.

[148] *Id.*

[149] "Counties Join Mayors In Threatening Litigation Over Internet Panel," State Tax Notes, 1999 STT 40-48. NACO 3/2/99 press release.

Activities of the ACEC: The ACEC first met in June 1999. Subsequent to that first meeting, a subgroup of commissioners—the Work Plan Subcommittee, drafted a list of five areas the ACEC should address:

1. State and local tax issues, including nexus;

2. The views of remote sellers of tangible and intangible products, and direct marketers, including issues between Main Street retailers and out-of-state vendors;

3. The philosophy of consumer advocates and low-tax advocates, including simplification and the level of taxation;

4. Taxation of Internet access and telecommunications; and

5. International taxation.[150]

At its meeting in September in New York City, the ACEC developed a list of 18 criteria for simplified application of sales tax to e-commerce:[151]

1. How does this proposal fundamentally simplify the existing system of sales tax collection?

2. How does this proposal define, distinguish, and propose to tax information, digital goods, and services provided electronically over the Internet?

3. How does this proposal protect against onerous and/or multiple audits?

4. Does this proposal impose any taxes on Internet access or new taxes on Internet sales?

5. Does this proposal leave the net tax burden on consumers unchanged?

6. Does the proposal impose any tax, licensing or reporting requirement, collection obligation or other obligation or fee on parties other than those with a physical presence in a particular state or political subdivision?

7. What features of the proposal will impact the revenue base of federal, state, and local governments?

8. Does this proposal remove the financial, logistical, and administrative compliance burdens of sales and use tax collections from Sellers? Does the proposal include any special provisions with respect to small, medium-sized, or start-up businesses?

9. Does the proposal treat purchasers of like products or services in as like a manner as possible through the implementation of a policy or system that does not discriminate on the basis of how people buy?

10. Does the proposal discriminate against out-of-state or remote vendors or among different categories of such vendors?

11. How does this proposal affect U.S. global competitiveness and the ability of U.S. businesses to compete in a global marketplace?

12. Can this proposal be scaled to the international level?

13. How does this proposal conform to international tax systems, including those that are based on source rather than destination? Is this proposal harmonized with the tax systems of America's trading partners?

14. Is the proposal technologically feasible utilizing widely available software to enable tax collection? If so, what are the initial costs and the costs for required updates, and how is to bear those costs?

15. Does the proposal protect the privacy of purchasers?

16. Does this proposal respect the sovereignty of states and Native Americans?

17. How does this proposal treat local governments' autonomy and their ability to raise a greater or lesser amount of revenues depending on the needs and desires of their citizens?

18. Is the proposal constitutional?

At its December 1999 meeting in San Francisco, the ACEC heard testimony and discussed various suggestions that had been offered for applying sales tax to e-commerce transactions and the Internet.

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150 "Federal Internet Subpanel Reaches Consensus on Focus Issues," 1999 STT 153-17 (8/9/99).

151 The 18 criteria are taken verbatim from the AC-EC's "Invitation for Proposals."

At the final meeting in March 2000, the ACEC was unable to obtain a 2/3 majority vote on any proposal before it. A subsequent conference call also failed to muster the requisite vote. However, Governor Gilmore did issue a report to Congress in April 2000 that included the proposal that received a simple majority vote of 11, as well as a few recommendations that received a 2/3 majority vote. However, the substantive tax proposal included in the report did not receive a 2/3 vote. There was some contention as to whether a report should be issued with a proposal in it when the enacting legislation for the ACEC required that any recommendation have a 2/3 majority vote.

Report of the ACEC: Despite failure to achieve the required 2/3 majority consensus on any position on how to apply the sales tax to electronic commerce transactions, the ACEC did include in its report to Congress a proposal that received 11 positive votes (out of 19 votes). The report of the minority was not included in this report. The key elements of the majority's sales tax proposal included in the ACEC's report to Congress are described below.

1. Extend and expand the moratorium

The majority of ACEC members advocated that the ITFA moratorium be extended an additional five years. In addition, they called for it to be broadened to also prohibit taxation of digitized goods and their non-digitized counterparts. Thus, for five years, no state or local governments would be allowed to collect sales tax on any sale of software, periodicals, books, videos, and any other items that can be digitized.

2. Provide a federal level definition of nexus

The majority proposed that the following factors should not cause a seller to have sufficient nexus for sales and use tax collection purposes:

"(a) a seller's use of an Internet service provider ("ISP") that has physical presence in a state;

(b) the placement of a seller's digital data on a server located in that particular state;

(c) a seller's use of telecommunications services provided by a telecommunications provider that has physical presence in that state;

(d) a seller's ownership of intangible property that is used or is present in that state;

(e) the presence of a seller's customers in a state;

(f) a seller's affiliation with another taxpayer that has physical presence in that state;

(g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state;

(h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller's website or catalogue to be returned to the other party's physical location within that state; and

(i) the advertisement of a seller's business location, telephone number, and website address."

3. Work towards a uniform sales and use tax law

The majority encouraged state and local governments to work with an existing organization involved in drafting uniform laws for the states to adopt[152] in order to create a uniform sales and use tax act. They suggested that this uniform act should cover tax base definitions, sourcing rules, audit procedures, and administration. In addition, the majority recommended that a new advisory commission be formed to oversee work towards a uniform sales and use tax act.

ACEC Minority Report: Five of the eight Commissioners representing government (Commissioners Jones, Leavitt, Lebrun, Kirk, and Locke) released a report on their own. This report explained the minority's concerns with the majority report, listed several principles that should guide reform and spelled out a proposal for state and local governments to address issues of applying the sales and use tax to e-commerce.

1. Concerns with majority report

The minority's concerns with the proposal of the majority was that it would create special "tax privileges" for e-commerce businesses leading to a $20 billion annual shift of taxes to main street businesses and individuals. They also suggested that the majority report was not "tax and technologically neutral" as required by the ITFA because it favored e-commerce businesses. The minority report also stated that the majority proposal would undermine state sovereignty by limiting state and local taxing authority and limit the ability to provide local services.

[152] National Conference of Commissioners of Uniform State Laws (NCCUSL).

2. Principles of applying sales and use taxes to e-commerce

The principles laid out in the minority report included:

a. There must be a "level-playing" field where all sellers are treated similarly regardless of their form of distribution.

b. There must be "radical" simplification of the sales and use tax.

c. The Internet should not be a "target" for new taxes.

d. The demand for services of state and local governments will not decline in the future and any changes to the tax system must recognize this.

e. There is no need for the federal government to restrict state and local taxing authority.

f. Changes in the telecommunications industry necessitate updating existing taxes imposed on this industry.

g. Tax policy must not compromise privacy rights on the Internet.

3. Minority sales and use tax proposal

The minority suggested a "streamlined and fair" tax system to include the following elements:

a. The moratorium against Internet access taxes and multiple and discriminatory taxes would be extended until simplification efforts were completed.

b. Give the states until the end of 2003 to radically simplify the sales and use tax. State and local governments should work with the National Conference of Commissioners on Uniform State Laws (NCCUSL) to create a "streamlined sales and use tax system." The features of such a system should include centralized registration, uniform definitions of the tax base, uniform sourcing rules, uniform exemption administration rules, protection of consumer privacy, a certification method for software to be used for compliance, uniform returns, and uniform audit procedures. In addition, Congress should adopt legislation to provide that states adopting the streamlined sales tax system would be allowed to collect use tax from remote sellers, although a de minimis rule would exist.

c. Congress should not legislatively define nexus (as suggested by the majority) because doing so would focus too much on physical activity which is not an important factor for e-commerce. Also, under the streamlined sales tax system, it would be simpler to determine tax collection obligations based on a seller's sales volume in the state. In the meantime, states should try to clarify nexus guidelines and have a procedure to enable sellers to determine if they have nexus in the particular state.

d. Telecommunications taxes should be simplified and modified to better address deregulation and other changes in the industry. The minority also suggested that consideration be given to phasing out the 3% federal telecommunications excise tax, if it made sense given existing federal revenue needs.

e. Citizens should be kept informed on various proposals and their likely impact to state and local revenues. In addition, revenue neutrality should be a goal.

f. By the end of 2003, the states should develop a uniform and simple system to tax digital products and services that does not violate individual privacy rights or create a compliance burden.

ITFA extensions and pros and cons: On November 28, 2001, Congress and the President extended the moratorium to November 1, 2003. The Internet Tax Nondiscrimination Act (ITNA; Public Law No. 107-75) made no changes to the 1998 legislation that created the moratorium—it merely extended it as is. The simple extension was likely due to the existence of more pressing items on the legislative and administrative agendas that warranted postponement of further discussion of Internet taxation issues.

P.L. 108-435 (12/3/04) extended the moratorium and grandfather provision retroactively until November 1, 2007. This extension also included:

- A provision was added that the term 'Internet access service' "does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access."

This change is due to confusion over whether DSL services are covered by the original moratorium language. Some states tax DSL on the basis that it consists of both Internet access services and telecom services. DSL providers argue that such treatment puts them at competitive disadvantage with cable modem and direct satellite providers.

- Guidance on VoIP: "Nothing in this Act shall be construed to affect the imposition of tax on a charge for voice or similar service utilizing Internet Protocol or any successor protocol. This section shall not apply to any services that are incidental to Internet access, such as voice-capable e-mail or instant messaging."
- Requires the GAO to conduct a study due November 1, 2005 on the impact of the moratorium on state and local governments and broadband deployment.[153]

The Congressional Budget Office (CBO) did a cost estimate under the Unfunded Mandates Reform Act on S. 150 in September 2003. At that time, S. 150 preserved the grandfather provision until October 1, 2006 and modified the definition of Internet access. The modification was to expand the statement on telecommunication services to read: "Such term does not include telecommunications services except to the extent such services are used to provide Internet access." CBO estimated that beginning in October 2006, state and local governments would begin to lose revenue beyond the UMRA threshold by 2007 ($64 million in 2007). Loss of the grandfather clause would result in revenue loss in 10 states[154] of between $80 and $120 million per year beginning in 2007. CBO stated that it could not estimate the impact of the change in the definition of Internet access.

P.L. 110-108 (10/31/07) extended the moratorium to November 1, 2014 with minor modifications.

Arguments for extending and modifying the moratorium(based on old S.150):

- "Abolishing the federal prohibition would force the Internet superhighway to navigate the same labyrinthine maze of overlapping and disparate state and local tax regulations and burdens that currently strangles the Nation's telecommunications services." "It should be the National Policy of the United States to promote freedom and ubiquitous Internet access and connectivity in America." Additional arguments include closing the digital divide, states are not dependent on Internet access taxes, and it prevents double taxation because the telecom aspect of the access is already subject to tax. Former Governor James Gilmore (Virginia), 4/1/03 testimony before the House Judiciary Committee. [http://commdocs.house.gov/committees/judiciary/hju86182.000/hju86182_0.htm]
- The moratorium "promotes across the board fairness, not special advantages for one group over another." Harris Miller of ITAA, 4/1/03 testimony before the House Judiciary Committee. [http://commdocs.house.gov/committees/judiciary/hju86182.000/hju86182_0.htm]
- The National Taxpayers Union referred to S. 2084 as a stealth tax hike that would hinder the continued advancement of the Internet and provide uncertainty that would lead to reduced investment in Internet technologies.[155]
- The Bush administration's support for the extension was expressed in a 11/5/03 press release from the Treasury and Commerce secretaries: "We believe that government should support the widespread availability and use of the Internet, including the use of broadband technology, and not discourage the Internet's growth through new access taxes. Keeping the Internet free of multiple or discriminatory taxes will help create an environment for innovation and will help ensure that electronic commerce remains a vital, and growing, part of our economy. A permanent moratorium means a permanent victory for American consumers and businesses. We urge the Senate to pass S. 150 as soon as possible so President Bush can sign a permanent Internet tax moratorium." [JS-971 at http://www.treas.gov/press/]

Arguments against extending and modifying the moratorium (based on old S.150):

- S. 2084 (108th Congress) to extend the moratorium was supported by the National Governor's Association and the National League of Cities. The NGA noted that S. 150 would lead to a revenue loss for California and its local governments of $836 million, while H.R. 49 would lead to a loss of $1,495 million. The H.R. 49

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153 The GAO issued two reports in 2006: Internet Access Tax Moratorium – Revenue Impacts Will Vary by State, GAO-06-273 (1/23/06), http://www.gao.gov/products/GAO-06-273; and Broadband Deployment is Extensive throughout the United State, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas, GAO-06-426 (5/06), http://www.gao.gov/new.items/d06426.pdf.

154 "CBO believes that as many as 10 states (Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington, Wisconsin) and several local jurisdictions in Colorado, Ohio, South Dakota, Texas, Washington, and Wisconsin are currently collecting such taxes and that these taxes total between $80 million and $120 million annually." CBO did not increase this amount for inflation to derive the revenue loss for 2006 because it assumed that change in technology and cost reductions would offset the inflation amount.

155 NTU press release of 2/11/04; http://www.ntu.org.

estimate was based on an assumption that governments lose all state and local telecom transaction taxes and business taxes "as companies migrate their telecommunications services to the Internet." The S. 150 estimate was based on the fact that the proposal "includes all telecommunications taxes except for 911 fees and business taxes such as property taxes, capital stock taxes on net worth, or sales and use taxes on business inputs." [Cong. Rec. 4/29/04, S4639 et seq]

- The NGA recommended that Congress adhere to three principles: [Cong. Rec. 4/29/04, S4640]

  1) "Do no harm"—be sure that any legislation preserves existing state and local revenues.

  2) "Be clear—definitions matter"—the original legislation specifically excluded telecom services from the definition of Internet access. This "allowed some jurisdictions to tax the telecommunications component of certain broadband technologies like DSL while others remained tax-free. This perceived inequity led to a push to alter the definition of Internet access in H.R. 49 and S. 150 to make tax free telecommunications services 'used to provide Internet access,' as a means to making the ITFA technology neutral. This change, however, is too broad. Not only would it prohibit taxes states and localities are collecting on DSL, it would also exempt all telecommunications services used anywhere along the Internet—from the end-user all the way to the 'backbone.' Compared to the original moratorium, which specifically expressly telecommunications services from it scope, H.R. 49 and S. 150 could ultimately put at risk most, if not all, state and local telecommunication tax revenue." The NGA is also concerned that the growth of VoIP usage that is bundled with Internet access will further hurt revenues.

  3) "Stay flexible—a temporary solution is better than permanent confusion"—the rapid pace of innovation surrounding the Internet makes it difficult to define terms and ongoing work of the FCC and others calls for the exercise of caution in governing in this area.

- The NLC noted that it had no goal to tax email or create new taxes for the Internet, but only wanted to preserve current telecom tax and franchise fee authority at the state and local level. [Cong. Rec. 4/29/04, S4641]

- The Center on Budget and Policy Priorities raised several concerns with S. 150 and H.R. 49 in a 10/03 report. These concerns included:[156]

- Loss of revenues to states that had fallen under the grandfather provision.

- Loss of revenue on the use of telecommunications services by ISPs. S. 150 modifies the definition of Internet access services by adding that it excludes telecom services except to the extent those services are purchased, used, or sold by an Internet service provider in providing Internet access. The CBPP noted that this is an area where the CBO was unable to project the revenue loss because telecom service providers do not report how much of their services were provided to ISPs. The CBPP also notes the irony of this change because an argument made by ISPs for the original moratorium was that it would avoid double taxation on the telecom services that are built-in to the access charges to customers.

- Loss of revenue as more Internet access providers bundle proprietary content (such as music, movies, games and software) with the access services.

- Possible loss of revenue beyond sales and excise with the removal of the grandfather provision. "Internet access providers (including telecommunications companies providing VoIP and other Internet-related telecommunications services such as DSL) could seek to establish in the courts that state and local taxes on their property and profits are prohibited *indirect* taxes on access service. Opening the door to such claims clearly is unintended, but to date the relevant Senate committees have been unwilling to add language to S. 150 . . . to eliminate any possibility of such litigation." [page 16 of the CBPP report at http://www.cbpp.org/10-20-03sfp.pdf]

- Why should state and local governments be forced to subsidize the growth of Internet access? Why shouldn't the federal government also bear some of the financial burden?

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[156] Center on Budget and Policy Priorities report—"Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities," 10/03; at http://www.cbpp.org/10-20-03sfp.pdf.

Reports/Activities—Federal Level

NOTE: The brief summaries of several of the major policy reports below should not serve as a substitute for reading the full text of each report. Several of the reports also include background information for better understanding of the Internet and e-commerce.

Selected Tax Policy Implications of Global Electronic Commerce[157]

The purpose of this November 1996 report by the Treasury Department was to provide an "introduction to certain income tax policy and administration issues presented by developments in communications technology and electronic commerce." The paper did not make any conclusions; instead, it raised issues and encouraged interested parties to submit both overall and specific comments on the topics, problems and issues identified in the paper. The paper was intended to stimulate public discussion on the issues it addressed. The paper presents a background to the Internet and the types of transactions that occur on it, as well as those that may occur in the future, such as settling stock trades electronically, and offshore banking. The paper also provided some introductory information on encryption and electronic money systems. The general themes of the paper included the following.

- *Neutrality*: New technologies should not be impeded by taxes or tax policies that treat them differently than existing technologies and transactions. "Our overall tax policy goal . . . should emulate policy in other areas—maintain neutrality, fairness and simplicity—a policy which serves to encourage all desirable economic activity new and old." The executive summary to the Treasury paper stresses that *neutrality* also means that new or additional taxes should not be imposed on electronic transactions.

- *Recognition of new ways of doing business*: The paper noted the decreased importance of borders to many transactions, the ability to transfer digitized information (such as music), the fact that some transactions might be untraceable and/or the identity of the parties may not be necessary or available, and the ease of moving people and equipment to change tax consequences. The paper provided an example of an individual who lives in Australia and uses a computer located in Canada to operate a commercial site on the Internet for U.S. customers. This individual can control the computer from her home country. In addition, various computer programs can be configured to run this system which will leave no audit trail. Finally, the paper pointed out that if the individual desired, she likely could easily move these operations to another location.

- *Application of current concepts to new transactions/technologies*: The paper pointed out that consideration should be given to determine how existing tax rules and concepts may apply to new technologies, as opposed to creating new rules. For example, the paper noted that a business that sells information may be analogized to a seller of goods in that the computer server where information is stored may be equivalent to the warehouse where tangible goods are stored, with permanent establishment rules applying similarly to each situation.

- *Possible broadness of §1.861-18 regulations*: The regulation (T.D. 8785) on classification of income from software transactions "may establish a framework applicable to any type of digitized information, at least to the extent it is protectable by copyright."

- *Increased importance of residence-based taxation*: "Transactions in cyberspace will likely accelerate the current trend to de-emphasize traditional concepts of source-based taxation, increasing the importance of residence-based taxation."

- *Fraud prevention and revised recordkeeping requirements*: Treasury was very concerned about the potential for the Internet and electronic transactions to make it easier for people to hide transactions, thereby leading to increased tax evasion. Treasury also noted that recordkeeping and verification systems must be considered as electronic transactions increase in number and type.

- *Ramifications beyond tax rules*: Treasury acknowledged that the Global Information Infrastructure (GII) would have ramifications beyond the tax law. Other areas affected by continued growth of the GII include national security, copyright, privacy, security, financial trading systems, and economic measurement.

- *Cooperation in rule development*: Treasury sought comments from and wanted to work with taxpayers, tax advisors, tax law specialists, computer technology specialists, academics, foreign tax policy makers and administrators (such as the OECD and U.S. treaty partners) and Congress to develop "clear and rational principles" to make sure that the tax law does not impede the growth of new technologies.

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[157] Available on the Internet at http://www.treasury.gov/resource-center/tax-policy/Documents/internet.pdf.

White House "Framework" on Electronic Commerce

This paper, released in July 1997, covered various legal and operational aspects of global electronic commerce.[158] The five principles discussed:

1. The private sector should lead.

2. Governments should avoid undue restrictions on electronic commerce.

3. Where governmental involvement is needed, it should support and enforce a predictable, minimalist and simple legal environment.

4. Government should recognize the unique qualities of the Internet.

5. Electronic commerce over the Internet should be facilitated on a global basis.

With respect to taxation and customs issues, the framework provided:

- The U.S. will advocate that the Internet be declared a tariff-free zone when used to deliver products or services.
- No new taxes should be imposed on Internet commerce.
- Taxation of e-commerce should follow current principles of international taxation, should avoid double taxation, and be simple to administer and easy to understand.
- Taxation of e-commerce should not hinder commerce and consist of a system that can accommodate both U.S. tax systems and those of other countries.
- Guidance should be based on existing tax concepts and principles, wherever possible.
- Any tax system applicable to e-commerce must address its special characteristics—possible anonymity of the parties, small transactions, and difficulties of trying to identify non-physical transactions with a physical location.
- The U.S. should work with the OECD to help achieve global consensus on taxation of e-commerce.
- The above principles should be applied not only in the international context, but also at the subnational levels.
- "Before any further action is taken, states and local governments should cooperate to develop a uniform, simple approach to the taxation of electronic commerce, based on existing principles of taxation where feasible."

Reports and Activities—Emphasis on Subnational Taxes

National Governors Association (NGA)

In 1999, the NGA called for industry and government to work together to streamline sales tax systems. Elements of this group's plan included:[159]

- Greater consistency among states with respect to definitions, forms, rules, and audit requirements.
- Simplification though uniform registration, forms, remittance requirements, and filing procedures. The NGA suggests that a system of independent third-party organizations to remit taxes to the states be considered. Use of such a system by remote sellers would eliminate the need to file forms with each state.
- Calling for Congress to require remote sellers to collect sales tax for any state that has simplified its sales tax system per the above principles. Exceptions should be provided for remote vendors with de minimis sales. However, small companies should be required to collect under the independent third-party administration system, but there should be no charge to such companies.
- "Although state action is needed to simplify the sales tax, federal action will be needed to ensure that it can be fairly applied."

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158 Available at http://clinton4.nara.gov/WH/New/Commerce/.

159 See http://govinfo.library.unt.edu/ecommerce/document/NGAPolicy.doc.

National Tax Association (NTA) Communications and Electronic Commerce Tax Project[160]

This industry-government group was formed in late 1996 to address state and local tax issues of applying subnational taxes to e-commerce, and to reach consensus, possibly in the form of model legislation for states to adopt. The group consists of 16 people from industry, 16 from government and 7 "other" from universities, the ABA, and the AICPA. The work of this NTA group is being carried out through the following subcommittees:

- Project scope
- Tax rates
- Tax base
- Sourcing transactions
- Filing simplifications
- Other simplifications

The federal Internet Tax Freedom Act provided that the Advisory Commission shall "to the extent possible, ensure that its work does not undermine the efforts" of the NTA E-Commerce group.

In September 1999, the NTA group issued its final report. This report included a very important caveat that "Nothing is agreed to until everything is agreed to." Thus, none of the preliminary conclusions noted in the report were to be considered final conclusions. Some of the significant preliminary recommendations or resolutions adopted, subject to the caveat, were,

- There should be one *rate* per state with some type of measure taken to "ensure protection and equitable distribution of revenues to local jurisdictions."
- States should have the ability to set their own tax *base* (no uniform base should be prescribed for the states).
- Transactions should only be *sourced* to the state level, not to the local level. Sourcing should be on the destination basis. If sourcing information is not available, default rules, to be developed, should be followed.
- State and local sales and use tax *administrative* rules should be simplified. Possible approaches include better use of technology, creating uniform vendor registration and exemption forms.

The NTA group could not issue any resolution regarding telecommunication taxes because it could not agree on a definition of "telecommunications."

Other Tax Reports of the Early Internet Era

The ACEC held a few public hearings and solicited comments from interested parties. The testimony and submissions are archived and may provide interesting background on initial issues and proposals to address international, federal, state and local tax issues raised by the Internet and e-commerce.[161]

21st Century Reports

Governments, industry groups, academics and others have continued to study and report on various aspect of e-commerce. As e-commerce technology continues to advance, new tax issues emerge to address (as noted earlier in this essay), and some of the issues noted in the reports of the 1990s become less important either because they have been resolved by new guidance or ways were found to resolve the issues within existing tax frameworks.

A sampling of reports issued subsequent to the year 2000 include the following:[162]

- Congressional Budget Office, *Economic Issues in Taxing Internet and Mail-Order Sales*, 2003.[163]
- Congressional Research Service (CRS), *State Taxation of Internet Transactions*, June 2011.

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[160] Draft papers and background information on the project are available on the Internet at *govinfo.library.unt.edu/ecommerce/document/final_NTA_Report.doc.*

[161] Advisory Commission on Electronic Commerce Library, http://govinfo.library.unt.edu/ecommerce/library.htm.

[162] Additional reports and links can be found at the author's e-commerce taxation website: http://www.cob.sjsu.edu/nellen_a/e-links.html.

[163] Congressional Budget Office, *Economic Issues in Taxing Internet and Mail-Order Sales*, 10/1/2003; http://www.cbo.gov/publication/14833.

- GAO, *International Electronic Commerce – Definitions and Policy Implications*, March 2002.[164]
- GAO, *Revenue Impacts Will Vary by State*, 2007.[165]
- IRS National Taxpayer Advocate, *2008 Report to Congress*.[166]

In addition to reports, a few congressional committees have held hearings on various aspects of Internet taxation. These hearings can be a good source of data, issues and possible solutions to Internet taxation issues. These hearings include the following by the House Judiciary Committee:[167]

- Constitutional Limitations on States' Authority to Collect Sales Taxes in E-Commerce, November, 30, 2011.
- H.R. 1860, the "Digital Goods and Services Tax Fairness Act of 2011," May 23, 2011.
- H.R. 1521, the "Cell Tax Fairness Act of 2009," June 9, 2009.
- VoIP — Who Has Jurisdiction to Tax It?, March 31, 2009.

Reports and Activities—International

In the 1990s, the OECD, Australia,[168] Canada,[169] and the European Union[170] issued extensive reports similar in concept and approach to the U.S. Treasury and White House papers. Common themes of these reports dealing with initial issues identified regarding Internet transactions included:

- The Internet and e-commerce present opportunities for both governments and businesses.
- New taxes should not be imposed because restricting development of the Internet and e-commerce will only harm the country's economy.
- Neutrality should be considered in applying tax laws to transactions in e-commerce so that the tax law does not distort behavior.
- Multiple taxation must be avoided.
- Tax systems should be simple in order not to hinder a business's expansion of its market into the large markets offered through e-commerce.
- Countries will need to work together to deal with tax issues so as to avoid multiple taxation, undue competition, updating and coordinating treaty provisions, coordinating the legal basis for taxing multinational transactions, and coordinating enforcement powers.
- Governments and taxpayers should work together to identify and address issues.

United Nations

In July 1999, the United Nations issued *Human Development Report 1999*. This report provides background to and solutions for dealing with various gaps that exist throughout the world, such as technology, wealth, and education. One solution offered for narrowing the technology gap was to create new funding mechanisms, such as a bit tax or a patent tax. These types of taxes would raise funds from people with technology and could be used to help provide the benefits to a broader group. A press release about the report noted that a tax of 1 cent on every 100 e-

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[164] GAO, *International Electronic Commerce – Definitions and Policy Implications*, GAO-02-404, March 2002; http://www.gao.gov/new.items/d02404.pdf.

[165] GAO, *Revenue Impacts Will Vary by State*, GAO-07-896T, May 23, 2007; http://www.gao.gov/products/GAO-07-896T.

[166] IRS National Taxpayer Advocate, *2008 Report to Congress*, identifies taxation of virtual worlds as an emerging issue in need of guidance, pages 213 - 226; http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf.

[167] For more information on congressional hearings on e-commerce taxation and links, see the author's tax reform activities website: http://www.cob.sjsu.edu/nellen_a/112th-hearings.htm.

[168] Australian Tax Office, Tax and the Internet (8/97) and "Tax and the Internet"—Second Report (12/99).

[169] Reports on e-commerce and taxes available at http://www.ccra-adrc.gc.ca/ecomm/.

[170] *A European Initiative in Electronic Commerce* report (COM(97)157) is at http://www.cordis.lu/esprit/src/ecomcom.htm.

mails would generate over $70 billion per year.[171] A subsequent statement from the U.N. noted that the "bit tax" example is an illustration and that the UN has no power to tax.

S. Con. Res. 52 (106th Congress) proposed a sense of Congress opposition to a bit tax on Internet data mentioned by the U.N. It noted that Americans would be disproportionately affected by a global Internet tax. Also see H. Con. Res. 172 (106th Congress).

OECD October 1998 Ottawa Conference[172]

(1) At the October 1998 Electronic Commerce and Taxation conference, senior tax officials from several countries and business representatives reached a joint declaration on taxation and e-commerce. Common views included: i) governments and businesses must co-operate in implementing a taxation framework for e-commerce in order for the full potential of new technologies to be realized; ii) new technologies have a great potential to simplify tax systems and enhance taxpayer service; iii) the tax framework for e-commerce should be guided by the same principles that are used in conventional commerce; iv) "significant input is needed and invited by the OECD from other governments and private sector."

(2) A 1998 report, "Electronic Commerce: Taxation Framework Conditions," was released by the OECD's Committee on Fiscal Affairs. The report noted taxpayer service opportunities presented by new technologies and that broad taxation principles should apply to e-commerce. With respect to consumption taxes, two conclusions of particular interest to state and local governments are:

- "Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction."
- "For the purpose of consumption taxes, the supply of digitized products should not be treated as a supply of goods."[173]

(3) Statement of Treasury Assistant Secretary of Tax Policy Donald C. Lubick:[174]

> [O]ur advocacy of a "reasonable and non-discriminatory tax policy" does not translate into "no taxation of electronic commerce." One of the principles that we endorsed at the recent OECD Conference on electronic commerce in Ottawa was that of "effectiveness;" in other words, our taxation systems must impose and collect with respect to electronic commerce the right amount of tax at the right time. We must not allow the Internet to become a tax haven that erodes the tax base and deprives governments—federal, state and local—of the revenue they need to invest in education and infrastructure and to provide essential services.

Other OECD work

Subsequent to the Ottawa conference in 1998, the OECD pursued a variety of research and study projects on how e-commerce might impact existing rules on permanent establishment, classification of revenues, model treaty provisions, administrative issues and other matters. The OECD formed a few Technical Advisory Groups (TAGs) consisting of both government and industry representatives to study particular tax issues and make recommendations for needed tax changes to ensure that international tax rules properly applied to e-commerce transactions.

The current work of the OECD can be found at http://www.oecd.org/ and linking to the tax and electronic commerce topic.

European Union Calls for VAT Collection on Electronically-Delivered Services

In May 2002, a Council Directive was passed requiring non-EU vendors of electronically supplied services to collect VAT from non-business customers. The purpose was to level the playing field so that purchases from non-EU vendors are not tax advantaged and to simplify compliance for non-EU businesses. The requirement went into effect on July 1, 2003. Affected non-EU vendors could either register in each EU member jurisdiction where they have customers or select a single member jurisdiction in which to register. If registered in a single jurisdiction, that jurisdiction will allocate the VAT to the appropriate jurisdictions. "Electronically supplied service" is one delivered

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171 United Nations, *Human Development Report 1999*, page 108; http://hdr.undp.org/en/reports/global/hdr1999/.

172 Documents about this conference can be found at http://www.oecd.org/dataoecd/45/19/20499630.pdf.

173 OECD, Electronic Commerce: Taxation Framework Conditions, A Report of the Committee on Fiscal Affairs, October 8, 1998; http://www.oecd.org/dataoecd/46/3/1923256.pdf.

174 Donald C. Lubick, "Treasury's Lubick Remarks on Subpart F Reexamination," 98 TNT 239-48 (12/11/98), RR-2855.

over the Internet or an electronic network with the nature of the service "heavily dependent" on information technology for its supply. Examples of such services include digitized software, web hosting, online auctions, remote systems administration, distance teaching, and use of search engines.[175]

Just like it is important to review the tax laws in any state in which a business has customers or any physical presence, businesses must do the same with any country in which they have customers or any presence or activity to determine if they are subject to any tax in that jurisdiction.

Conclusion

The Internet and e-commerce have posed various challenges to tax rules that were not designed with this type of technology and transactions in mind. It has been a slow process of study, discussion, litigation and more study for industry and policymakers to get a handle on what types of tax law changes are necessary and appropriate. Practitioners need to be careful to determine where clients have nexus for income and sales/use tax purposes or a permanent establishment for tax obligations outside of the U.S., examine the rules of each jurisdiction to determine what types of transactions are taxable, and keep up with activities in this area by tax agencies, courts and legislators.

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[175] EU, Directive 2002/38/EC amending the Sixth VAT Directive; available at http://europa.eu/legislation_summaries/consumers/protection_of_consumers/l31044_en.htm and http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm.

