Internet Business, Local Taxation & Nexus

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How do we separate difficult problems from unsolvable ones?

I. Grasping the Big Picture: What is "Internet Business" - Why Do Tax Concerns Exist?

E-business includes transactions and ways of doing business that were not contemplated when most tax rules of today were written. Tax systems and rules are outdated in many ways in their lack of guidance regarding intangibles and mobile property, emphasis on physical borders, and taxation of tangible consumption (rather than also intangibles and services – wrt sales and use tax).

§ "Internet Business"

While "Internet Business" might make most people think of Internet retailing and companies like Amazon.com, it really should be viewed as much broader than that. "Internet business" would include businesses in the following areas that enable companies like Amazon.com to exist and function:

- Hardware
- Software
- Telecommunications infrastructure
- Transaction facilitation (such as EBay, security, advertisers, electronic payment)
- Search engines
- Web hosting
- Internet service providers
- Retailers and wholesalers of tangible and intangible items
- Service providers

All of the companies in the above categories might be facing new tax issues with the advent of e-business (which is a larger set of transactions than e-commerce). These issues are listed later in this outline.

§ Selected Business Realities of the Internet

The Internet has changed sales and operations of many businesses, and created new business models, such as those used by Amazon.com. Internet technology—

- Makes borders unimportant (although businesses must still often consider laws and customs in the countries in which their products and services are available).
- Enables businesses of all sizes to more easily and cost-efficiently reach a global marketplace.
- Allows for new types of deliveries for services, as well as for products that can be digitized, such as books and videos. As technology advances to provide greater bandwidth at low cost, digitized products will likely become more prevalent.
- Manufacturing and delivery methods will likely change for some industries due to cost efficiencies and improved customer satisfaction available via use of e-commerce. For example, some manufacturers could use custom goods created via customer specs received online. Reduced costs of maintaining an inventory will also affect land use.
- Changes business practices and decisions. Many businesses provide customer support via the Internet. Some businesses have also created intranets to allow for improved internal communications and data sharing. Some decisions have been quite significant, such as

Egghead's decision of several years ago to get rid of its bricks and mortar stores and just sell software via the Internet. The ability to reach large markets from a single location can lead businesses, particularly new ones, to consider tax rules in their location decisions. For example, it was reported in a story about Amazon.com that one of the reasons for not locating the company in California was that there are too many customers there and they would have to pay sales tax when buying books from an in-state company.[1]

§ The E-Commerce Model Can Change Tax Results For Governments

Example: Andy, who lives in San Jose, 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	6%	0% (1% goes to Cupertino)
c. Buys the book from San Jose bookstore's web site; mailed to him.	6%	1%
d. Buys the book over the Internet from a store not physically located in CA	0% (Andy owes 6% use tax)	0% (Andy owes 1% use tax)
e. Buys the book in digitized form and it is delivered to him over the Internet	0% (no tax owed on intangibles)	0% (no tax owed on intangibles)

Note: Regulation 1802 provides that for retailers with one place of business, the sale is deemed to occur at that place of business. For retailers with more than one place of business in California, the sale is sourced to the place of business where the principal negotiations are carried on. The place of title passage is not important to the Reg 1802 sourcing rule. In contrast, district taxes (those imposed by special districts) are sourced to the place of delivery.[2]

[1] David Streitfeld, "Booking the Future; Does Amazon.com Show That Publishing Clicks on the Internet?," *The Washington Post*, July 10, 1998, page A1. Also see Chip Bayers, "The Inner Bezos," *Wired*, March 1999, page 115, 174. The *Wired* article notes that Amazon.com also has a warehouse in Delaware that has no state sales tax, and will open a third in Nevada to help serve its large California customer base (without having a presence in California). Of course, the California customers must self-assess and pay *use* tax, but compliance and awareness of this tax is very low.

[2] For further information on local sales and use taxes and district taxes, see SBE publications 28, 44 and 105, available at http://www.boe.ca.gov/sutax/staxpubsa.htm.

§ Traits of the E-Commerce Business Model and the Tax and Fiscal Issues They Raise – The chart on the next few pages summarizes some of the tax issues facing businesses, as well as tax and fiscal issues for state and local governments posed by the e-commerce business model.

E-Commerce Traits	Tax & Fiscal Considerations for Businesses	Tax & Fiscal Considerations for Government	Examples
Location: ▪ Ability to interact with customers is not dependent on location. ▪ Can reach customers in many different states and countries without the need for many physical locations. ▪ Some physical assets needed to conduct business (such as servers) are not necessarily tied to a single physical location, but can easily be relocated without any interruption to business. ▪ Mobile equipment (servers through which web pages are accessed and orders processed) can easily be moved to a more favorable tax location. ▪ More custom inventories so less storage needs. ▪ Less vertical integration, more outsourcing.	▪ Reduced operating costs. ▪ Fewer physical facilities needed, so companies have a physical presence in very few states and countries in which they have customers. ▪ Sales tax issue of distinguishing between taxable goods and non-taxable services. ▪ Improved tax-planning opportunities due to lower costs of moving servers rather than physical structures.	▪ Land-use decisions. ▪ Increased competition among local jurisdictions as they work to encourage e-commerce companies to locate their physical facility in their jurisdiction. ▪ Onerous tax systems can more easily be avoided by businesses because may be easy to relocate. Competition among taxing jurisdictions may increase. ▪ Greater likelihood that residents purchase from foreign (out-of-state) vendors—use tax collection issue; dealing with a global economy. ▪ May need to reconsider tax rules that base jurisdiction to tax on location. A server is not like a vending machine because the server's location is not tied to the ability to serve particular customers. Also, servers can be moved.	▪ Amazon.com (8 physical locations in U.S. and at least 3 in Europe, but customers in over 150 countries) ▪ Egghead.com (sells software only via the Internet) ▪ Purchase of cars via the Internet
Transaction details: ▪ Possibility of anonymous transactions where products are delivered electronically and payment is made with electronic money.	▪ Streamlined operations that in many cases can be completed by a computer that can be located anywhere in the world.	▪ Difficulty of verifying that a transaction occurred and where it occurred; loss of an audit trail.	▪ Sale of software and other information electronically.

E-Commerce Traits	Tax & Fiscal Considerations for Businesses	Tax & Fiscal Considerations for Government	Examples
Nature of products: ▪ Digitized products, rather than physical products.	▪ Reduced costs of storage and delivery. ▪ Is the digitized product subject to sales and use tax? Laws vary from state to state. ▪ Shift from selling tangible products to digitized ones may cause shifts in state income tax liability and increased filing obligations because of different sourcing rules for tangible versus intangible sales and the fact that P.L. 86-272 does not apply to the sale of intangible items.	▪ Less tangible personal property - thus, smaller sales tax base. ▪ Fewer physical business locations are needed, so businesses are more likely to have customers in the state, but no physical presence (nexus). At the international level, countries will find that businesses have a permanent establishment (taxing presence for income taxes) in fewer countries. ▪ Should P.L. 86-272 be updated to also address nexus for state income tax purposes for sales of intangible items and services? ▪ Should souring of revenues be standardized among the states to avoid multiple taxation of income and to simplify multistate taxation rules? Today, for income tax purposes, most states source sales of tangible products to the destination state (in most states, if the seller is not subject to tax in that state, the sale is "thrown back" to the state of origin). Sales of intangibles are typically sourced to the state where the greatest income-producing activity occurs. However, a few states, such as Minnesota, source revenue from services and intangibles to the state where service is received or the intangible is used by the purchaser. ▪ Should sales and use taxes bases be broadened beyond tangible personal property?	▪ Music, books, videos, and software transferred via the Internet

E-Commerce Traits	Tax & Fiscal Considerations for Businesses	Tax & Fiscal Considerations for Government	Examples
Nature of transactions: ▪ Increased use of bartering (such as for advertising on web pages). ▪ Improved ability to reach a larger customer base by advertising on the Internet. ▪ Improved ability to match willing buyers and sellers. ▪ Improved use of technology to set prices.	▪ Challenges of valuing the transaction for financial and tax reporting purposes. ▪ Ability to reach a broad market across many states and countries without the need for a physical presence, thus reducing multistate and international tax obligations. ▪ Reduced costs.	▪ Fewer intermediaries who may have previously served as a tax collection point. ▪ Valuation and reporting issues (bartering transactions are generally required to be reported to the government and the other party for tax purposes). ▪ Ease of selling by anyone, such as on E-Bay, challenges the "occasional sale" rule for sales tax purposes which exempts sales from sales tax if there are only a few per year or below a specified dollar amount (in California, occasional means 1 or 2 in 12 months; R&T §6019; rules vary among the states).	▪ E-Bay and other auction sites ▪ http://www.usbid.com/ ▪ http://www.tradeout.com ▪ http://www.priceline.com/ ▪ Sept. 2000 report that Amazon.com was tracking data about customer buying habits and using variable pricing to retain customers. This is certainly easier to do on-line than in person at a store.[3]

[3] David Coursey, "Behind Amazon's preferential pricing," Yahoo! News, 9/11/00.

Distribution methods: ▪ Reduced (or sometimes changed) need for intermediaries (disintermediation).	▪ Reduced costs to customers. ▪ Possible quicker service and closer tie to customers. ▪ New types of intermediaries created, such as ISPs, virtual malls, repair services and various portals. ▪ May reduce number of places where vendor has nexus. For example, in some states, a vendor that has arrangements with a company to provide warranty services may be found to have nexus in the state where the repair company is located. An alternative today is to just sell (resell) customers a service contract between the customer and warranty repair company. For example, see WarrantyNow.com.	▪ Fewer tax collection points. ▪ May need to attempt to collect tax (such as some excise taxes) from consumers or use new intermediaries.	▪ Sales of clothes from manufacturer to final consumer. ▪ Purchase of airline tickets directly form airline's web site. ▪ Consumer purchase of fishing equipment from outside of the U.S. where no excise tax is collected. ▪ Vendors arranging for sale of services directly between customer and third parties who will provide services (rather than the vendor being directly involved with the third party which may create nexus for the vendor).

E-Commerce Traits	Tax & Fiscal Considerations for Businesses	Tax & Fiscal Considerations for Government	Examples
Greater Outsourcing: ▪ Use of companies to create web sites and to store information on servers ▪ Use of service companies to assist with technology deployment ▪ Less vertical integration – greater focus on key business activity	▪ Does the relationship with the third party (outsourcing company) create nexus for the business in the locations where the third party is located?	▪ Existing rules and guidance on nexus may not be sufficient to address new transactions, such as web hosting. ▪ Guidance on how much and what type of physical presence creates nexus varies among the states and court decisions have not always been consistent.	Companies providing outsourcing services: ▪ Exodus Communications, Inc. ▪ Digital Island, Inc.
Global Marketplace: ▪ The Internet makes it easier and cheaper for even small businesses to sell goods and services in the global marketplace.	▪ Some small businesses may get involved in complex international and multistate tax issues.	▪ Tax agencies may find increased non-compliance due to lack of global tax expertise within small businesses.	▪ Various companies exist that provide assistance to small businesses engaging in e-commerce. For example: http://smallbusiness.yahoo.com/ http://Bigstep.com/
Workforce: ▪ Remote workforce that may be scattered throughout a state or country, rather than working in a single work location together.[4]	▪ Issues as to whether the presence of employees in the state or country creates tax obligations for sales, income and other tax purposes.	▪ Reduced infrastructure costs as more people work closer to their homes. ▪ Which home workers are subject to business license taxes? Do business license tax rules need to be updated?	▪ Customer support provided via the Internet with workers working out of their homes, rather than the company's physical location.

[4] The GartnerGroup predicts that by 2003, one-third of the U.S. workforce will be working remotely at least one day per week. Jack Lessinger, author of *Penturbia*, predicts that more of the workforce will move from urban and suburban settings to telecommute from remote areas including resort areas and farms. "For Bettor or Worse, IT's Influence Over Our Daily Lives Will Only Grow," *Executive Edge*, June/July 1999, page 15.

E-Commerce Traits	Tax & Fiscal Considerations for Businesses	Tax & Fiscal Considerations for Government	Examples
Technology: ▪ Businesses using technology to track customer buying habits, adjust prices, track orders, etc.	▪ Improved customer service at lower costs.	▪ Can the software/data tracking be broadened to assist in tax determinations and collections?	▪ Amazon.com keeps track of all orders a customer has made (customer can access), makes book recommendation based on prior orders.
More Power to Customers: ▪ More information on products and prices is easily available to consumers from the Internet. ▪ It is easy to shop for the “best deal” without leaving your computer. ▪ Supplier exchanges can be formed to reduce inventory, improve availability of information and to speed up orders.	▪ Increased price competition and need to get information to consumers in a timely manner. ▪ Need to identify new ways to serve customers and suppliers.	▪ Increased competition may reduce number of companies and reduce profits. ▪ Opportunity to benefit from new ways of purchasing goods and services.	▪ Business-to-business supplier exchange formed in February 2000 by General Motors, Ford, and Daimler-Chrysler. ▪ Web sites that help consumers find the best deal on a particular product on the Internet.

• Various features of Internet transactions do not fit well within the rules and theories underlying current tax rules that were created in a world involving tangible property and the ability to physically observe transactions. A brief overview of some of the features of today's sales and use tax is sufficient to highlight various "disconnects" between various features of our current tax systems and features of the Internet.

Sales and Use Taxes	
Tax System Feature	**Conflicting Internet Feature**
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 e-commerce 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. 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 does 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. As stated in AB 1614, "Addresses on the Internet are designed to be geographically indifferent. Internet transmissions are insensitive to physical distance and can have multiple geographical addresses."

II. Internet Business Today – Trends and Stats

> E-commerce sales are growing. The vast majority of online transactions continue to be B-to-B ones that have high tax compliance rates. The future of e-commerce retails transactions is likely to be through "multi-channelers" with both bricks-and-mortar and online operations working together to serve customer needs and wants. Ongoing high software piracy means not only loss of revenue for software companies, but loss of tax revenues for all levels of government. As broadband access and usage increases, the likely results will be increased economic activity, increased downloads of information and music even at the "micropayment" level and a declining sales tax base for CA.

- In May 2004, the Department of Commerce reported that U.S. retail e-commerce sales for the first quarter of 2004 were estimated to be $15.5 billion which is 28% higher than in the first quarter of 2003. During these quarters, e-commerce sales were 1.9% of total retail sales for 2004 and 1.6% in 2003.[5]

  In 2001, "Non-Store Retailers" accounted for 75% of retail e-commerce. Most of the activity was for electronic retailers and catalog houses. The largest category of products in this category is computer hardware, followed by clothing.[6]

- A report by Forrester for the National Governor's Association and the National Conference of State Legislators noted the following:[7]
  - B-to-C online sales were about $104 billion in 2003, which was a 39% increase over 2002 online sales. Forrester notes that its data indicates larger volume than does the Department of Commerce data because Forrester includes online travel and gross sales from online auction sites that the DOC omits.
  - B-to-C online sales are projected to increase to $229 billion by 2008.
  - Some of the growth will be the result of greater use of broadband as competition has brought the price down.
  - In 2003, 52% of online buyers were women.
  - For the weekend following Thanksgiving 2003, more people shopped online than in department stores, although some of that may have been due to bad weather.
  - For the key remote shopping categories, online has become the largest followed by mail order and then television sales.
  - Online sales are primarily from multichannel retailers, rather than pure online operations, such as Amazon.com. In 2003, 75% of online sales were from multichannel retailers (such as Target, Sears and Wal-Mart). The top demand of cross-channel shoppers was to be able to buy online and return at the brick-and-mortar store. Of the top 100 retailers, Forrester reported that 66 sell online. Of those selling online, 94% collect sales tax, 23% allow customers to buy online and pick up at the physical store and 83% allow online buyers to return items to the physical store.
    - Note: This consumer desire to have a connection between the online and physical stores will resolve many of the nexus concerns of state and local governments

[5] Data can be found at http://www.census.gov/eos/www/ebusiness614.htm.
[6] Dept. of Commerce, ***E Stats***, 3/19/03; see http://www.census.gov/eos/www/papers/2001/2001estatstext.pdf.
[7] Forrester Research, Inc., "The Growth of Multichannel Retailing," released by the NCSL in July 2004; available at http://www.ncsl.org/print/press/forrester.pdf.

where bricks-and-mortar operations were forming separate entities for online sales in order to avoid having to collect use tax (by ensuring that the online entity had a physical presence in very few states).

- In 2001, 93% of e-commerce was B-to-B.[8]
- A survey by the Ipsos-Reid and Jupiter Research in 2003 found the following top reasons why consumers shop online: save time, shop when stores are closed, find better prices, find a product more easily, find products not available in stores, compare prices easily and have the product shipped directly to recipient.[9]
- The Tower Group estimates 23% growth in micropayment revenue from 2003 to 2009. They define micropayments as being under $5 per transaction. They estimate that growth will occur not so much because the technology for handling small payments has advanced, but that the number of opportunities for low-cost transactions, such as music or information, will grow.[10]
- Software Trends
    - The Business Software Alliance reports that 36% of software in use worldwide is pirated – a revenue loss of about $29 billion worldwide. The piracy rate for the U.S. was 22% - about a $6 billion annual loss. An April 2003 study found that lowering piracy by 10 percentage points over 4 years would result in an increase of 1 million jobs and $400 billion in economic growth worldwide.[11] Piracy also means a significant loss of income, sales and value-added tax revenues.
    - The growth of broadband and internet usage will increase the number of transactions where software is transferred via telecommunications (not subject to sales tax) rather than on a diskette or CD (taxable).
    - For an interesting report on the future of software innovation and its expected impact on the economy and society, see a white paper – ***Enabling Tomorrow's Innovations*** by the Business Software Alliance (10/03) available at http://www.bsa.org/usa/research/.
- An August 2002 report of the CA Public Utilities Commission (CPUC) found that 73% of Californians had high-speed Internet access available to them, yet only 13 – 17% subscribe to such access.[12]

  In testimony submitted to the CPUC in June 2003 in response to a CPUC study called for by SB 1563 (R.03-04-003, discussed later), Verizon summarized the benefits of broadband as follows:

  > "The widespread availability and use of an advanced broadband communications infrastructure can transform our economy. Widespread broadband will allow consumers to benefit from new and improved modes of shopping, entertainment, telecommuting, and communications, while businesses will benefit from increased productivity and greater demand for electronic equipment, computers, networking equipment and household entertainment. Government gains from the corresponding increased tax base. Society as a whole will benefit in ways still unforeseen from improved education, healthcare, commerce and government. The estimated benefit of widespread deployment of broadband in the United States is in the range of $500 billion annually. As the leader in the information technology and entertainment industries and representing 14% of the

[8] Dept. of Commerce, *E Stats*, 3/19/03; see http://www.census.gov/eos/www/papers/2001/2001estatstext.pdf.
[9] As reported by Emarketer, 8/5/04 at http://www.emarketer.com/Article.aspx?1002977.
[10] As reported by Emarketer, 8/4/04 at http://www.emarketer.com/Article.aspx?1002971.
[11] See full report at http://www.bsa.org/globalstudy/.
[12] CPUC, Broadband report; available at http://www.cpuc.ca.gov/Published/Report/18279.htm. The report was issued in response to SB 1712 which queried whether all universal service should be redefined to include high-speed Internet access. The CPUC concluded that such access was not an essential service.

U.S. economy, California stands to benefit enormously from the economic stimulus and the increased consumer choices that will result from greater broadband deployment."[13]

- The Pew Internet & American Life Project's data on "who is online" indicated (at August 2004):[14]
  - 61% of women
  - 66% of men
  - 78% of 18 – 29 year olds
  - 25% of those 65 or older
  - 44% of those with incomes below $30,000
  - 89% of those with incomes over $75,000
  - 32% of those who attained less than a high school degree
  - 88% of those who attained a college degree or higher
- The Pew Internet & American Life Project reports that 27% of Internet users, representing 17% of Americans have heard of VoIP (Voice over Internet Protocol) and 3% of Internet users have considered adopting the technology in their homes.[15]
- A Pew Internet & American Life Project survey in 2003 found that "97 million adult Americans, or 77% of Internet users, took advantage of e-gov in 2003, whether that meant going to government Web sites or emailing government officials. This represented a growth of 50% from 2002."[16]
- Chaska, Minnesota became one of few cities to offer residents Wi-Fi as a municipal service. The monthly cost for users is $16 making it very competitive with commercial providers.[17]

III. Local Government Concerns and Constraints

> Estimated sales and use tax losses from e-commerce vary widely because of assumptions in compliance rates, what constitutes e-commerce sales, future trends in e-commerce and various ways to measure e-commerce sales. However, the data all indicate uncollected sales and use tax.
>
> Local governments face a variety of constitutional and statutory constraints at the federal and state levels that limit their ability to change revenue.

- Uncollected Sales and Use Tax (private studies): 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

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[13] Testimony available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.
[14] Data reported at http://www.pewinternet.org/trends/DemographicsofInternetUsers.htm. Similar data reports available at http://www.pewinternet.org/trends.asp.
[15] June 2004 report available at http://www.pewinternet.org/pdfs/PIP_VOIP_DataMemo.pdf.
[16] See 2004 report at http://www.pewinternet.org/pdfs/PIP_E-Gov_Report_0504.pdf.
[17] Findlaw, "Minn. City to Become Internet 'Hot Spot,'" 5/26/04, http://news.findlaw.com.

sales tax loss was $170 million for 1998, representing one-tenth of 1% of total state and local sales tax collections.[18]

§ Uncollected Sales and Use Tax (government studies): A June 2000 General Accounting Office (GAO) study estimated that the state and local sales and use tax losses 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 figures are due to varying assumptions as to business-to-business compliance rates and the estimated amount of e-commerce sales.[19]

§ In March 1999, the California Board of Equalization estimated that California's annual loss of sales and use tax from e-commerce was about $18.5 million.[20] The June 2000 GAO study projected sales and use tax losses in California from all Internet sales for 2000 as between $23 and $533 million. The GAO's projection of lost revenue for 2003 was between $86 and $1,720 million.[21]

§ The June 2000 report from the GAO indicated a wide range of estimates on what consumer and business compliance rates was 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. [22] Because cars must be registered, the use tax can be collected and use tax compliance is about 100%.[23]

§ In July 2004, Drs. Bruce and Fox of the University of Tennessee updated earlier estimates of state and local tax revenue losses from e-commerce. The new estimates are reduced due to the reality that "e-commerce has been a less robust channel for transacting goods and services than was anticipated" earlier. The new estimate for 2008 indicates state and local tax revenue loss of between $21.5 and $33.7 billion depending on the growth assumption used. The 2003 estimate for losses in California is between $2.1 and $2.2 billion, and between $2.95 and $4.62 billion for 2008. For the 2008 estimate, between $637 and $996 million represents losses for local governments.[24]

§ A 2003 report by the Direct Marketing Association has questioned the data from the University of Tennessee for 2000 and 2001. The DMA suggests that for 2001, uncollected sales tax on e-commerce was only $1.9 billion and will likely be $4.5 billion by 2011 which is 10% of the University of Tennessee estimate (the UT estimate was $54.8 billion[25]). Some of the differences between the UT and DMA estimates are due to DMA using a higher tax compliance rate for

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[18] Ernst & Young, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by The Internet in 1998*, June 18, 1999.
[19] GAO, *Sales Taxes – Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000.
[20] California Senate, *E-Commerce - Taxing Internet Sales and Access*, Pub. #99-1, September 1999.
[21] GAO, *Sales Taxes – Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, Table V.1 and Table V.2.
[22] GAO, *Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, pages 34 - 35.
[23] Some states, including California, have begun to collect excise and use taxes from consumers on on-line purchases of tobacco products with the help of a 50 year old federal law that requires reporting of purchaser names. David Streitfeld, "Online Tobacco Sales Ignite Fight Over Taxes," *The Washington Post*, August 29, 2000, page A1.
[24] Dr. Donald Bruce and Dr. William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004," July 2004, available at http://www.ncsl.org/print/press/Ecommerceupdates.pdf,
[25] Bruce and Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," 9/01, available at http://cber.bus.utk.edu/ecomm/ecom0901.pdf. Also see additional reports at http://cber.bus.utk.edu/ecomm.htm.

businesses and recognizing the likely growth of multi-channel, clicks and bricks commerce where consumers want to be able to buy online but return at a physical store which will lead retailers to have nexus in the state for their online operations and be required to collect sales tax (rather than the consumer having to self-report use tax). Another difference is that DMA suggests that billions of dollars of EDI (Electronic Data Interchange) activity among businesses should have been excluded as not being Internet sales.[26]

§ The BOE notes that the loss of use tax from retail e-commerce may not be as large as might be expected when one looks solely at online sales. This is because some of the online sales are substitutions for what would have otherwise been a mail order sale with the same use tax problem.[27]

§ Lack of Taxpayer Respect for the Tax System? The 2004 annual report of the IRS Oversight Board noted that tax cheating is up from 1999. In 1999, 11% of Americans believed it was acceptable to cheat at least a little on their tax return. That amount increased to 13% in 2002 and was 17% in 2003 – almost 1 in 5 people.

§ Constraints and Limitations on Local Government Taxing Authority

Briefly summarized below is a list of some of the legal restrictions on the ability of local government in California to assess certain taxes or make certain revenue changes.

1. Federal nexus restrictions as dictated by the Commerce and Due Process Clauses.
2. Telecommunications Act of 1996 (P.L. 104-104) – (a) Section 602 of the Act preempts local governments from collecting any tax or fee on direct-to-home satellite (Direct Broadcast Satellite or DBS) service. The prohibition only applies to local jurisdictions, not to states. It is permissible for the state to collect a tax on DBS services and distribute it to local jurisdictions. (b) Section 253, Removal of Barriers to Entry prevents state and local governments from imposing rules that have the effect of limiting or prohibiting a company from providing telecommunications services. "No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service. … Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with section 254, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers. … Nothing in this section affects the authority of a State or local government to manage the public rights-of-way or to require fair and reasonable compensation from telecommunications providers, on a competitively neutral and nondiscriminatory basis, for use of public rights-of-way on a nondiscriminatory basis, if the compensation required is publicly disclosed by such government."
3. Internet Tax Moratorium – the federal moratorium expired in November 2003, but could be renewed (see discussion later in this outline). The California moratorium expired in January 2004.
4. Sales and Use Tax – California Revenue and Taxation Code exempts intangibles, including software transferred via telecommunications and most services from the sales and use tax. The Bradley-Burns Uniform Local Sales Tax Act enacted in 1955 allows counties and cities

[26] Dr. Peter A. Johnson, Direct Marketing Association, "A Current Calculation of Uncollected of Uncollected Sales Tax Arising from Internet Growth," March 2003; available at http://www.the-dma.org/taxation/CurrentCalculationofUncollectedSalesTax.pdf.
[27] SBE, *Economic Perspective*, August 2004, page 3; available at http://www.boe.ca.gov/news/pdf/EP804.pdf.

to impose a sales tax with a base similar to that of the state and administered at the state level. Thus, local jurisdictions have their sales tax base defined at the state level.

5. CA Constitution as Modified by Various Propositions – CA Constitution Article XIIIA, Section 3 provides: "any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed." The legislature does not need to have a 2/3 majority vote to impose or increase a fee; a simple majority will suffice.

   Also, Article XIIIA, Section 4 provides that cities, counties and special districts may only impose special taxes (except for taxes on real property) if there is a 2/3 majority vote of qualified electors in the jurisdiction. A majority vote of the electorate is required to impose a general tax. Article XIIIC, Section 1(a) of the California Constitution defines a general tax as "any tax imposed for general governmental purposes." Section 1(d) defines a special tax as "any tax imposed for specific purposes, including a tax imposed for specific purposes, which is placed into a general fund." The significance of these terms is that a local government may not impose, extend, or increase a general tax unless approved by a majority of the electorate. A special tax may not be imposed, extended, or increased unless approved by a 2/3 majority of the electorate (Article XIIIC, Section 2; Proposition 218). These restrictions do not apply to fees, although local jurisdictions may be required to hold public hearings and notify the public prior to instituting or increasing certain fees.

   Local jurisdictions may not change the voting restrictions to conflict with the CA Constitution. In a recent decision, *Howard Jarvis Taxpayers Association v. City of San Diego* (D042801, 7/1/04, CA Ct of Appeal 4th Appellate District), the court invalidated a local proposition that would amend the city charter to require a 2/3 majority vote for general tax increases. The court found that provision to conflict with Article XIIIC, Section 2(b) of the CA Constitution which calls for only a majority vote (which the court ruled does not include a 2/3 vote).

6. November 2004 Local Government Ballot Initiative – passage of one of the ballot initiatives on the fiscal relationship of the state and local governments in November will add or modify restrictions on how local governments can legally change or design their tax streams. The Prop 1A website (1A is the agreement reached by the governor and local governments) indicates that the original proposition advocated by the California League of Cities – Prop 65, is no longer needed.[28]

[28] For information on Prop 1A, see http://www.cacities.org/and http://www.yesonprop1a.com/1A.php.

IV. Selected Rulings and Events of the Past Year – Getting a Perspective on What's At Issue

Nexus refers to the connection between a jurisdiction and an entity such that it is permissible for the government to impose its laws on the entity. The Due Process and Commerce Clauses of the U.S. Constitution are relevant in determining if nexus exists. States also have laws and guidelines to help define the level of activity necessary to create nexus in a state for tax purposes. The rules differ from state to state and whether or not a business has nexus in a state is a frequently litigated matter. A 1959 federal law – P.L. 86-272, that defines nexus for state income tax purposes, is outdated because it only applies to sales of tangible personal property and only to income taxes. There are a variety of proposals to provide a single definition of nexus for all taxes.

An additional state and local tax issue involves defining the tax base, particularly for items that were not contemplated when rules were originally written.

There is a lot of discussion and analysis occurring with respect to telecom at the federal (FCC and Congress) and state levels. Issues include determining whether a new service, such as VoIP, should be regulated and taxed.

While the federal Internet tax moratorium expired almost one year ago, it is possible that it will be renewed and perhaps made permanent. There is much discussion and confusion as to the effect of and need for such a moratorium.

a. Nexus 101

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 current state of the law as to how these rules apply in determining whether a state may impose sales and use tax collection obligations on a remote (non-physically present) vendor.

<u>Due Process Clause</u>

"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." [14th Amendment, clause 1]

"[D]ue process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 345 (1954).

"The simple but controlling question is whether the state has given anything for which it can ask return." [*National Bellas Hess, Inc. v. Dept. of Rev.*, 386 U.S. 756 (1967)]

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

"The Congress shall have power ... to regulate commerce with foreign nations, and among the several States, and with the Indian tribes." [Article I, Section 8, clause 3]

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

Key Sales and Use Tax Nexus Case - *Quill Corporation v. North Dakota*[29]

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*.[30] In that case, the Court ruled that 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.

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[29] *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).
[30] *National Bella Hess .v Department of Revenue of Illinois*, 386 U.S. 753 (1967).

How Much Physical Presence is Needed? The answer to this question also depends on the law of each state because some states have specifically excluded some types of presence from creating tax obligations. For example, some states exclude presence at trade shows for a limited number of days from creating tax obligations.

- Less than a physical presence—In *Goldberg v. Sweet*, 488 U.S. 252 (1989), the Court stated: "We doubt that States through which the telephone call's electronic signals merely pass have a sufficient nexus to tax that call. See *United Air Lines, inc. v. Mahin*, 410 U.S. 623, 631 (1973) (State has no nexus to tax an airplane based solely on its flight over the State); *Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292, 302-304 (1944) (Jackson, J., concurring) (same). We also doubt that termination of an interstate telephone call, by itself, provides a substantial enough nexus for a State to tax a call."
- 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.[31]
- 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 web sites. The taxpayer, a dealer of car parts, has a web page that allows 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 web site. 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 web site. 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 it is an exempt purchase.
- 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.
- *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).]

California Enforcement Activities

In the past few years, booksellers who believed they had no physical presence in California discovered that the State Board of Equalization viewed the situation differently. In *Matter of Barnes & Noble.com* (SC OHB 97-732835; 9/02), the Board found that the retail store's distribution of discount coupons to its customers for credit when they buy books online created an agency and nexus. BN.com also paid to have its logo printed on shopping bags used in the retail

[31] *Quill Corp. v. North Dakota*, 504 U.S. 298, fn. 1 (1992).

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. Such distribution was found to be beyond mere advertising.

In the *Matter of the Petition for Redetermination under the Sales and Use Tax Law of Borders Online, Inc.* (SC OHA 97-638364; 9/01) – the Board 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 part of the selling process and that Borders.com had a physical presence in California.

Starting in 2003, a line was added to the CA individual income tax forms so that individuals could easily submit their California use tax. Many states have had similar lines for years.[32]

b. Sales and Use Tax – Recent Rulings and Developments

§ Sales/Use Tax Nexus and Third Party Service Providers: 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 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 US 207 (1960)), that Dell owes use tax on computer sales in the state because BancTec is 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.[33]

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[32] *State Legislatures* (magazine of the NCSL) reported that 20 states have a use tax line on their income tax forms: Alabama, California, Connecticut, Idaho, Indiana, Kentucky, Louisiana, Maine, Massachusetts, Michigan, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Carolina, Utah, Vermont, Virginia, and Wisconsin; May 2004, page 7.

[33] The Multistate Tax Commission's (MTC) Bulletin 95-1 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 activity, 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."

In 1996, both the California Franchise Tax Board and Board of Equalization withdrew their support of Bulletin 95-1. ["California FTB Pulls Out of MTC Bulletin 95-1," 96 STN 180-2] Reasons for the withdrawal appeared to include faulty legal analysis regarding nexus in 95-1 and failure to follow the Administrative Procedures Act. CA

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 (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 (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 had no 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. [Dell Catalog Sales v. Commissioner, Department of Revenue Services, 834 A2d 812 48 Conn Supp 170 (July 2003)]

R&T Regulation 1684 now specifically states that a vendor “is not ‘engaged in business in this state’ based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services with respect to tangible personal property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar.”

Similarly, see State v. Dell Catalog Sales, L.P., La. District Ct., No. 456,807 (May 2004), where the court did not find that an agency relationship existed between Dell and BancTec and that BancTec's services were provided on behalf of customer who purchased a contract and not on behalf of Dell Catalog.

§ Defining the Tax Base

The tax base subject to sales and use taxes varies among the states. For example, California exempts software that is custom (services) or transferred electronically (intangible). However, other states either tax all software or have special definitions of custom software and it may or may not be taxable. The rules defining the tax base are not always clear, as evidenced by the following May 2004 private letter ruling in Kansas and court case from Tennessee on ISP services.

1. PLR No. P-2004-006 involved a question as to which of the following items were subject to sales tax in Kansas, with the results indicated for each:
   - Web site consulting – taxable custom software
   - Web site design using purchased software such as Adobe GoLine and HTML – taxable custom software
   - Web site hosting - exempt
   - Reselling domain names - exempt
   - Statistics and search engine services - exempt

   However, law changes related to the state's changes in its sales tax to adopt the Streamlined Sales Tax Model Act, make custom software exempt starting 1/1/05.

2. Under Tennessee law, sales tax applies to the "furnishing, for consideration, of either intrastate or interstate telecommunication services." Telecommunications is defined broadly under the law to include communication by electric or electronic transmission of impulses, and all types of telecom transmission including paging service and cable TV service. At issue in ***Prodigy Services Corp v. Johnson, Comm'r. of Revenue, State of Tennessee***, No. M2002-00918-COA-R3-CV (8/12/03) was services offered by Prodigy that involved software distributed to customers that allowed subscribers "to access information and to perform certain functions through the internet." In 1991, the Dept of Revenue told Prodigy that its online services were not taxable, but changed that position in 1996 on the argument that Prodigy's services had changed and had become taxable. Prodigy argued that what the Department was trying to tax did not exist when the statute was written, it was not the intent of the legislature to tax the services.

   The court found the statute to have "expansive language," such as "transmission by or through any media." However, the court also found evidence that the legislature did not intend to include online services because in 1993 it removed "valued added network" from the definition of telecom services for tax purposes. The court also noted that Prodigy's services were considered to be "enhanced" rather than "basic" under the FCC rules and unregulated since Prodigy is not a telecom service provider. Finally, the court stated that telecom services are not the "true object" of the sale "even if some of the services fit that definition." Prodigy customers need to provide their own telecom services to use the Prodigy services.

   In January 2004, the Tennessee Dept. of Revenue issued Notice 04-03 to advise ISPs and telecom companies that "effective immediately, ISPs should stop collecting sales tax from consumers on the sale of Internet access." The notice also explained how to file claims for refund.

§ Sales Tax Holidays

Many states use sales tax holidays – days when no sales and use tax will be charged as stimulus measures or to encourage certain types of purchases. For example, Vermont had 6 days of no sales tax in August and October for personal computers in order to encourage more of its residents to obtain this technology. Printers and handheld devices were not exempt. The holiday applied to purchases of $4,000 or less. [http://www.state.vt.us/tax/legal/tb/tb30.htm]

c. 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 web site 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.[34] In situations where the person made no deliberate or repeated contact with the state, jurisdiction will likely not be found. Consider an example where a vendor's web site is selling regionalized merchandise (such as something related to a college or sports team in the area) yet anyone could 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 web site that does not prohibit customers in any particular state constitute purposefully directing activities to 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 the Court in *Quill* reminded everyone that Congress could address the Commerce Clause issue that prohibits states from making remote vendors collect sales taxes, 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 certainly impede interstate commerce. See later discussion on some of the objections raised by businesses regarding the Streamlined Sales Tax Project – objections that were presented to Congressional committees in the past few years.
3. Will Nexus Guidelines Help?—P.L. 86-272 has provided certainty to many multistate businesses with respect to whether they are subject to *income* taxes 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 is needed to create 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 taxes 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

[34] See *Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414 (9th Cir. 1997), and *Millennium Enterprises v. Millennium Music*, Civ. No. 98-1058-AA (DC Or 1999).

continues to study whether changes or clarifications are needed on what constitute a PE in the e-commerce realm.

d. Telecom Regulation and Taxes

§ Digital Divide - California Legislature

In 9/02, SB 1563 was enacted (Chapter 674). It calls upon the CA Public Utilities Commission (CPUC) to investigate and report on a plan to encourage widespread availability and use of advanced communications so that more people had access to state-of-the-art technologies. A report is due to the Governor and Legislature by the end of 2004.

Points made in comments submitted to the PUC in June 2003 include:[35]

- The dominant broadband providers are unregulated cable providers, not regulated telcos. There are a variety of ways for broadband capabilities to achieve high-speed Internet access including cable modem, DSL, satellite, wireless, and electric power lines. Consumers mostly see these technologies as equivalents in terms of capabilities.
- The California Teleconnect Fund (CTF) is a good vehicle for greater broadband access. [Note: Funding for the CTF was ended with the 04/05 state budget; http://www.cpuc.ca.gov/static/industry/telco/public+programs/ctf.htm.]
- The infrastructure should be both competitively and technologically neutral. This is necessary in order that technology advance as it should and to enable companies to have an incentive to innovate and provide services – that they will be able to get a market return on their investment. The CPUC should be sure not to regulate in a manner that will defeat this goal. "In order to be neutral, broadband policy must treat all providers alike."[36]
- Competition should be encouraged as it leads to technological improvements, better service, and price reductions.
- "Since broadband competition is already robust, direct government intervention is unnecessary and would impede market growth."[37] However, TURN did not view the market as having robust competition because in some markets, such as DSL, there are few providers.[38]
- "Widespread broadband availability will require the investment of staggering amounts of capital into California's telecommunications infrastructure. Investors can be encouraged to risk billions of dollars to build a broadband network if they are confident that future regulation will not limit the rewards by giving their gains to competitors."[39]
- Tax incentives can be helpful in encouraging broadband deployment.
- "In its report to the Legislature, the Commission can and should include a recommendation that municipalities not be permitted to impose unreasonable fees for providers to enter the market, for example, by imposing non-cost based licensing,

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[35] See http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.
[36] Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 10; available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.
[37] Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 15; available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.
[38] Opening comments of TURN (The Utility Reform Network) to the CPUC hearings related to SB 1563, June 2003; available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.
[39] Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 18; available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.

permitting, and application fees; or unreasonable right-of-way access requirements, tower siting restrictions, and zoning requirements. All such fees and requirements raise the cost of providing service, hinder investment in broadband infrastructure, and are at odds with the Commission's vision of widespread broadband availability."[40]

- "[T]he issue of bridging the digital divide is far more complex than deploying more telecommunications infrastructure and therefore, the Commission should endeavor to create partnerships with other relevant organizations and state agencies rather than spending its scarce resources trying to solve the issues by itself."[41] For example, issues of illiteracy and training to use hardware and software exist.

Local governments will want to read the CPUC report when it is released later this year to see if there are any implications for local regulation, Utility User Tax (UUT) application or other opportunities for revenue and economic development.

§ VoIP[42] - Federal

Congress: H.R. 4129 (108th Congress) would provide that the federal government has sole regulatory jurisdiction over VoIP. It directs the "Federal Communications Commission (FCC) to: (1) establish rules and standards for appropriate arrangements to compensate providers of facilities and equipment used to transmit communications employing a connected VoIP application; and (2) maximize participation in the support of universal service among the greatest number of providers of connected VoIP applications. Requires such providers to assist the Federal Government in enforcement actions.

Requires the FCC to appoint an appropriate representative industry organization to develop guidelines, protocols, or performance requirements pertaining to the offering or provision of connected VoIP applications for: (1) providing comparable capabilities to 911 services; (2) improving use by the disabled community; (3) improving reliability of VoIP applications; and (4) ensuring appropriate security for the application and voice communications.

Prohibits a State or political subdivision from imposing a tax or other charge on the offering or provision of a VoIP application." [CRS summary at http://thomas.loc.gov]

H.R. 4129 was introduced in April 2004 and referred to both the House Committee on Energy and Commerce the Committee on the Judiciary.

Similarly, see S. 2281 passed by the Senate's Commerce, Science, and Transportation Committee on 7/22/04. S. 2281 also includes a provision prohibiting any state or local government from imposing "any tax, fee, surcharge, or other charge for the purpose of generating revenues for governmental purposes on the offering or provision of a VOIP application." With respect to universal service, S. 2281 provides that the FCC "shall ensure that all providers of a connected VOIP application contribute, directly or indirectly, to the preservation and advancement of Federal universal service programs based on a flat fee, which could include a collection methodology based on the assignment of telephone numbers to end users."

At the Senate committee hearing, government and industry representatives testifying noted privacy, law enforcement needs (such as for surveillance) and security concerns with some new technologies, as well as the need to be able to continue to fund services such as 911 calls

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[40] Opening comments of Verizon to the CPUC hearings related to SB 1563, June 2003, page 5; available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.

[41] Opening comments of TURN (The Utility Reform Network) to the CPUC hearings related to SB 1563, June 2003, page 2; available at http://www.cpuc.ca.gov/static/industry/telco/sb1563/commentsinr0304003.htm.

[42] For a description on how VoIP works, see the FCC website at http://ftp.fcc.gov/cgb/consumerfacts/voip.html. This site also lists concerns consumers should be aware of in using VoIP including that they may not have access to 911 or directory assistance. Also, the service may not work during a power outage.

and universal service. Industry reps indicated the importance of deregulation of the new technologies to promote their growth and continued technological development. Commissioner Stan Wise of the Georgia Public Service Commission noted that he and his colleagues had "come to the conclusion that writing broad new policies around specific technologies will always leave us one step behind and may even hurt the development of technology by sending distorted signals to the marketplace."[43]

FCC: "On February 12, 2004, the FCC found that an entirely Internet-based VoIP service was an unregulated information service. On the same day, the FCC began a broader proceeding to examine what its role should be in this new environment of increased consumer choice and what it can best do to meet its role of safeguarding the public interest."[44] On 12/1/03, the FCC formed an Internet Policy Working Group to advise the FCC on policy issues related to the movement of more types of telecommunications services to Internet-based platforms. [http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-241761A1.pdf]

§ VoIP – California Public Utilities Commission

On 2/11/04, the CPUC issued an order[45] that it would begin to investigate what the "appropriate regulatory framework" is that "should govern the provision of Voice over Internet Protocol telephony." The order notes that even traditional voice telephony providers are using VoIP and that there are few barriers to entry for VoIP providers. Advantages of VoIP include lower rates and the ability to make and receive a phone call from any high-speed Internet connection globally. The CPUC notes public policy issues in this movement, particularly the fact that traditional phone charges lead to fees for "critical universal service programs designed to ensure accessible and affordable telephone service to low-income customers, customers in high-cost and rural areas, and to disabled customers." Additional concerns include the ability to address public safety and reliability concerns. Finally, the order notes: "we are mindful of the need to minimize regulation so as not to stifle the continued development of VoIP service while simultaneously fulfilling our responsibilities under state law to realize state-mandated policies and objectives on behalf of all California customers."

The CPUC projects that by 2008, VoIP will represent 40 – 43% of total intrastate telecom revenues in California. If universal service programs continue to rely on regulated revenues, the expansion of VoIP will result in between $183 and $407 million in lost revenue for the 5 mandated programs by 2008. The CPUC also notes that VoIP providers do not pay access charges to ILECs for the origination and/or termination of calls on the PSTN.

In explaining VoIP, the CPUC order states: "Viewing VoIP functionally from the end-user's perspective, and consistent with definitions in the Public Utilities Code, we tentatively conclude that those who provide VoIP service interconnected with the PSTN [Public Switched Telephone Network] are public utilities offering a telephone service subject to our regulatory authority."

The CPUC order was released the day before the FCC ruled that Free World Dial-Up was an unregulated information service subject to federal jurisdiction (see above; http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-04-27A1.pdf).

[43] Testimony of 6/16/04 available at http://commerce.senate.gov/hearings/testimony.cfm?id=1230&wit_id=3541.
[44] FCC at http://ftp.fcc.gov/cgb/consumerfacts/voip.html and http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-04-27A1.pdf.
[45] CPUC order available at http://www.cpuc.ca.gov/Published/Final_decision/34221.htm.

- National Conference of State Legislatures Resolution on Telecom Tax Reform

  In July 2004, the NCSL adopted a resolution to encourage states to work with local governments and telecom providers to simplify and modernize state and local telecom taxes based on 7 principles. Principle 5 calls upon states to "include provisions to mitigate potential local government revenue impacts associated with telecommunications tax reform." Principle 6 on economic development provides: "States need to simplify, reform and modernize state and local telecommunications tax systems to encourage economic development, reduce impediments to entry, and ensure access to advanced telecommunications infrastructure and services throughout the states."[46]

- Federal Excise Tax

  - IRS and the 3% Excise Tax – On 7/2/04, the IRS issued an advance notice of proposed rulemaking (REG-137076-02) seeking comments and suggestions "describing the various technologies, services, and methods of transmission currently available for transmitting data and voice communications and how they should be treated under [Internal Revenue Code] section 4251." The IRS is considering updating very old regulations to "reflect changes in technology." The excise taxes apply to local and toll phone service. "Toll telephone service" includes "telephonic quality communication for which there is a toll charge that varies in amount with the distance and elapsed transmission time of each individual communication."

    Soon after the release of the advance notice, some people thought the IRS was planning on taxing VoIP. The IRS subsequently stated that it was not considering applying the 3% excise tax on VoIP.

    Does the 3% excise tax still exist? Yes. While there were recent efforts in Congress to repeal this 100+ year old tax, including H.R. 3916 (106th Congress, 2000) that passed in the house 420-2, nothing was ever enacted. The tax remains and given current budget deficits and probably no serious belief that the tax impedes the growth of the Internet, it is likely to be with us for some time.

  - Some VoIP providers may be collecting the 3% federal excise tax on VoIP. In a 8/4/04 interview, 8X8, Inc.'s CEO noted that it collects the federal excise tax from customers even though it views its services as information services rather than telecom services.[47]

  - Courts Conflicted over What is Taxable under IRC §4251 and 4252

    Office Max, Inc. v. U.S., 93 AFTR 2d 2004-1190, 309 F.Supp2d 984 (ND Ohio) – the court held that the 3% federal excise tax did not apply to long-distance phone services provided by MCI WorldCom and MCI because they did not fall within Section 4251 or 4252. Section 4252(b)(1) defines a toll phone service as a telephonic quality communication for which there is a toll charge which varies in amount with the distance and elapsed transmission time of each individual communication. Office Max argued that the amount it was charged by providers for phone service was never based on the distance. The tax at issue totaled almost $400,000 over 3 years. The court did not agree with the IRS that the statute was ambiguous so held that there was no need to review the legislative history. The court held that distance and time both had to be met for the service to be subject to the 3% excise tax.

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[46] NCSL Resolution, available at http://www.ncsl.org/programs/fiscal/teltaxreform.htm.

[47] See http://www.viodi.com/newsletter/040800/article2.htm. Per 8X8 Inc.'s 10-K report for 2002, its business is to "develop and market telecommunication technology for Internet Protocol, or IP, telephony and video applications."

A contrary result was reached in ***American Bankers Insurance Group, Inc.,*** 93 AFTR2d 2004-1435, 308 F.Supp2d 1360 (SD Fl). In this case, the court ***did*** find the statute ambiguous so reviewed the legislative history which the court viewed as Congress intending to tax all long distance commercial services.

In ***Fortis Inc. v. U.S.***, 94 AFTR2d 2004-6005 (SD NY 9/16/04), the court ruled similar to the ***Office Max*** case that for §4252 to apply, the charges must be based on both time and distance. Similarly, see ***National Railroad Passenger Corp v. U.S.,*** 94 AFTR 2d 2004-___ (DC DC). In this case, the judge begins the opinion with: "When a defined term in the Internal Revenue Code ("Code"), 26 U.S.C. §1 et seq., fails to keep pace with technological advances and other changes in the commercial world, may the Internal Revenue Service ("IRS") nonetheless construe the Code to levy a tax arguably envisioned by Congress? This case concerns the proper interpretation and implementation of a federal excise tax on communications services. Finding that Congress meant what it plainly said in 1965, the Court concludes that only Congress, and not the IRS on its own, may update the statutory text. The motion for summary judgment filed by the United States ("IRS") will be denied and the National Railroad Passenger Corporation's ("Amtrak") motion for summary judgment will be granted."

Some state or local jurisdictions use the IRC excise tax definitions in applying telecom taxes. For example, the utility user tax (UUT) imposed by many California cities on telephone services is based on the IRC definitions of §4251 and §4252.

In August 2004, the IRS issued Notice 2004-57 indicating that despite the conflicting decisions of the District Courts, the excise tax remains payable on all taxable communication services (as identified as taxable by the IRS). The IRS and Treasury also issued temporary and proposed regulations on the service provider's obligation to collect the excise tax when the customer refuses to pay it (TD 9149 and REG 163909; 8/10/04). "The temporary regulations provide that the collector must report the refusal to pay the tax to the IRS by the due date of the return on which the tax would have been reported but for the refusal to pay. In addition, the temporary regulations provide that, for a person using the alternative method, the separate account cannot be adjusted to reflect a refusal to pay tax for the month unless such refusal has been reported."

- Local UUT and Franchise Fee Considerations Regarding Telecom Changes
  - Local governments may find themselves out of the loop with the ability of the federal and state governments to discuss and potentially regulate telecom and classification of services can have an impact on whether something is taxed. Local governments will want to keep tabs on the federal and state projects, submit testimony as appropriate and consider what the revenue impact might be of possible changes.
  - For an overview of the telecom industry, taxation of telecom at the state and local levels, policy implications and recommendations for reform, see Prieger, Sexton, and Nellen, "The Taxation of Telecommunications in California," July 2002, available at http://www.ucop.edu/cprc/telecomtaxrpt.pdf.
  - League of California Cities activities: The Revenue and Taxation Policy Committee of the League noted at a June 2004 meeting that there are two issues facing local governments due to the expansion of VoIP: "maintain the current application of utility users tax on telephonic services and the compatibility with current 911 services" as explained in a white paper of the UUT Technical Task Force. The white paper notes: "Internet telecommunication services should be subject to local UUT, Federal Excise Tax (FET), and to 9-1-1 taxes and fees in the same manner as their functional equivalent, traditional telephone service. Legislators and regulators should base their decisions on the functional nature of the service and not on the technology

it employs. This assures equal tax treatment, administrative ease, and competitive fairness."[48]

- Query: Has technology outpaced the ability to tax telecommunications in an efficient and neutral manner? Are there more efficient alternatives that might also be simpler for payors and providers?

e. Expiration of the Internet Tax Moratoriums

§ Federal Internet Tax Moratorium: The Internet Tax Freedom Act moratorium expired on November 1, 2003. Several bills have been introduced to extend it, expand it or tighten it.

Moratorium Review: The Internet Tax Freedom Act[49] (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, and multiple or discriminatory taxes on e-commerce. This moratorium was extended to November 1, 2003 (P.L. 107-75; 11/28/01). The ITFA preserved state and local taxing authority to the extent a particular tax was not covered under the moratorium. Thus, sales and use taxes still applied to sales of taxable items made via e-commerce.

- ITFA defined "Internet" as "collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio."
- ITFA defined "Internet access service" as "a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to consumers. Such term does not include telecommunications services."
- ITFA defined ``telecommunications service'' as having the meaning given such term in section 3(46) of the Communications Act of 1934 (47 U".S.C. 153(46)) and includes communications services (as defined in section 4251 of the Internal Revenue Code of 1986)."

§ S. 150 extends the moratorium and grandfather provision retroactively until 11/1/07. Other provisions include (also see Appendix A):

§ Adding a provision 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.

§ VoIP – the bill adds: "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

[48] League of California Cities, materials for 6/4/04 meeting of the Revenue and Taxation Policy Committee; available at http://www.cacities.org/resource_files/22370.RT%20Agenda%20Packet.6-04.pdf.
[49] Full text of ITFA available at http://www.ecommercecommission.org/ITFA.htm.

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."

- § Calls for the GAO to conduct a study due 11/1/05 of the impact of the moratorium on state and local governments and broadband deployment.

S. 150 passed in the Senate (93-3) on 4/29/04, with 4 senators not voting, including Senator Kerry (he appears to support a moratorium and voted yes on the original legislation S. 442 in 1998). See Appendix A for how S. 150 would change the language of the ITFA, as amended by P.L. 107-75.

The CBO did a cost estimate[50] under the Unfunded Mandates Reform Act on S. 150 in September 2003. At that time, S. 150 preserved the grandfather provision until 10/1/06 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 10/06, 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[51] 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.

H.R. 49, calling for a permanent moratorium and repeal of the grandfather provision passed in the House on 9/17/03. The CBO cost estimate on this bill is similar to that for S. 150 only the effect would start earlier because H.R. 49 would eliminate the grandfather clause immediately. See Appendix B for how H.R. 49 would change the language of the ITFA, as amended by P.L. 107-75.

S. 2084 calls for (1) a 2-year extension; (2) adding: "The term `Internet access service' does not include telecommunications services, except to the extent such services are purchased, used, or sold by an Internet access provider to connect a purchaser of Internet access to the Internet access provider;" (3) modifying the grandfather clause; (4) adding an accounting rule – "If charges for Internet access are aggregated with and not separately stated from charges for telecommunications services or other charges that are subject to taxation, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business;" and (5) providing that nothing in the Act is to prevent the collection of universal access and 911 fees. Senator Feinstein is a co-sponsor.

S. 2348 would extend the current moratorium until June 1, 2005. Senator Feinstein is a co-sponsor.

<u>Arguments in Favor of Extending and Modifying the Moratorium</u>

- o "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

[50] CBO cost estimates are available at http://www.cbo.gov/CESearch.htm.

[51] "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.

subject to tax. Former Governor James Gilmore (Virginia), 4/1/03 testimony before the House Judiciary Committee. [http://www.house.gov/judiciary/gilmore040103.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://www.house.gov/judiciary/miller040103.htm]
- "We estimate that taxes on the full amount of the basic monthly dial-up subscription service for typical members would increase its cost by approximately $2 to $3 per month on basic dial-up service. For higher cost broadband service, the cost could be an additional $5 to $10 per month." Joseph Ripp of AOL, 7/16/03 testimony before the Senate Committee on Commerce, Science and Transportation. [http://commerce.senate.gov/hearings/witnesslist.cfm?id=861]
- Congressman Cox in a 3/10/04 speech to the League of CA Cities: "unfortunately Senator Feinstein has not yet supported us because she's under the impression that our bill could cost cities and counties revenue by preventing taxes on VOIP services. But VOIP services are taxed now and will continue to be, under the moratorium. It is only Internet access that is not taxed now, and it still won't be. DSL is not taxed now, and it won't be. No change. If every town in America begins taxing the Internet, and taxing authorities around the world begin setting up new tollbooths on the Internet, make no mistake, California will be the biggest loser of all." [http://cox.house.gov/html/speeches.cfm?id=721]
- The National Taxpayers Union refers to S. 2084 as a stealth tax hike that will hinder the continued advancement of the Internet and provide uncertainty that will lead to reduced investment in Internet technologies.[52]
- The Bush administration supports S. 150 per 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

- S. 2084 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 estimate is 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 is 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]

[52] NTU press release of 2/11/04; http://www.ntu.org.

- 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 has no goal to tax email or create new taxes for the Internet, but only wants 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 include:[53]
  - Loss of revenues to states that had fallen under the grandfather provision.
  - Loss of revenue to many states if DSL services are also protected by the moratorium.[54] In October 2003, the 9th Circuit overturned an FCC ruling that cable modem was solely an information service. The court found it to be both a telecom service and an information service.[55] Thus, the CBPP questions why Congress should apply the moratorium to DSL services rather than require cable modem operators to break down their bills between telecom and information services.
  - 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 notes 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

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[53] 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.

[54] The CBPP notes that at least 27 states and the District of Columbia current receive sales and excise taxes fro=m DSL services. California is not one of those states. CBPP estimates the revenue loss at $70 million per year.

[55] *Brand X Internet Services v. FCC*, 345 F.3d 1120 (9th Cir. 10/6/03); available at http://caselaw.lp.findlaw.com/data2/circs/9th/0270518p.pdf.

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 from the expected growth of usage of VoIP since such services will likely qualify as Internet access.
- 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?

- CA Internet Tax Moratorium: The moratorium expired January 1, 2004. AB 1791 would extend it to January 1, 2010.

  CA Moratorium Review: The CA-ITFA imposed a moratorium to prevent any city, or county, or city and county from assessing taxes on Internet access, on-line computer services, or the use of Internet access or any on-line computer service; a bit tax or bandwidth tax;[56] or any discriminatory tax on Internet access or on-line computer services. The prohibition did not apply to any new or existing tax of general application imposed or assessed in a uniform and nondiscriminatory manner without regard to whether the activities or transactions taxed are conducted through the use of the Internet, Internet access, or Online Computer Services. Thus, sales and use taxes, business license taxes, utility user taxes generally continued to apply. If the FCC were to find that Online Computer Services or Internet access delivered over a cable television system are not cable services, a cable television franchise fee may not be imposed on such services.

  "It is the intent of this Legislature that no existing or future state taxes or state fees be imposed by the state in a discriminatory manner upon Internet access or Online Computer Services. This statement of legislative intent is meant to place the greatest possible barrier to the creation of discriminatory taxes or fees upon this Legislature and all future Legislatures." [from AB 1614, Chapter 351, 8/24/98]

[56] A bandwidth tax is defined as "any transactional tax imposed on or measured by the physical capacity of an available signal to transmit information electronically or by fiber optics."

V. Active Proposals and Projects

There are a variety of proposals and projects underway to clarify and improve the application of existing taxes to both new and old transactions. These include the Streamlined Sales Tax Project, nexus proposals, and efforts to accelerate the deployment of certain technologies in the hopes of stimulating the economy and use of technology.

a. Streamlined Sales Tax Project (SSTP)

- Background

This project, begun in 2000, is designed to simplify and modernize state sales and use tax systems in order to reduce the burden on companies of collecting the taxes. There are 42 states and the District of Columbia participating in the project. The model tax agreement of the SSTP contains uniform definitions, allowance of one state rate per state and a second state rate in limited circumstances for food and drugs, one local rate for each local jurisdiction, state level tax administration for the state and local taxes, uniform sourcing rules, uniform audit procedures and state funding of the technological models provided for in the agreement.

Per an April 2004 project summary: "Sellers who do not have a physical presence or 'nexus' are not required to collect sales and use taxes unless Congress chooses to require collection from all sellers for all types of commerce. Sellers without a physical presence can volunteer to collect under the proposed simplifications. Registration by sellers to voluntarily collect sales and use taxes will not infer that the business must pay business activity taxes, such as the corporate franchise or income tax."
[http://www.streamlinedsalestax.org/execsum0404%20.pdf]

To be a member state must conform its sales/use tax rules to that called for in the model agreement and have a "certificate of compliance" to be part of the interstate Agreement. There will be a Governing Board made up of a representative from each member state. The board will interpret the Agreement, amend it and issue resolutions.

As of 11/12/02, 30 states plus DC approved the interstate Agreement. As of 4/04, 20 states have enacted all or part of the conforming legislation – the Streamlined Sales and Use Tax Agreement (SSUTA). For more information, see http://www.streamlinedsalestax.org.

States may need to make significant changes in their existing sales tax rules to be part of the Agreement. Also, it is not clear whether Congress will act to, in effect, repeal the *Quill* decision for adopting states so that the states may enforce collection of use tax by remote vendors. The SSTP's list of states and their role/status in the SSTP is at http://www.streamlinedsalestax.org/statestatus.pdf. It notes that the Agreement becomes effective once at least 10 states representing 20% of the population of states imposing a sales tax have enacted appropriate legislation. It also notes that compliance by remote vendors is voluntary under the agreement until Congress or the U.S. Supreme Court indicates otherwise.

There is also a list of states and the status of their SSTP legislation at the Equipment Leasing Association (ELA) website at http://www.elaonline.com/govtrelations/state/streamometer/. Most of the states that have enacted appropriate legislation (although no legislation has been certified yet) are small, such as Nevada, Utah, North Dakota, West Virginia and Vermont which each have less than 1% of the US population (less the 4 states without a sales tax – Delaware, Montana, New Hampshire and Oregon). However, if all of the states indicated as having enacted complete SSTP legislation were certified, it would be about 23% of the population and thus, a Governing Board would come into existence.

- Will Congress Help the SSTP Efforts? A few bills have been introduced to enable states that adopt the SSTP legislation and once the number of states meets the level for a Governing Board to exist, to allow such states to also collect use tax from remote vendors. H.R. 3184 is such a bill that also includes an exemption for small remote vendors – those with gross remote taxable sales under $5 million in the preceding year. The ability to collect from remote vendors also requires that the state provide reasonable compensation to sellers for collecting the sales and use tax for the state. H.R. 3184 also lists the minimum simplification provisions that must be included in the SSTP Agreement. H.R. 3184 also provides that nothing in the proposal is intended to add or expand a state's ability to assess other tax obligations on vendors. S. 1736 is the companion bill in the Senate. The bills are still in committee and have few sponsors.

- "Preliminary Analysis of California Issues"[57]

  The "Board of Governance," created by SB 157 in 2003, represents CA in the SSTP meetings and must report quarterly to the legislative tax-writing committees. The BG's April 2004 report listed the following issues for CA under the SSTP:

  - The Governing Board created by the model act may draft rules and procedures. It may also resolve issues. This would conflict with the role of the CA legislature and BOE because if they wavered from the Agreement, they could be expelled from membership.
  - CA's compliance with the model act "may require significant revisions" to its sales and use tax law. Analysis is needed to determine if such changes would result in revenue increases or decreases.
  - The model act requires destination-based sourcing. This is not the case today for property that is not delivered to the customer at the seller's business location. There could be negative impacts to some local taxing jurisdictions.
  - Under the model act, the tax base is to be the same at the state and local levels. This is not true today for retail transfers of motor vehicles, aircraft, watercraft, modular homes, manufactured homes and mobile homes.
  - The model act requires a state to provide compensation to certified service providers and sellers for collecting and reporting sales and use tax. CA does not currently do this.

- Selected State Activity Related to the SSTP

  - Utah delayed its implementation of the model act one year – until 7/1/05 so that there could be a study on the effects to taxpayers and recommendations made on how to mitigate adverse impacts of the changes.
  - The Iowa Revenue Department issued a notice to all sales tax permit holders letting them know that there would be relaxed enforcement of the new sourcing rules from the effective date of 7/1/04 to the end of the year. No penalties will be assessed for errors during the 6-month period provided honest efforts were made to comply.

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[57] Board of Governance (created by SB 157), "Streamlined Sales Tax Project – A Report to the Legislature on the Streamlined Sales Tax Project," April 30, 2004; available at http://www.boe.ca.gov/pdf/1Q04SSTPLegRptFinal42204.pdf.

- Arguments in Favor of the SSTP[58]
  - The National Retail Federation has stated that the SSTP provides certainty and simplification to retailers. It also provides equal collection equal collection responsibility for sellers and is a "careful balance of both sovereignty and simplification." Uniform definitions and administration procedures provide simplification for retailers.[59]
  - It provides for compensation to vendors to partially compensate them for collecting the tax.
  - It provides technological solutions to simplify the assessment and collection process.
- Arguments Against the SSTP[60]
  - 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.
  - "Congress should not grant states the right to tax Internet sales unless they have first eliminated protectionist laws and regulations that discriminate against e-commerce, or unless they can make a clear and compelling argument that discriminatory laws or regulations are required for consumer protection." Examples of protectionist laws include not letting patients have a copy of their lens prescription so they cannot get glasses online, prohibitions against marketing used cars on the web, and rules prohibiting shipping of wine into a state. The Progressive Policy Institute estimates that these protectionist rules result in consumers paying $22 billion more per year on goods and services than otherwise required.[61]
  - Problems with the Model Act, such as:
    - Each member state gets just one vote, so California, with its large population and market, will have a small voice in interpreting and changing the model act.
    - A major simplification – one rate per state, is missing because local jurisdictions are allowed to set their own rate.
    - It does not address the problem that led to the *Quill* decision – states wanting remote vendors to collect sales tax. The SSTP 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 H.R. 3184 (discussed above),that exempts retailers with $5 million or less of remote taxable sales, states will likely have a reduced incentive to adopt the SSUTA. Also, it is arguable that Congress suggesting such an exemption indicates that the SSUTA is not simple enough.
    - Many states, including California, will need to change their sourcing rules which for many retailers will be 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 model act, 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

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[58] For materials submitted for a 10/1/03 hearing on the SSTP before the House Judiciary Committee, see http://www.house.gov/judiciary/89635.PDF.

[59] Maureen B. Riehl, National Retail Federation, testimony before the 10/1/03 House judiciary Committee, pages 12 - 17, at http://www.house.gov/judiciary/89635.PDF.

[60] For materials submitted for a 10/1/03 hearing on the SSTP before the House Judiciary Committee, see http://www.house.gov/judiciary/89635.PDF.

[61] Robert D. Atkinson, "Leveling the E-Commerce Playing Field," 6/30/03; available at http://www.ppionline.org/.

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, with no transition rule provided.

- Exemptions are still allowed if it is a separately defined category under the Act SSUTA §316). Thus, retailers will still need to track exemptions by state.
- Governor Bill Owens of Colorado has spoken out against the SSTP and the NCSL has argued that his arguments are "filled with misstatements and misconceptions." The arguments and counterarguments raised by Governor Owens and the NCSL provide a good illustration of some of the challenges of a model act to replace 46 diverse sets of tax rules and items that need to be debated by legislatures. For example, Governor Owens states that the SSTP is not revenue neutral while the NCSL states that each state has the authority to make their participation revenue neutral. That is, a state can adjust its sales tax rate or other taxes to maintain revenue neutrality and it could help cover the cost of required vendor compensation through other taxes or collections from remote sellers (however, the SSTP does not require remote sellers to collect use tax).[62]

b. Proposals to Clarify When Nexus Exists

- California Attempt to Clarify Nexus: AB 2061 would "enact the Business Activity Tax Simplification Act pursuant to which no person, as defined, would be subject to a business activity tax, as defined, imposed by this state unless that person has a physical presence in this state during the taxable period with respect to which the tax is imposed."

  See FTB analysis at http://www.ftb.ca.gov/law/legis/03_04bills/AB2061_021704.pdf and http://www.ftb.ca.gov/law/legis/03_04bills/AB2061_042104.pdf.

- In 2002, the Multistate Tax Commission (MTC) issued a draft proposal to determine when a company has nexus for business activity taxes. The proposal – referred to as a "factor presence nexus standard" states that a company that is organized or commercially domiciled in a state has substantial nexus in that state. In addition, if during a tax period, a company has either (a) $50,000 of property, (b) $50,000 of payroll, (c) $500,000 of sales or (d) 25% of total property, payroll or sales in the state, it has substantial nexus in the state. The dollar amounts would be adjusted for inflation.[63] The MTC approved the draft on October 17, 2002 with California abstaining.
- The MTC has a draft affiliate nexus proposal dated 7/13/04.[64] Under the proposal, a remote vendor has substantial nexus in a State for collection of use tax if (1) the vendor is related to an in-state business that maintains one or more locations within the state, and (2) the 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 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." The proposal also includes a definition for "related."

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[62] Governor Owens' arguments can be found at pages 4 to 12 of the 10/1/03 House Judiciary Committee hearing on the SSTP at http://www.house.gov/judiciary/89635.PDF, and the NCSL counterarguments can be found at http://www.ncsl.org/standcomm/sctech/tax_Misconceptions.htm.
[63] Proposal available at http://www.mtc.gov/UNIFORM/Factor%20Presence.pdf.
[64] Available at http://www.mtc.gov/MEETINGS/Uniformity%20Materials/AffiliateNexusPropos07-13-04.pdf.

This proposal is similar to a California proposal of a few years ago - AB 2412 (Migden and Aroner). AB 2412 proposed to clarify the sales and use tax rules to provide that a retailer is responsible to collect sales tax if engaged in business in the state who processes orders electronically (by fax, via Internet, etc.). AB 2412 would also "prospectively clarify" that "a retailer is presumed to have an agent within the state," if it meets both of the following conditions. "(A) The retailer holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in California or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof; and (B) The retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to California purchasers". Thus, a company with an affiliate, subsidiary or related entity in the state would have the same nexus as the related entity if they sell the same type of products and there is a substantial ownership interest. A substantial ownership interest was defined by reference to federal law under Title 15, §78p (federal securities law) which refers to an ownership level in excess of 10%.

The apparent goal was to address the sponsor's concern that some bricks and mortar stores established separate legal entities for their e-commerce activities which did not have a physical presence in California and were therefore not required to collect sales tax from customers. However, case law supports the view that a separate legal entity does not have nexus of a related entity attributed to it. For example, in *Current, Inc. v. SBE*, 24 Cal. App 4th 382, 29 Cal Rptr.2d 407 (Ct. Appeal 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, did not have integrated operations and did not act as the alter ego or agent of the other for any purpose. The court noted that 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."

In the *Current* case, the court found that R&T §6203(g) (as it existed then) was unconstitutional under the commerce clause. This provision imposed a tax collection responsibility upon "any retailer owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business in this state." The language found to be unconstitutional in the *Current* case is quite similar to the proposed language of AB 2412.

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 (SCt Ohio 1995), and ***Bloomingdale's v. Dept. of Revenue***, 567 A.2d 773 (1989), aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992).

In contrast, in ***The Reader's Digest Association, Inc. v. Mahin***, 255 N.E.2d 458 (S Ct Ill 1970), cert denied 399 U.S. 919 (1970), the presence of subsidiaries in Illinois was attributed to the parent corporation. One of the subsidiaries solicited advertising for the parent corporation's magazine, thus acting as the parent's agent.

The difference between the approach of AB 2412 and existing law is that AB 2412 would label two corporations as being in an agency relationship without looking at what the one does for the other to indicate an agency relationship. Ownership and similar business activities do not create an agency relationship. In the *Reader's Digest* case, the subsidiary solicited advertising on behalf of the parent corporation, creating an agency relationship. In the other cases cited above, the situation was similar to that laid out in AB 2412 and attribution of one corporation's presence to another corporation was found to be unconstitutional. Rather than describing an agency relationship, AB 2412 seemed to take the approach that two legal entities are deemed to be just one entity if a substantial ownership relationship exists and they sell the same products or assist in advertising. This ignored many years of case law that treat separate legal entities as separate taxpayers unless there is a basis for piercing the corporate veil due to insufficient financing or independence.

AB 2412 was reintroduced as AB 81 in 2001, but subsequently changed to address energy issues. Similar legislation was introduced in 2003 (SB 103).

In 2001, Arkansas passed legislation similar in effect to AB 2412. [Act 922 (HB 1440), see http://www.arkleg.state.ar.us/ftproot/bills/2001/htm/hb1440.pdf.] In 2003, similar legislation passed in Alabama (H.B. 650).

As noted earlier, some businesses that established separate entities for online operations have modified their plans in order to satisfy customer wishes to be able to buy online and return to a store. When an online operations arranges for returns to a physical store, that store is likely its agent causing the online vendor to have nexus in the state and required to collect sales tax.

§ H.R. 3220 (108th Congress), the Business Activity Tax Simplification Act, would modify P.L. 86-272 by removing the provision that the prohibition on state taxation only applies to tangible personal property and by having the prohibition apply to more than just income taxes. The revised rule would apply to net income taxes and "other business activity taxes." "Other business activity tax" means "(i) a tax imposed on or measured by gross receipts, gross income, or gross profits; (ii) a business license tax; (iii) a business and occupation tax; (iv) a franchise tax; (v) a single business tax or a capital stock tax; or (vi) any other tax imposed by a State on a business for the right to do business in that State or measured by the amount of, or economic results of, business or related activity conducted in that State."

The jurisdictional standard to be satisfied for entities not incorporated or commercially domiciled in a state in order for a state to impose, assess or collect a net income tax or other business activity tax is a physical presence.

"A person has a physical presence in a State only if such person's business activities within such State include any of the following during the person's taxable year:

(1) Being an individual physically within the State, or assigning one or more employees to be in such State, on more than 21 days. However, the following shall be disregarded in determining whether such 21-day limit has been exceeded:

(A) Activities in connection with a possible purchase of goods or services for the business.

(B) Gathering news and covering events for print, broadcast, or other distribution through the media.

(C) Meeting government officials for purposes other than selling goods or services.

(D) Participation in educational or training conferences, seminars or other similar functions.

(E) Participating in charitable activities.

(2) Using the services of another person, except an employee, in such State, on more than 21 days to establish or maintain the market in that State, unless that other person performs similar functions on behalf of at least one additional business entity during the taxable year.

(3) The leasing or owning of tangible personal property or real property in such State on more than 21 days. However, the following shall be disregarded in determining whether such 21-day limit has been exceeded:

(A) Tangible property located in the State for purposes of being assembled, manufactured, processed, or tested by another person for the benefit of the owner or lessee, or used to furnish a service to the owner or lessee by another person.

(B) Marketing or promotional materials distributed in a State using mail or a common carrier, or as inserts in or components of publications.

(C) Any property to the extent used ancillary to an activity excluded from the computation of the 21-day period under paragraph (1) or (2)."

Exceptions exist, such as for performers and professional athletes, where the 21-day limit is changed to a 1-day limit.

Arguments in Favor of H.R. 3220[65]

- § A federal definition of nexus for the states will provide simplicity to businesses and reduce the likelihood of businesses being subject to tax on the same income or transaction in more than one state. It should also reduce the amount of litigation and its associated costs for businesses and governments in determining if a business has nexus in a state.
- § The physical presence standard "ensures that state tax impositions are appropriately borne only by those businesses that receive such benefits and protections [education, roads, police, fire, etc.] from the taxing state."[66]
- § The states will not lose revenue from H.R. 3220. "H.R. 3220 does not depart to any significant degree from what is now being done in the states." It should not reduce the tax burden of businesses, but better ensure that it is paid to the "correct jurisdiction."[67]
- § The physical presence standard ties to the permanent establishment approach used in international taxation and a similar approach by the states will be beneficial to the international standard. [68]
- § H.R. 3220 "is consistent with the constitutional separation of powers between the federal and state governments; … it would contribute to state economic growth and job creation, and; … it will maintain the principle of tax competition among the states."[69]

Arguments Against H.R. 3220[70]

- § The National League of Cities suggests that the H.R. 3220 approach could result in annual revenue losses to local governments of $60 billion.[71]
- § "HR 3220 would have a profound impact on the principles of federalism and the delicate balance in the federal/state relationship. For over 225 years, Congress had recognized the sovereign authority of states to raise revenue. HR 3220 would destroy this core principle and supplant the authority and judgment of state and local elected officials with the judgment of Congress." [MTC, 5/13/04 testimony before the House Judiciary Committee; available at http://www.mtc.gov.]
- § A focus only on physical presence ignores long-standing law and the concept of taxing income-producing activities sourced to a state. "HR 3220 establishes a system of

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[65] For materials submitted for a 5/13/04 hearing on H.R. 3220 before the House Judiciary Committee, see http://www.house.gov/judiciary/93657.PDF.
[66] Art Rosen, testimony on H.R. 3220 before the House Judiciary Committee on 5/13/04, page 3; available at http://www.house.gov/judiciary/rosen051304.pdf.
[67] Art Rosen, testimony on H.R. 3220 before the House Judiciary Committee on 5/13/04, page 12 - 13; available at http://www.house.gov/judiciary/rosen051304.pdf.
[68] Art Rosen, testimony on H.R. 3220 before the House Judiciary Committee on 5/13/04, page 14; available at http://www.house.gov/judiciary/rosen051304.pdf.
[69] Testimony of State Rep Jamie Van Fossen, before the House Judiciary Committee on 5/13/04; available at http://www.house.gov/judiciary/vanfossen051304.htm.
[70] For materials submitted for a 5/13/04 hearing on H.R. 3220 before the House Judiciary Committee, see http://www.house.gov/judiciary/93657.PDF.
[71] NLC press release 5/12/04, http://www.nlc.org/nlc_org/site/newsroom/.

'headquarters only' taxation that is directly counter to the system of sharing the tax base among the states where real economic activity is occurring. A 'headquarters only' system is a colonial concept of taxation that allows companies to earn income and benefit from the services of other jurisdictions, but does not ask them to make a fair payment for the use of those public services." [MTC, 5/13/04 testimony before the House Judiciary Committee; available at http://www.mtc.gov.]

- "Market states" do provide benefits to businesses. For example, "an educated, financially prosperous, secure market is essential for a business to prosper." State spending on education benefits a non-present business with customers in the state. Non-present vendors also benefit from police and fire protection and the court system. [MTC, 5/13/04 testimony before the House Judiciary Committee; available at http://www.mtc.gov.]
- Physical presence is not necessarily a simple concept, as evidenced by the litigation following the *Quill* decision.
- It would be almost impossible for states to track the 21 day type activities of companies to see if they have become present in the state. The exceptions to the 21 day rules will likely lead to planning solely to avoid taxation and attempts to generate income not taxed in any state.
- HR 3220 is contrary to the laws of all states.

c. Promotion of Technology (particularly broadband and VoIP)

- What is Broadband? There are a variety of definitions. An August 2002 CPUC report used the following FCC definition: "'broadband' or 'broadband services' means any transmission service that supports a minimum of 200 kbps in either direction (either downstream from the Internet to the user, or upstream from the user to the Internet) more than four times the speed attainable with a regular telephone line and a computer modem -->200 kbps versus 56 kbps. Consumer oriented broadband services can be provided by cable modem, digital subscriber lines (DSL) over traditional telephone lines, satellites, and terrestrial fixed wireless services."[72]

  The FCC broadband initiative defines "broadband technologies" as those that "encompass all evolving high-speed digital technologies that provide consumers integrated access to voice, high-speed data, video-on-demand, and interactive delivery services, are a fundamental component of the communications revolution. Fully-evolved broadband will:

  - Virtually eliminate geographic distance as an obstacle to acquiring information, and
  - Dramatically reduce the time it takes to access information."[73]

- Does Broadband Need to be Promoted? A 2/19/04 CBO report – "Is the United States Falling Behind in Adopting Broadband?" included the following points:[74]
  - Most U.S. users of Internet access services reach the Internet via dial-up services, which is slower than DSL or cable modem. There is concern that such users cannot access some of the new and emerging Internet applications and services which will lessen the economic and other benefits potentially to be derived.
  - While the U.S. has more broadband subscribers than other OECD countries, it ranks 6th based on number of subscribers per 100 people.

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[72] CPUC, August 2002 Broadband Report; available at http://www.cpuc.ca.gov/Published/Report/18279.htm.
[73] FCC at http://www.fcc.gov/broadband/Welcome.html.
[74] CBO, "Is the United States Falling Behind in Adopting Broadband?" 2/19/04; available at http://www.cbo.gov/ftpdocs/50xx/doc5082/02-19-Broadband.pdf.

- Statistics of usage likely don't tell the full story. Broadband in a household likely serves more than one member of that household. Many workers have access to broadband at work. Also, broadband access at schools and universities serve many individuals.
- The large number of subscribers in the U.S. is important because content and services will develop in response to numbers of subscribers – there needs to be a critical mass that can create economies of scale. The U.S. market also has advantages of wealth, fast growth rate, secure servers, large number of websites, and "unity" (a single language and a single set of laws and customs).
- The size of the U.S. market has led to some providers and retailers offering new services, such as a "major U.S. online bookseller" (probably refers to Amazon) digitizing about 33 million pages from about 120,000 books to enable customers to browse books online.
- The CBO paper – "Does the Residential Broadband Market Need Fixing?"[75] concluded that "the domestic market for broadband subscriptions was growing at such a fast rate that federal subsidies intended to boost that rate were unlikely to produce additional economic gains large enough to offset the potential costs that subsidies might impose in other parts of the economy. In contrast, an increase in the number of broadband connections in other nations provides an incentive to U.S. businesses and consumers to purchase high-speed access without giving rise to such costs."

§ Broadband Deployment: Various bills in Congress propose some incentive to encourage the development and/or purchase of broadband. Incentives include immediate expensing of equipment (rather than capitalization) and tax credits. See for example H.R. 4520, S. 1637, and H.R. 267.

d. International Proposals and Activities

§ Congressional Proposal to Encourage Companies to Bring Foreign Earning Back to the U.S. for Investment

Significant tax legislation (in terms of number of provisions and cost of them) passed in the House and Senate prior to the August recess – S. 1637 and H.R. 4520. As of August 25, 2004, it was unclear whether the House would appoint conferees so one bill could be taken back to both houses for a vote. These bills include a variety of international tax reforms and simplification measures. One of interest to state and local governments is a temporary lowering of the tax rate on repatriated foreign earning. The purpose is to encourage companies with earning from a foreign subsidiary to bring the funds back to the U.S. by having a rate lower than 35% applied to the funds, such as perhaps a 5.25% rate.

Query: Will states enact any measures to incentivize companies to invest such earning in their states?

§ OECD Developments:

(1) Tax Treaties: In November 2003, the Technical Advisory Group (TAG) established in 1999 on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits issued its draft report. The draft covers the emergence of new business models, current

[75] CBO report available at http://www.cbo.gov/ftpdocs/48xx/doc4868/12-03-Broadband.pdf.

treaty rules for taxing business profits, relevant tax principles, alternatives to the current rules, conclusions and examples. The TAG concluded that major modifications were not appropriate (at least at this time) particularly in light of the fact that e-commerce does not seem to have resulted in "any significant decrease to the tax revenues of capital importing countries." The TAG also notes that fundamental changes "should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that have been suggested so far appears to meet that condition." Such a change would "create difficult transition rules." Finally, the TAG noted that the effect of the new business models on direct tax revenues should continue to be monitored and further recommendations could be made after the TAG reviews comments received on the draft. See http://www.oecd.org/dataoecd/2/38/20655083.pdf.

(2) Further work by OECD: Additional reports are likely to be issued in 2004 on possible changes or recommendations for change to treaty provisions on permanent establishment (PE), effective place of management, business profits, consumption tax matters and tax administration. See http://www.oecd.org/taxation and http://www.oecd.org/dataoecd/45/19/20499630.pdf.

VI. Parameters for the Big Picture – Good Tax Policy and Internet Taxation

Consideration of the Guiding Principles of Good Tax Policy:[76]

Should Internet Commerce Be Subject To Sales & Use Tax?

Background

A state may only require a vendor to collect sales tax from customers if the vendor has a physical presence in the state. The e-commerce business model makes it relatively easy for vendors to have customers in all states, but only have physical presence in a few states. Thus, the vendor is only required to collect tax from a subset of customers. Customers in states where the vendor is not required to collect the sales tax are required to self-assess the use tax, but compliance is very low because most consumers do not know about the tax or do not maintain sufficient records to calculate the tax. In fact, many consumers who are not charged sales tax on a purchase from an Internet company, such as Amazon.com, likely assume either that the goods are not taxable or are exempt by the Internet Tax Freedom Act moratorium.

Some people and groups have suggested that e-commerce should not be subject to sales and use tax in order to help this form of commerce grow. Others may believe that sales tax from e-commerce sales should be subject to a different set of rules, such as having the vendor collect the tax based on its location (origin) rather than the customer's location (destination).

State and local governments are very interested in the issues of how sales and use tax is imposed and collected on e-commerce transactions because as this form of commerce grows, so will the amount of uncollected sales and use tax.

Analysis

The following ratings were derived by asking the question – Is the tax policy principle met if e-commerce transactions that are equivalent to traditional commerce transactions are not subject to sales and use tax?

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[76] The analysis uses the tax principles identified in AICPA, Tax Policy Statement No. 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf.

The key to the rating system:

+	This principle is satisfied for the item being evaluated
—	This principle is not satisfied for the item being evaluated
n/a	This principle is not affected by the item being evaluated
+/—	Some aspects of the item being evaluated meet the principle and other aspects do not

Principle	Application and Analysis	Rating
	Fairness	
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	Vendors selling goods and services online should be treated similarly to "Main Street" vendors selling the same goods and services and vice versa. While the cost of the sales and use tax is actually imposed on the buyer, rather than the seller, the compliance burden and price competition presented by the sales tax makes this a significant tax to vendors. Certainly, the compliance costs of the sales tax is greater for vendors with customers and taxable presence (nexus) in many states because of the varying sales tax rules among states and even some cities. But, is a multistate vendor similarly situated to a "Main Street" vendor with a single location? For example, assume vendors are required to collect sales tax from all customers, even in states where the vendor has no physical presence. A Main Street retailer with a store in San Jose would have much lower compliance costs than an online vendor also located only in San Jose, but who sells to customers in all states. The online vendor would need to determine where all of its customers live and charge the applicable sales tax (in contrast, under today's sales tax law, the Main Street vendor is allowed to just charge the San Jose rate to all customers that come into the store). Thus, arguments of "leveling the playing field" must consider the added compliance burden placed upon vendors required to collect tax based on the location of their buyers. While the prices charged by the multistate vendor and Main Street retailer would be the same if both are required to collect sales tax, the playing field is not level if the online vendor has greater compliance costs. *	—
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Sales and use taxes are visible because they are shown on the customer's invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that a sales tax exists on particular transactions. For example, many consumers who are not charged sales tax on online sales likely believe it is due to the Internet Tax Freedom Act when it is most likely due to the *Quill* decision. Also, customers likely don't know all that the sales tax applies to – for example, will it apply to "free" items obtained from online vendors? Does it apply to shipping charges?	+/—
	Operability	
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Lack of certainty in the tax system reduces the confidence taxpayers have that they have computed their tax liability correctly. Today, with over 6,000 jurisdictions able to assess sales tax and a lack of uniformity in the rules of these jurisdictions, as well as frequent changes to the rules, uncertainty exists for multistate vendors. In addition, vendors with customers in many states face uncertainty as to where they have tax filing obligations because the rules are not clear as to how much physical presence is needed to cause a vendor to have nexus (taxable presence) in a state. If e-commerce transactions were not subject to sales and use tax,	+

	certainty would exist.	
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Convenience of payment could exist in taxing e-commerce because a customer's credit card could be charged by the state taxing agency for the sales tax at the same time the vendor is paid.	n/a
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	The costs to taxpayers of complying with the sales tax rules of many states are quite significant for multistate vendors due to the large number of taxing jurisdictions and lack of uniformity in the rules.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	For multistate vendors, sales and use taxes fail to satisfy the simplicity principle. The multiple definitions, rules, registration procedures, exemptions, rates, filing and audit procedures result in a great deal of complexity. While not subjecting e-commerce transactions to sales and use tax would provide simplicity to e-commerce vendors, the system is still complex for other types of transactions.*	n/a
Minimum Tax Gap A tax should be structured to minimize non-compliance."	If e-commerce transactions were exempt from sales and use tax, no tax would be owed and current non-compliance would no longer exist.	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Today, less than 1% of retail sales are online sales. Thus, lost use tax is still small. It is really the potential growth of e-commerce that poses the greatest use tax loss for state and local governments. This growth will adversely affect the predictability and reliability of governments to determine their expected tax revenues. Also, for the few states, such as California, that do not tax products transferred electronically, as more and more items are transferred in digitized form, there will be a drop in the tax base. To improve the predictability and reliability (as well as stability) of sales tax revenues, improvements are needed to the system now while the revenue losses are relatively small. If e-commerce transactions were exempt from sales and use tax, state and local governments would lose an important source of revenue.	—
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	As evidenced by the earlier statements, the sales tax law is not neutral with respect to e-commerce for either vendors or customers. Sales tax has played a part in location and form of operation decisions for some vendors. For example, the founder of Amazon.com has stated that he purposely did not locate the company in California because he expected to have many customers there and did not want to have to charge sales tax.[77] Also, as noted in the testimony of Peter Lowy for the e-Fairness Coalition, some brick-and-mortar vendors established separate subsidiaries for their online sales in order to reduce the number of states	—

[77] David Streitfeld, "Booking the Future; Does Amazon.com Show That Publishing Clicks on the Internet?" *The Washington Post*, July 10, 1998, page A1. Also see Chip Bayers, "The Inner Bezos," *Wired*, March 1999, page 115, 174. The *Wired* article notes that Amazon.com also has a warehouse in Delaware that has no state sales tax, and will open a third in Nevada to help serve its large California customer base (without having a presence in California).

	where the online entity would have a physical presence, and thus, a sales tax collection obligation.[78] Thus, sales tax has played a significant role in taxpayer location and form of operation decisions and is not neutral. Also, the current situation where remote (non-present) vendors are not required to collect sales tax can cause sales tax to play a part in a customer's decision as to how and where to purchase goods and services. For example, a customer may decide to purchase a computer online to avoid sales tax rather than purchase the computer from a Main Street vendor. Also, in a few states, such as California, software (and other digitized goods) transferred online are not subject to sales tax, while their tangible counterpart (that is, a boxed music CD or software) is subject to sales tax. Thus, the sales tax law is not neutral in that it will play a role in a customer's decision as to how and where to purchase certain products.*	
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	This is the argument to support not taxing online sales – that doing so will impede growth of the Internet. However, the Internet seems to be growing without any indication that it is due to the current tax rules. For example, the Department of Commerce reported that e-commerce sales increased 33.5% in first quarter 2001 over first quarter 2000.[79] In early 1998, prior to the enactment of the Internet Tax Freedom Act, it was reported that the number of Internet hosts was growing at a rate of 40% to 50% annually.[80] While some studies have found that taxation of online shopping will reduce online shopping, the issue isn't really so simple as to argue that taxes should be avoided. Today, online purchases are subject to sales and use tax in all states that impose a sales tax. However, the ability of states to collect use tax on remote online sales is quite low. Also, will imposition of taxes eliminate the sale, or just move it from the Internet to Main Street? Or, will Internet vendors find some way to reduce costs to help "compensate" for the added costs of both shipping and sales tax?	**+/—**

* Examples of further analysis to identify how a minus might be addressed:

Equity and fairness: Equity and fairness between Main Street and online vendors requires some consideration of the compliance costs each faces. This principle could be achieved by 1) requiring the Main Street retailer to charge sales tax based on where its customers live, 2) allowing the online vendor to charge San Jose/California sales tax to all customers regardless of where they live (origin approach), 3) providing compensation to the online vendor for the extra compliance costs, or 4) providing a mechanism, such as a third party collector funded by the government, to handle the online vendor's compliance activities.

Simplicity: Improvements to simplify the sales tax system include uniformity of rules and procedures, better use of technology to compute and collect the tax, use of a third party to compute and remit the tax, or perhaps a federal level tax to replace the state sales tax. An example of efforts to simplify sales and use tax compliance is the Streamlined Sales Tax Project (http://www.streamlinedsalestax.org).

Neutrality: Example of further analysis to identify how a minus might be addressed: The sales tax could be made more neutral by requiring sales tax to be charged by remote vendors, enforcing use tax rules (customers making taxable purchases from remote vendors would be required to remit use tax on their own), exempting all digitized items from sales tax along with their tangible counterpart, or taxing all products regardless of how they are transferred.

[78] Hearing on Internet taxation (107th Congress) at http://www.senate.gov/~commerce/hearings/0314low.pdf.
[79] Department of Commerce, press release of May 16, 2001, http://www.census.gov/mrts/www/current.html.
[80] James Glave, "Dramatic Internet Growth Continues," *Wired News*, February 16, 1998, http://www.wired.com/news/topstories/0,1287,10323,00.html

Appendix A

Internet Tax Moratorium Statutory Provisions – As Proposed to be Amended by S. 150

Only Sections 1101 and 1004 of the statute are provided below because these are the relevant parts in any extension of the moratorium.

SEC. 1101. MORATORIUM.

(a) Moratorium.**--**No State or political subdivision thereof ~~shall~~ may impose any of the following taxes during the period beginning on ~~October~~ November 1, ~~1998~~2003, and ending ~~on~~ November 1, ~~2003~~ 2007:

(1) Taxes on Internet. ~~access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and~~

(2) Multiple or discriminatory taxes on electronic commerce.

(b) Preservation of State and Local Taxing Authority.**--** Except as provided in this section, nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.

(c) Liabilities and Pending Cases.**--**Nothing in this title affects liability for taxes accrued and enforced before the date of enactment of this Act, nor does this title affect ongoing litigation relating to such taxes.

~~(d) Definition of Generally Imposed and Actually Enforced.--For purposes of this section, a tax has been generally imposed and actually enforced prior to October 1, 1998, if, before that date, the tax was authorized by statute and either--~~

~~(1) a provider of Internet access services had a reasonable opportunity to know by virtue of a rule or other public proclamation made by the appropriate administrative agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; or~~

~~(2) a State or political subdivision thereof generally collected such tax on charges for Internet access.~~

(~~e~~d) Exception to Moratorium.**--**

(1) In general.**--**Subsection (a) shall also not apply in the case of any person or entity who knowingly and with knowledge of the character of the material, in interstate or foreign commerce by means of the World Wide Web, makes any communication for commercial purposes that is available to any minor and that includes any material that is harmful to minors unless such person or entity has restricted access by minors to material that is harmful to minors**--**

(A) by requiring use of a credit card, debit account, adult access code, or adult personal identification number;

(B) by accepting a digital certificate that verifies age; or

(C) by any other reasonable measures that are feasible under available technology.

(2) Scope of exception.**--**For purposes of paragraph (1), a person shall not be considered to making a communication for commercial purposes of material to the extent that the person is**--**

(A) a telecommunications carrier engaged in the provision of a telecommunications service;

(B) a person engaged in the business of providing an Internet access service;

(C) a person engaged in the business of providing an Internet information location tool; or

(D) similarly engaged in the transmission, storage, retrieval, hosting, formatting, or translation (or any combination thereof) of a communication made by another person, without selection or alteration of the communication.

(3) Definitions.**--**In this subsection:

(A) By means of the world wide web.**--**The term ``by means of the World Wide Web'' means by placement of material in a computer server-based file archive so that it is publicly accessible, over the Internet, using hypertext transfer protocol, file transfer protocol, or other similar protocols.

(B) Commercial purposes; engaged in the business.**--**

(i) Commercial purposes.--A person shall be considered to make a communication for commercial purposes only if such person is engaged in the business of making such communications.

(ii) Engaged in the business.--The term ``engaged in the business'' means that the person who makes a communication, or offers to make a communication, by means of the World Wide Web, that includes any material that is harmful to minors, devotes time, attention, or labor to such activities, as a regular course of such person's trade or business, with the objective of earning a profit as a result of such activities (although it is not necessary that the person make a profit or that the making or offering to make such communications be the person's sole or principal business or source of income). A person may be considered to be engaged in the business of making, by means of the World Wide Web, communications for commercial purposes that include material that is harmful to minors, only if the person knowingly causes the material that is harmful to minors to be posted on the World Wide Web or knowingly solicits such material to be posted on the World Wide Web.

(C) Internet.--The term ``Internet'' means collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.

(D) Internet access service.--The term ``Internet access service'' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to consumers. ~~Such term does not include telecommunications services~~. 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.

(E) Internet information location tool.--The term ``Internet information location tool'' means a service that refers or links users to an online location on the World Wide Web. Such term includes directories, indices, references, pointers, and hypertext links.

(F) Material that is harmful to minors.--The term ``material that is harmful to minors'' means any communication, picture, image, graphic image file, article, recording, writing, or other matter of any kind that is obscene or that--

(i) the average person, applying contemporary community standards, would find, taking the material as a whole and with respect to minors, is designed to appeal to, or is designed to pander to, the prurient interest;

(ii) depicts, describes, or represents, in a manner patently offensive with respect to minors, an actual or simulated sexual act or sexual contact, an actual or simulated normal or perverted sexual act, or a lewd exhibition of the genitals or post-pubescent female breast; and

(iii) taken as a whole, lacks serious literary, artistic, political, or scientific value for minors.

(G) Minor.--The term ``minor'' means any person under 17 years of age.

(H) Telecommunications carrier; telecommunications service.--The terms ``telecommunications carrier'' and ``telecommunications service'' have the meanings given such terms in section 3 of the Communications Act of 1934 (47 U.S.C. 153).

(~~f~~e) Additional Exception to Moratorium.--

(1) In general.--Subsection (a) shall also not apply with respect to an Internet access provider, unless, at the time of entering into an agreement with a customer for the provision of Internet access services, such provider offers such customer (either for a fee or at no charge) screening software that is designed to permit the customer to limit access to material on the Internet that is harmful to minors.

(2) Definitions.--In this subsection:

(A) Internet access provider.--The term ``Internet access provider'' means a person engaged in the business of providing a computer and communications facility through which a customer may obtain access to the Internet, but does not include a common carrier to the extent that it provides only telecommunications services.

(B) Internet access services.--The term ``Internet access services'' means the provision of computer and communications services through which a customer using a computer and a modem or other communications device may obtain access to the Internet, but does not include telecommunications services provided by a common carrier.

(C) Screening software.--The term ``screening software'' means software that is designed to permit a person to limit access to material on the Internet that is harmful to minors.

(3) Applicability.--Paragraph (1) shall apply to agreements for the provision of Internet access services entered into on or after the date that is 6 months after the date of enactment of this Act.

SEC. 1104. GRANDFATHERING OF STATES THAT TAX INTERNET ACCESS.

(a) Pre-October 1998 Taxes-

`(1) IN GENERAL- Section 1101(a) does not apply to a tax on Internet access that was generally imposed and actually enforced prior to October 1, 1998, if, before that date, the tax was authorized by statute and either--

`(A) a provider of Internet access services had a reasonable opportunity to know, by virtue of a rule or other public proclamation made by the appropriate administrative agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; or

`(B) a State or political subdivision thereof generally collected such tax on charges for Internet access.

`(2) TERMINATION- This subsection shall not apply after November 1, 2007.

`(b) Pre-November 2003 Taxes-

`(1) IN GENERAL- Section 1101(a) does not apply to a tax on Internet access that was generally imposed and actually enforced as of November 1, 2003, if, as of that date, the tax was authorized by statute and--

`(A) a provider of Internet access services had a reasonable opportunity to know by virtue of a public rule or other public proclamation made by the appropriate administrative agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; and

`(B) a State or political subdivision thereof generally collected such tax on charges for Internet access.

`(2) TERMINATION- This subsection shall not apply after November 1, 2005.

SEC. ~~1104~~1105. DEFINITIONS.

For the purposes of this title:

(1) Bit tax.--The term ``bit tax'' means 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.

(2) Discriminatory tax.--The term ``discriminatory tax'' means--

(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) ~~except with respect to a tax (on Internet access) that was generally imposed and actually enforced prior to October 1, 1998,~~ 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.

(3) Electronic commerce.--The term ``electronic commerce'' means any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access.

(4) Internet.--The term ``Internet'' means collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.

(5) Internet access.--The term ``Internet access'' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. ~~Such term does not include telecommunications services.~~ 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.

(6) Multiple tax.--

(A) In general.--The term ``multiple tax'' means any tax that is imposed by one State or political subdivision thereof 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 certificate) for taxes paid in other jurisdictions.

(B) Exception.--Such term shall not include a sales or use tax imposed by a State and 1 or more political subdivisions thereof on the same electronic commerce or a tax on persons engaged in electronic commerce which also may have been subject to a sales or use tax thereon.

(C) Sales or use tax.--For purposes of subparagraph (B), the term ``sales or use tax'' means a tax that is imposed on or incident to the sale, purchase, storage, consumption, distribution, or other use of tangible personal property or services as may be defined by laws imposing such tax and which is measured by the amount of the sales price or other charge for such property or service.

(7) State.--The term ``State'' means any of the several States, the District of Columbia, or any commonwealth, territory, or possession of the United States.

(8) Tax.--

(A) In general.--The term ``tax'' means--

(i) any charge imposed by any governmental entity for the purpose of generating revenues for governmental purposes, and is not a fee imposed for a specific privilege, service, or benefit conferred; or

(ii) the imposition on a seller of an obligation to collect and to remit to a governmental entity any sales or use tax imposed on a buyer by a governmental entity.

(B) Exception.--Such term does not include any franchise fee or similar fee imposed by a State or local franchising authority, pursuant to section 622 or 653 of the Communications Act of 1934 (47 U.S.C. 542, 573), or any other fee related to obligations or telecommunications carriers under the Communications Act of 1934 (47 U.S.C. 151 et seq.).

(9) Telecommunications service.--The term ``telecommunications service'' has the meaning given such term in section 3(46) of the Communications Act of 1934 (47 U.S.C. 153(46)) and includes communications services (as defined in section 4251 of the Internal Revenue Code of 1986).

(10) Tax on Internet access.--~~The term ``tax on Internet access'' means a tax on Internet access, including the enforcement or application of any new or preexisting tax on the sale or use of Internet services unless such tax was generally imposed and actually enforced prior to October 1, 1998.~~

(A) In General – The term 'tax on Internet access' means a tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access and regardless of the terminology used to describe the tax.

(B) General Exception – The term 'tax on Internet access' does not include a tax levied upon or measured by net income, capital stock, net worth, or property value.'

SEC. 1106. ACCOUNTING RULE.

(a) IN GENERAL- If charges for Internet access are aggregated with and not separately stated from charges for telecommunications services or other charges that are subject to taxation, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business.

(b) DEFINITIONS- In this section:

`(1) CHARGES FOR INTERNET ACCESS- The term `charges for Internet access' means all charges for Internet access as defined in section 1105(5).

`(2) CHARGES FOR TELECOMMUNICATIONS SERVICES- The term `charges for telecommunications services' means all charges for telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access.

SEC. 1107. EFFECT ON OTHER LAWS.

(a) UNIVERSAL SERVICE- Nothing in this Act shall prevent the imposition or collection of any fees or charges used to preserve and advance Federal universal service or similar State programs--

(1) authorized by section 254 of the Communications Act of 1934 (47 U.S.C. 254); or

(2) in effect on February 8, 1996.

(b) 911 and E-911 Services- Nothing in this Act shall prevent the imposition or collection, on a service used for access to 911 or E-911 services, of any fee or charge specifically designated or presented as dedicated by a State or political subdivision thereof for the support of 911 or E-911 services if no portion of the revenue derived from such fee or charge is obligated or expended for any purpose other than support of 911 or E-911 services.

(c) NON-TAX REGULATORY PROCEEDINGS- Nothing in this Act shall be construed to affect any Federal or State regulatory proceeding that is not related to taxation.

SEC. 1108. EXCEPTION FOR VOICE SERVICES OVER THE INTERNET.

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.

Non-Code Provisions:

SEC. 7. GAO STUDY OF EFFECTS OF INTERNET TAX MORATORIUM ON STATE AND LOCAL GOVERNMENTS AND ON BROADBAND DEPLOYMENT.

The Comptroller General shall conduct a study of the impact of the Internet tax moratorium, including its effects on the revenues of State and local governments and on the deployment and adoption of broadband technologies for Internet access throughout the United States, including the impact of the Internet Tax Freedom

Act (47 U.S.C. 151 note) on build-out of broadband technology resources in rural under served areas of the country. The study shall compare deployment and adoption rates in States that tax broadband Internet access service with States that do not tax such service, and take into account other factors to determine whether the Internet Tax Freedom Act has had an impact on the deployment or adoption of broadband Internet access services. The Comptroller General shall report the findings, conclusions, and any recommendations from the study to the Senate Committee on Commerce, Science, and Transportation and the House of Representatives Committee on Energy and Commerce no later than November 1, 2005.

SEC. 8. EFFECTIVE DATE.

The amendments made by this Act take effect on November 1, 2003.

Appendix B

Internet Tax Moratorium Statutory Provisions – As Proposed to be Amended by H.R. 49

Only Sections 1101 and 1004 of the statute are provided below because these are the relevant parts in any extension of the moratorium.

SEC. 1101. MORATORIUM.

(a) Moratorium.--No State or political subdivision thereof ~~shall~~ may impose any of the following taxes: ~~during the period beginning on October 1, 1998, and ending on November 1, 2003 --~~

(1) Taxes on Internet access.~~, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and~~

(2) Multiple or discriminatory taxes on electronic commerce.

(b) Preservation of State and Local Taxing Authority.-- Except as provided in this section, nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.

(c) Liabilities and Pending Cases.--Nothing in this title affects liability for taxes accrued and enforced before the date of enactment of this Act, nor does this title affect ongoing litigation relating to such taxes.

~~(d) Definition of Generally Imposed and Actually Enforced.--For purposes of this section, a tax has been generally imposed and actually enforced prior to October 1, 1998, if, before that date, the tax was authorized by statute and either--~~

~~(1) a provider of Internet access services had a reasonable opportunity to know by virtue of a rule or other public proclamation made by the appropriate administrative agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; or~~

~~(2) a State or political subdivision thereof generally collected such tax on charges for Internet access.~~

(e) Exception to Moratorium.--

(1) In general.--Subsection (a) shall also not apply in the case of any person or entity who knowingly and with knowledge of the character of the material, in interstate or foreign commerce by means of the World Wide Web, makes any communication for commercial purposes that is available to any minor and that includes any material that is harmful to minors unless such person or entity has restricted access by minors to material that is harmful to minors--

(A) by requiring use of a credit card, debit account, adult access code, or adult personal identification number;

(B) by accepting a digital certificate that verifies age; or

(C) by any other reasonable measures that are feasible under available technology.

(2) Scope of exception.--For purposes of paragraph (1), a person shall not be considered to making a communication for commercial purposes of material to the extent that the person is--

(A) a telecommunications carrier engaged in the provision of a telecommunications service;

(B) a person engaged in the business of providing an Internet access service;

(C) a person engaged in the business of providing an Internet information location tool; or

(D) similarly engaged in the transmission, storage, retrieval, hosting, formatting, or translation (or any combination thereof) of a communication made by another person, without selection or alteration of the communication.

(3) Definitions.--In this subsection:

(A) By means of the world wide web.--The term ``by means of the World Wide Web'' means by placement of material in a computer server-based file archive so that it is publicly accessible, over the Internet, using hypertext transfer protocol, file transfer protocol, or other similar protocols.

(B) Commercial purposes; engaged in the business.--

(i) Commercial purposes.--A person shall be considered to make a communication for commercial purposes only if such person is engaged in the business of making such communications.

(ii) Engaged in the business.--The term ``engaged in the business'' means that the person who makes a communication, or offers to make a communication, by means of the World Wide Web, that includes any material that is harmful to minors, devotes time, attention, or labor to such activities, as a regular course of such person's trade or business, with the objective of earning a profit as a result of such activities (although it is not necessary that the person make a profit or that the making or offering to make such communications be the person's sole or principal business or source of income). A person may be considered to be engaged in the business of making, by means of the World Wide Web, communications for commercial purposes that include material that is harmful to minors, only if the person knowingly causes the material that is harmful to minors to be posted on the World Wide Web or knowingly solicits such material to be posted on the World Wide Web.

(C) Internet.--The term ``Internet'' means collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.

(D) Internet access service.--The term ``Internet access service'' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to consumers. Such term does not include telecommunications services except to the extent such services are used to provide Internet access.

(E) Internet information location tool.--The term ``Internet information location tool'' means a service that refers or links users to an online location on the World Wide Web. Such term includes directories, indices, references, pointers, and hypertext links.

(F) Material that is harmful to minors.--The term ``material that is harmful to minors'' means any communication, picture, image, graphic image file, article, recording, writing, or other matter of any kind that is obscene or that--

(i) the average person, applying contemporary community standards, would find, taking the material as a whole and with respect to minors, is designed to appeal to, or is designed to pander to, the prurient interest;

(ii) depicts, describes, or represents, in a manner patently offensive with respect to minors, an actual or simulated sexual act or sexual contact, an actual or simulated normal or perverted sexual act, or a lewd exhibition of the genitals or post-pubescent female breast; and

(iii) taken as a whole, lacks serious literary, artistic, political, or scientific value for minors.

(G) Minor.--The term ``minor'' means any person under 17 years of age.

(H) Telecommunications carrier; telecommunications service.--The terms ``telecommunications carrier'' and ``telecommunications service'' have the meanings given such terms in section 3 of the Communications Act of 1934 (47 U.S.C. 153).

(f) Additional Exception to Moratorium.--

(1) In general.--Subsection (a) shall also not apply with respect to an Internet access provider, unless, at the time of entering into an agreement with a customer for the provision of Internet access services, such provider offers such customer (either for a fee or at no charge) screening software that is designed to permit the customer to limit access to material on the Internet that is harmful to minors.

(2) Definitions.--In this subsection:

(A) Internet access provider.--The term ``Internet access provider'' means a person engaged in the business of providing a computer and communications facility through which a customer may obtain access to the Internet, but does not include a common carrier to the extent that it provides only telecommunications services.

(B) Internet access services.--The term ``Internet access services'' means the provision of computer and communications services through which a customer using a computer and a modem or other communications device may obtain access to the Internet, but does not include telecommunications services provided by a common carrier.

(C) Screening software.--The term ``screening software'' means software that is designed to permit a person to limit access to material on the Internet that is harmful to minors.

(3) Applicability.--Paragraph (1) shall apply to agreements for the provision of Internet access services entered into on or after the date that is 6 months after the date of enactment of this Act.

SEC. 1104. DEFINITIONS.

For the purposes of this title:

(1) Bit tax.--The term ``bit tax'' means 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.

(2) Discriminatory tax.--The term ``discriminatory tax'' means--

(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) ~~except with respect to a tax (on Internet access) that was generally imposed and actually enforced prior to October 1, 1998,~~ 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.

(3) Electronic commerce.--The term ``electronic commerce'' means any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access.

(4) Internet.--The term ``Internet'' means collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.

(5) Internet access.--The term ``Internet access'' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content,

information, and other services as part of a package of services offered to users. Such term does not include telecommunications services except to the extent such services are used to provide Internet access.

(6) Multiple tax.--

(A) In general.--The term ``multiple tax'' means any tax that is imposed by one State or political subdivision thereof 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 certificate) for taxes paid in other jurisdictions.

(B) Exception.--Such term shall not include a sales or use tax imposed by a State and 1 or more political subdivisions thereof on the same electronic commerce or a tax on persons engaged in electronic commerce which also may have been subject to a sales or use tax thereon.

(C) Sales or use tax.--For purposes of subparagraph (B), the term ``sales or use tax'' means a tax that is imposed on or incident to the sale, purchase, storage, consumption, distribution, or other use of tangible personal property or services as may be defined by laws imposing such tax and which is measured by the amount of the sales price or other charge for such property or service.

(7) State.--The term ``State'' means any of the several States, the District of Columbia, or any commonwealth, territory, or possession of the United States.

(8) Tax.--

(A) In general.--The term ``tax'' means--

(i) any charge imposed by any governmental entity for the purpose of generating revenues for governmental purposes, and is not a fee imposed for a specific privilege, service, or benefit conferred; or

(ii) the imposition on a seller of an obligation to collect and to remit to a governmental entity any sales or use tax imposed on a buyer by a governmental entity.

(B) Exception.--Such term does not include any franchise fee or similar fee imposed by a State or local franchising authority, pursuant to section 622 or 653 of the Communications Act of 1934 (47 U.S.C. 542, 573), or any other fee related to obligations or telecommunications carriers under the Communications Act of 1934 (47 U.S.C. 151 et seq.).

(9) Telecommunications service.--The term ``telecommunications service'' has the meaning given such term in section 3(46) of the Communications Act of 1934 (47 U.S.C. 153(46)) and includes communications services (as defined in section 4251 of the Internal Revenue Code of 1986).

(10) Tax on Internet access.--The term ``tax on Internet access'' means a tax on Internet access, including the enforcement or application of any new or preexisting tax on the sale or use of Internet services. ~~unless such tax was generally imposed and actually enforced prior to October 1, 1998.~~