INTERSTATE COMMERCE AND THE FUTURE OF STATE SALES AND USE TAXES

The way in which consumers buy goods and services has changed dramatically in the last several decades. Huge supermarkets and malls have replaced neighborhood stores. The growth of the mail order catalogue has allowed consumers to purchase items without ever leaving their homes. Now, the Internet may revolutionize the way that goods and services reach consumers.

Today, Internet sales continue to make up a relatively small percentage of overall sales in the U.S. economy. However, Internet sales have grown dramatically in only the few years since businesses began offering products over the Internet. Although many groups and organizations have attempted to forecast the growth of Internet sales into the future, according to the United States General Accounting Office, there simply is not enough data to make a reliable forecast.[1] While it is uncertain how fast and to what extent Internet sales will grow in the future, there seems to be a consensus that Internet commerce will soon play a large role in the U.S. economy.[2]

With this vast and growing marketplace on the horizon, states are greedily eyeing Internet transactions as a new source for potential revenues. Since Mississippi adopted the first sales tax in 1935,[3] forty-four out of the remaining forty-nine states have adopted sales taxes.[4] Total sales tax revenues in 1998 totaled $156 billion, which was thirty-three percent of total state tax revenues. In states without an income tax, more than fifty percent of state revenues are provided by the sales tax.[5] Additionally, local governments in two-thirds of the states now have sales taxes.[6] If Internet commerce grows as expected, and if states continue to rely on the sales tax as a primary

1. *See* U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain* (June 30, 2000), *at* http://www.unclefed.com/GAOReports/ggd00-165_sum.html. The GAO concluded that there was simply too much uncertainty over future Internet sales and their impact on local sales to accurately forecast the effects of Internet commerce on state revenues.

2. *See id.*

3. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION II: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 12.02 (3d ed. 2001).

4. *Id.* The only states today without a sales tax are Delaware, Montana, New Hampshire, and Oregon. *Id.*

5. *Id.* Florida, Tennessee, Texas, and Washington do not have income taxes and depend heavily on their sales tax for revenues. *Id.*

6. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 12.02.

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source of revenue, then states may have to impose a tax on Internet transactions.[7]

Despite the states' desire to tax the growing tax base of Internet commerce, constitutional and practical burdens lie in their way. Internet commerce by its nature will almost always be interstate commerce, and will therefore be subject to the plenary powers of Congress under the Commerce Clause of the Constitution.[8] The nature of Internet commerce makes the transactions difficult to fit into existing state tax systems and fears of multiple taxation exist. Additionally, many people question the taxation of Internet commerce on policy grounds, fearing that subjecting it to state sales taxation might stifle the growth of this important new segment of the U.S. economy. Because of these fears, Congress passed The Internet Tax Freedom Act in 1998, imposing a three-year moratorium on state taxation of Internet commerce with the exception of existing taxes, such as state sales and use taxes in their existing framework.[9] The Act also created the Advisory Commission on Electronic Commerce to study and make recommendations on the tax treatment of electronic commerce.[10] The Advisory Commission submitted a report to Congress in April of 2000 including a majority proposal.[11] However, the Commission's proposal failed to get the required two-thirds supermajority of votes required under the Act to make findings and proposals.[12] On November 28, 2001, Congress extended the moratorium for an additional three years.[13]

This Comment will discuss and analyze the Constitutional issues regarding sales and use taxes on Internet commerce. Part I will provide necessary background on state sales taxes and on the mechanics of an Internet transaction. Part II will identify, explain, and analyze constitutional issues as they relate to sales and use taxes in general and specifically as applied to mail order and Internet transactions. Part III will conclude.

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7. However, some argue that state economies will not suffer by permanently exempting Internet commerce from sales tax. Proponents of a tax-free Internet argue that taxing the Internet will greatly inhibit its growth, while allowing it to grow tax free, will increase GDP giving a boost to states' economies. *See* Adam D. Thierer, *Why Congress Should Counter Efforts to Tax Internet Commerce* (Oct. 5, 1999), *at* http://www.heritage.org/Research/InternetandTechnology/EM628.cfm.

8. U.S. CONST. art. I, § 8, cl. 3.

9. 47 U.S.C. §§ 1100-1104 (2001).

10. *Id.*

11. ADVISORY COMM'N ON ELEC. COMMERCE, REPORT TO CONGRESS (Apr. 2000), *available at* http://www.ecommercecommission.org/acec_report.pdf [hereinafter COMMERCE].

12. *Id.*

13. 47 U.S.C. §§ 1100-1104 (2001).

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I. BACKGROUND

A. Sales and Use Taxes

1. Sales Tax

The term "sales tax" can include a large number of different types of taxes.[14] While more than one of these various taxes could be applicable to Internet transactions, this Comment will focus on the retail sales tax for purposes of simplicity and because the retail sales tax is "[t]he most significant form of sales taxation in the United States."[15] The retail sales tax, theoretically, is imposed on a purchaser who purchases tangible personal property within the taxing state for personal consumption.[16] However, in practice, many business purchasers are subject to sales tax.[17] This purchaser is ultimately liable for the payment of the tax, although states require the vendor to collect and remit the tax.[18]

It is important to note that a sales tax by definition in most states is imposed on the sale of all tangible personal property except property specifically excluded, but it is not imposed on the sale of services unless the service is specifically included.[19] The sale of intangible property is excluded from this definition; therefore, properly defining property as tangible or intangible is vitally important to determining sales tax liability. Ordinarily this is not a major problem. However, with the creation of new types of property for sale on the Internet, problems will certainly arise in classifying the property as tangible or intangible.

It is also important to note that the sales tax is only imposed on purchases within a state. This occurs when the buyer and purchaser are located in the same state. When the buyer and purchaser are not located in the same state, which is often the case in mail order and Internet purchases, the sales tax may not apply to the transaction. The state may nevertheless capture revenue from these transactions by imposing a compensating tax known as a use tax, which is discussed in the following paragraph.

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14. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 12.01. The term sales tax includes:

> (1) retail sales tax; (2) single-stage excise on sales by manufactures or wholesalers; (3) multiple-stage "gross sales" or "turnover" tax, applying to all sales by manufacturers, wholesalers, and retailers; (4) "gross income" tax, applying not only to sales of tangible commodities but also to gross income from services; finally (5) the tax on "value added" may be considered a general consumption, as well as a general business, tax.

Id.

15. *Id.*
16. *Id.*
17. *Id.* ¶ 12.04[4]. While theoretically, the retail sales tax should only be paid when the goods reach the ultimate consumer, in reality a manufacturer will likely be taxed on its office supplies despite the fact that the cost of those supplies is ultimately passed on to the ultimate consumer of its manufactured product, who then pays a retail sales tax on it. This phenomenon results in a "pyramiding" effect on the retail sales tax. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 12.04[4].
18. *Id.* ¶ 12.01.
19. *Id.* ¶ 12.04[1].

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2. Use Tax

A use tax is defined in most states as a tax on the use, storage, or consumption of tangible personal property within the state.[20] This tax is meant to complement the sales tax by taxing the use of goods inside the state on which no sales tax has been paid.[21] For the most part, the use tax is a tax on goods used within a state that were purchased in another state.[22] To withstand a Commerce Clause challenge, any use tax must provide a credit against any sales tax paid in another state to prevent multiple taxation.[23] Most Internet sales and mail order sales escape the sales tax but fall prey to the use tax. However, as will be discussed in Part II, the Commerce Clause, as interpreted by the United States Supreme Court, prevents a state from forcing a vendor who does not have a "physical presence" within the taxing state to collect its use tax.[24]

B. Ordinary In-Store Transaction

In a traditional in-store transaction, in which a consumer purchases tangible personal property, the buyer and the seller are, by necessity, located within the same state. That state is the situs of the transaction and may impose a sales tax on the transaction. The state may require the vendor to collect and remit the sales tax.

C. Mail Order Transaction

In a mail order transaction the buyer and seller may or may not be located in the same state. For large mail order companies making sales in many states, the probability is high that most sales will be to purchasers outside of the vendor's state. Vendors typically advertise and send catalogs into target states. Purchasers read the catalogs, make a decision to buy an item, and send in an order to the vendor. The vendor then processes the order and mails the goods to the purchaser.

In a mail order transaction, the seller is purposefully availing itself of a market in states in which it sends catalogs. This economic presence in a taxing state, as will be discussed in Part II, will give the state the power to tax the vendor without violating the vendor's due process rights. However, this may not be enough of a presence to force the vendor to collect the tax under the Commerce Clause.

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20. *Id.* ¶16.02.
21. *Id.*
22. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 16.01[2].
23. *Id.*
24. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

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D. Internet Transaction

1. Basics on How the Internet Works

The Internet is a network of independent computers connected to one another that share information with one another. It is a system of electronic signals output from one computer and input into others. Computers called servers act as traffic directors to keep these signals flowing in an orderly manner. Each computer has its own address with information flowing between computers over wires and cables. However, the path is not direct. The servers route and reroute in an attempt to find the most efficient path for the electronic impulses to get to the other computer. The Internet does not recognize the existence of geographic boundaries.

2. The Internet Commerce Transaction

In an Internet commerce transaction, the buyer, usually by either typing in an Internet address or through a search engine, accesses a Web site of a vendor. The electronic signals between the buyer's and vendor's computers travel without respect to geographic boundaries, as described above. The buyer may then purchase goods or services from the vendor in a variety of ways. He may purchase directly over the Internet, sending an order to the vendor, which will then mail the goods to the purchaser much like in a mail order transaction. Alternatively, the buyer may receive a telephone number or mailing address on the vendor's Web site and place an order. This is almost identical to a traditional mail order transaction. Finally, the buyer may buy certain digital property immediately via the Internet by downloading onto his computer. This is the most difficult Internet transaction to analogize to mail order.

3. Legal Conceptualization of the Internet

In order for a state to adjudicate a dispute arising through an Internet connection or to tax an Internet transaction, the state must have personal jurisdiction in order to satisfy the Due Process Clause. The test for personal jurisdiction has long required some sort of presence or "minimum contacts."[25] However, in an Internet transaction, the answer to the minimum contacts question is unclear. Neither the courts nor commentators seem to be able to reach a consensus as to when, or if, Internet users are "present" in a state.

There are three basic views of presence concerning the Internet. One view, known as "virtual presence," considers a person who places a message on the Internet to be "present" in all geographical areas where the sig-

25. *See, e.g.*, Int'l Shoe Co., Inc. v. Washington, 326 U.S. 310 (1945).

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nal could be intercepted.[26] Thus, under this conceptualization, a person who sets up a Web site is present in every jurisdiction in the United States at the same time.[27] Another view, known as the "cyberspace model," considers the Internet as divorced from the physical world and thus subject to no geographic jurisdiction.[28] Under this view, information traveling over the Internet exists only in cyberspace; therefore, without more, no state can assert jurisdiction.[29] The third view, known as "single-point presence," analogizes the Internet to physical travel from an origination point to a termination point.[30] Under this view, the person is only present at one point at any given time.[31]

Different courts appear to view the Internet under all three possibilities.[32] However, none of these cases deal with taxation of Internet commerce. This is so because the Commerce Clause has prohibited states from forcing vendors to collect their taxes unless they have a "physical presence" within the taxing state. If the vendor has a physical presence in the taxing state, there is no need to even attempt to assert jurisdiction through a mere Internet connection. However, if the physical presence standard is overruled, due process concerns will become important, and decisions will turn, in large part, on the courts' conceptualization of the Internet. The "single-point presence" view is the best and most likely conceptualization for purposes of taxation. It can be easily analogized to existing law concerning mail order and telephone commerce. The remainder of this Comment will adopt the view of "single point presence."

II. CONSTITUTIONAL ISSUES

Two constitutional issues concern sales and use taxes. The Due Process Clause prevents a state from imposing a tax when it does not have jurisdiction to impose the tax.[33] The Commerce Clause puts limits on states' ability to tax interstate commerce.[34] Because a retail sales tax is solely intrastate, and because the taxing state will always have jurisdiction to tax a purchaser buying property within the taxing state, the sales tax does not run into constitutional roadblocks. However, the Constitution poses some real problems on states wishing to impose and collect a use tax. The use tax is almost always a tax on interstate commerce; therefore the Commerce Clause applies. Additionally, if the state wants to require the vendor to collect its use tax, it

26. Leif Swedlow, *Three Paradigms of Presence: A Solution for Personal Jurisdiction on the Internet*, 22 OKLA. CITY U. L. REV. 337, 370 (1997).

27. *Id.*

28. *Id.* at 378.

29. *Id.*

30. *Id.* at 375.

31. Swedlow, *supra* note 26, at 375.

32. *See id.* at 370-81.

33. U.S. CONST. amend. XIV.

34. U.S. CONST. art. 1, § 8, cl. 3.

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must assert jurisdiction over a vendor, which did not make the sale in the taxing state.

Prior to *Quill*, the Court applied the same test for due process and Commerce Clause analysis.[35] For due process the relevant inquiry was "whether the state has given anything for which it can ask return."[36] In order for state taxation of interstate commerce to meet the requirements of the Commerce Clause, the tax must be "designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys."[37] In *Bellas Hess*, the Court held that both the Due Process Clause and the Commerce Clause required some physical presence in the taxing state, if the state wishes to require a vendor to collect a use tax.[38]

However, in *Quill*, the Court distinguished the two clauses. The Court stated that the "Due Process Clause and the Commerce Clause reflect different constitutional concerns."[39] While the Due Process Clause is concerned primarily with the fairness of being hailed into court in a jurisdiction, the Commerce Clause is concerned with "the effects of state regulation on the national economy."[40] Thus, while both tests may require a nexus, the required nexus for fairness, and the required nexus for not creating an undue burden on interstate commerce, may not always be the same. "[W]hile a state may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the Commerce Clause."[41] In addition to the differences in constitutional analysis, the Commerce Clause is a plenary power of Congress; therefore, it can always pass legislation authorizing states to burden interstate commerce.[42] However, Congress may not authorize the states to violate the Due Process Clause.[43]

A. Due Process

The power to tax is an issue of personal jurisdiction subject to the Due Process Clause of the Constitution. The relevant inquiry in determining whether due process has been satisfied is "whether a defendant had minimum contacts with the jurisdiction 'such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.'"[44] As

35. Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753, 756 (1967), *overruled by* Quill Corp. v. North Dakota, 504 U.S. 298 (1992) ("[T]he test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a State's compliance with the requirements of due process in this area are similar.").

36. *Bellas Hess*, 386 U.S. at 756 (quoting Wisconsin v. J.C. Penny Co., 311 U.S. 435, 444 (1940)).

37. *Id.* (quoting Freeman v. Hewit, 329 U.S. 249, 253 (1946)).

38. *Id.* at 758.

39. *Quill*, 504 U.S. at 305.

40. *Id.* at 312.

41. *Id.* at 305.

42. *Id.*

43. *Id.*

44. *Quill*, 504 U.S. at 307 (quoting Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)) (internal quotation marks omitted).

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applied to the ability of states to impose a duty on an out-of-state vendor to collect a use tax, the Court has stated that the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[45] The relevant inquiry into whether the above test has been satisfied has evolved over time. A court must ask "whether the state has given anything for which it can ask return."[46] This has been interpreted to mean that the person against whom a tax is imposed must have been "accorded the protection and services of the taxing State."[47] In *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*,[48] the United States Supreme Court held that a company whose only connection with the taxing state was economic or by "common carrier" did not have the "minimum contacts" required by the Due Process Clause.[49] However, in *Quill Corp. v. North Dakota*,[50] the Court reversed *Bellas Hess*, holding that the inquiries for due process and Commerce Clause analysis were not the same.[51] While some physical presence within the taxing state is required by the Commerce Clause,[52] the "minimum contacts" required by due process do not require a physical presence.[53] Instead, the proper question is whether it is reasonable "to require [the taxpayer] to defend the suit in that State."[54] Due process is met if the company "purposefully avails itself of benefits of an economic market in the forum State."[55]

An Internet transaction is similar to a mail order transaction; therefore, it is helpful to closely examine the Court's decision in *Quill* to determine when a state may tax an Internet transaction without violating due process. In *Quill*, the North Dakota statute under attack required "every person who engages in regular or systematic solicitation of a consumer market in th[e] state" to collect its sales and use taxes and remit them to the state.[56] Quill Corporation challenged this statute as violating its due process rights and the Commerce Clause of the Constitution.[57] Quill was a Delaware Corporation that sold office supplies nationally and solicited its business through catalogs and flyers.[58] It had no employees located in North Dakota.[59] Nor did it have any real or tangible personal property in North Dakota.[60] How-

45. *Id.* at 306 (quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954)).
46. *Bellas Hess*, 386 U.S. at 756.
47. *Id.* at 757.
48. 386 U.S. 753 (1967).
49. *Bellas Hess*, 386 U.S. at 758.
50. 504 U.S. 298 (1992).
51. *Quill*, 504 U.S. at 306-07.
52. *Id.* at 317.
53. *Id.* at 307. "[I]f a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State." *Id.*
54. *Id.*
55. *Quill*, 504 U.S. at 307.
56. *Id.* at 302-03.
57. *Id.* at 303.
58. *Id.* at 302.
59. *Id.*
60. *Quill*, 504 U.S. at 302.

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ever, $1 million out of a total of $200 million annual national sales were made to about 3000 customers located in North Dakota.[61] The Court held that requiring Quill to collect a use tax under these circumstances did not "offend 'traditional notions of fair play and substantial justice.'"[62] By "purposefully direct[ing] its activities at North Dakota residents," Quill "clearly ha[d] 'fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign.'"[63] Quill's fairly substantial economic presence in North Dakota, caused by its purposeful use of the North Dakota market, was enough of a nexus with North Dakota to satisfy due process. The state's maintenance of a free market, through protections and services provided to Quill's consumers, was a service to Quill for "which it can ask return."[64]

While an Internet transaction is similar to a mail order transaction, the two forms of doing business are not identical. It is obvious that a mail order business that sends catalogs into a state is purposefully availing itself of that state's market. It seems less certain whether a woman who makes homemade dolls in her living room in Alabama and sells them through her own Web site has purposefully availed herself of any particular state's market. It could be argued that she has purposefully availed herself of all markets in the United States, or no markets at all.[65] Alternatively, she may not have availed herself of any market until she receives and accepts an order, at which point she has purposefully availed herself of that state's market.[66]

Because the physical presence standard has prohibited states from imposing taxes on remote Internet sales, there has been no caselaw on the restraints of due process on Internet taxation. However, there have been many due process cases involving the question of whether a state has personal jurisdiction over a person who merely has a website that can be accessed from that state. The cases range along a continuum from holding that a Web site alone is never enough to establish personal jurisdiction, to holding that a Web site alone is always enough.[67] If an Internet vendor sends goods through the mail to a buyer in another state, the transaction resembles a mail order transaction. In such a case, it is likely that the vendor has purposely availed itself of a market in the other state, thereby allowing that state to tax the transaction without violating the vendor's due process rights. However, if the purchaser can download the property via the Internet for a fee, it seems far more questionable whether the vendor has purposefully availed itself of a particular state's market. While Congress may legislate under the Commerce Clause to impose burdens on interstate commerce, it may not legislate in a way that violates rights under the Due Process Clause.

61. *Id.*

62. *Id.* at 307.

63. *Id.* at 308 (quoting Shaffer v. Heitner, 433 U.S. 186, 218 (1977)).

64. *Bellas Hess*, 386 U.S. at 756.

65. *See* Swedlow, *supra* note 26, at 370-81.

66. *See id.*

67. *Id.*

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B. Commerce Clause

The Commerce Clause grants Congress the explicit power to "regulate Commerce with foreign Nations, and among the several States."[68] While this affirmative grant of power does not say that states lack the power to regulate interstate commerce, the Supreme Court has long interpreted a negative component of the Commerce Clause, known as the "dormant" Commerce Clause, which prohibits states from unduly burdening interstate commerce.[69]

The Court's interpretation of the "dormant" Commerce Clause as applied to a state's ability to tax interstate commerce has evolved over the years. Early on, the Court imposed a strict prohibition on taxing interstate commerce stating that "no State has the right to lay a tax on interstate commerce in any form."[70] The Court later distinguished between taxes that directly burdened interstate commerce and taxes that indirectly burdened interstate commerce; taxes that directly burdened were prohibited, while taxes that only indirectly burdened were generally allowed.[71] Today these formalisms have been abandoned and "with certain restrictions, interstate commerce may be required to pay its fair share of state taxes."[72]

Today, the Court determines whether a tax violates the Commerce Clause by applying the four-part test set out in *Complete Auto Transit, Inc. v. Brady*.[73] Under the *Complete Auto* test, a tax on interstate commerce will be sustained against a Commerce Clause challenge if the "tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."[74] As applied to state use tax collection, the "substantial nexus" prong is usually the only obstacle. However, because mail order commerce and Internet commerce are not exactly the same, and because each of the four prongs are important as tax policy concerns, it is important to examine all four prongs of the *Complete Auto* test before analyzing any proposal for an Internet tax.

1. Substantial Nexus

The first prong of the *Complete Auto* test requires a "substantial nexus with the taxing state" before a state may levy a tax on interstate commerce.[75] This requirement has been interpreted by the Court as requiring a physical presence in the taxing state. In *Bellas Hess*, the Court held that the

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68. U.S. CONST. art. I, § 8, cl. 3.
69. *See, e.g.*, Gibbons v. Ogden, 22 U.S. 1, 224 (1824).
70. Leloup v. Port of Mobile, 127 U.S. 640, 648 (1888).
71. *See, e.g.*, Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 256-58 (1938).
72. D.H. Holmes Co. v. McNamara, 486 U.S. 24, 31 (1988).
73. 430 U.S. 274, 279 (1969).
74. *Quill*, 504 U.S. at 311 (citing *Complete Auto*, 430 U.S. at 279).
75. *Complete Auto*, 430 U.S. at 279.

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substantial nexus requirement was met if the company had employees, agents, retail stores, or warehouses in the taxing state.[76] However, the nexus requirement was not met if the seller's "only connection with customers in the State is by common carrier" or advertising.[77] In *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*,[78] the Court held that the State of Washington could require Tyler to collect its use tax even though Tyler's only connection with the taxing state, other than by mail or advertising, was through independent contractors acting as sales representatives.[79] The Court held that the test was whether the independent contractors' activities were "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing state]."[80] These decisions were reaffirmed in *Quill*, when the Court held that the substantial nexus requirement required some "physical-presence" in the taxing state.[81]

The physical presence test of *Quill* has been a substantial roadblock for states' attempts to tax mail order companies. As a result of *Quill*, a company that does business exclusively by mail, with no salesmen in the field, can locate all of its assets within one state so that it only has a physical presence in that state. Furthermore, there is an incentive for such a company to choose to locate its physical presence in a state with little or no sales taxes. The physical presence test applies to all interstate Internet sales. If the company doing business via the Internet does not have a physical presence in the taxing state, the state cannot require it to collect its use tax.

While states reluctantly accepted the physical presence test for mail order sales, they have become far more vocal as they have seen the boom in Internet commerce on the horizon. Fearing huge revenue losses in the future due to inability to tax Internet sales, states have actively begun seeking either judicial or legislative relief.

One major effort undertaken by the states, is the simplification of state taxes. This initiative is known as the Streamlined Sales Tax Project (SSTP). As of December 2002, thirty-four states and the District of Columbia were actively participating in the SSTP and another five states were observing.[82] Additionally, twenty of these states had already enacted some simplification legislation.[83] The SSTP goals include uniform definitions for tax bases, uniform sourcing rules, and rate simplification.[84] The states' reasoning behind the SSTP arises out of mail order caselaw. In *Bellas Hess*, one of the major reasons the Court required a physical presence in the taxing state was because requiring a mere economic presence could cause a company to have

76. *Bellas Hess*, 386 U.S. at 757.

77. *Id.* at 758.

78. 483 U.S. 232 (1987).

79. *Tyler Pipe*, 483 U.S. at 251.

80. *Id.* at 250 (quoting Tyler Pipe Indus. v. Wash. Dep't of Revenue, 732 P.2d 123, 126 (1986)).

81. *Quill*, 504 U.S. at 317.

82. STREAMLINED SALES TAX PROJECT, EXECUTIVE SUMMARY (Dec. 2002), *at* http://www.streamlinedsalestax.org/execsum1202.pdf.

83. *Id.*

84. *Id.*

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to collect use taxes in all fifty states. Given that each state, not to mention localities, have different rates, as well as different tax bases and exclusions, the Court found that requiring collection without a physical presence would place an undue burden on interstate commerce, which is prohibited by the Commerce Clause.

Because *Quill* reaffirmed the physical presence test of *Bellas Hess*, some believe that the Court in *Quill* based much of its decision on the undue burden of collection analysis of *Bellas Hess*; therefore, it is argued, if the states simplify their sales tax systems, making collection of use taxes less burdensome, the Court might abandon its physical presence standard and force mail order and Internet companies to collect use taxes. This argument is based on a misinterpretation of *Quill*. The *Quill* Court did not base its decision on an assumption that the complexities of the tax law would create an undue burden on out-of-state sellers.[85] In fact, the Court rejected this very argument. The North Dakota Supreme Court had refused to apply the physical presence standard in part because it found that "advances in computer technology greatly eased the burden of compliance with a 'welter of complicated obligations'"[86] Nevertheless, the Court maintained the test to provide certainty and a "safe harbor for vendors."[87]

Rather than applying an undue burdens balancing analysis, the Court focused on the certainty that having a bright line test establishes, and how this certainty advances the goals of the "dormant" Commerce Clause.[88] The Court reasoned that despite the artificiality of the bright-line test, where a vendor with a small office located within a state but with very little sales in the state could be compelled to collect sales tax, while a vendor with no physical presence but with millions in sales could not be so compelled, this "artificiality . . . is more than offset by the benefits of a clear rule."[89] The Court stated:

> [A] bright-line rule in the area of sales and use taxes . . . encourages settled expectations and, in doing so, fosters investment by businesses and individuals. Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in *Bellas Hess*.[90]

In addition to relying on the advantages of a bright-line test, the Court also relied, perhaps most heavily, on the fact that Congress is free to burden interstate commerce in any way it chooses through legislation.[91] Because

85. *See Quill*, 504 U.S. at 314-17.
86. *Id.* at 303 (quoting Quill Corp. v. North Dakota, 470 N.W. 2d 203, 215 (1991)).
87. *Id.* at 313.
88. *Id.*
89. *Id.* at 315.
90. *Quill*, 504 U.S. at 316.
91. *Id.* at 318.

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Congress had not passed any legislation in the twenty-five years between *Bellas Hess* and *Quill* regarding this issue, despite legislation being proposed, the Court concluded that this could be based on congressional approval of the physical presence test.[92] The Court reasoned that "Congress may be better qualified to resolve" the issue.[93] In fact, the Court openly invited Congress to legislate on the issue, stating, "Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."[94]

It seems clear from the *Quill* decision that the only hope of states wanting to tax remote vendors with no physical presence within their state is to seek congressional relief. Simplifying sales taxes through the SSTP may be quite helpful in their lobbying efforts. However, thus far, Congress has been unable to reach anything nearing a consensus.[95]

2. Fair Apportionment

The second prong of *Complete Auto* requires that any sales tax on interstate commerce be fairly apportioned.[96] The Court has held that this test has two components. It must be internally consistent and externally consistent.[97] "To be internally consistent, a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result."[98] In order to be externally consistent, the tax may only tax "that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."[99] Thus, the internal consistency test looks solely to the logical application of identical taxes in other states without any analysis of the economic realities, while the external test examines the economic realities of the tax.[100]

The Court closely examined the fair apportionment prong in *Goldberg v. Sweet*.[101] In *Goldberg*, the challenged Illinois statute was not technically a sales tax, but rather was a tax on the gross charge of telecommunications that originated or terminated within the taxing state and were charged to a service address within the state.[102] Under this statute, the location where the telephone call was billed or paid was irrelevant.[103] The tax applied to both interstate and intrastate telephone calls.[104] It also provided a credit to any

92. *Id.*
93. *Id.*
94. *Id.*
95. COMMERCE, *supra* note 11, at 19-20.
96. *Complete Auto*, 430 U.S. at 279.
97. Goldberg v. Sweet, 488 U.S. 252, 261 (1989).
98. *Goldberg*, 488 U.S. at 261.
99. *Id.* at 262.
100. Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).
101. 488 U.S. 252 (1989).
102. *Goldberg*, 488 U.S. at 256.
103. *Id.*
104. *Id.*

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taxpayer who could prove that he paid a tax in another state on the same telephone call to avoid multiple taxation.[105] While this tax was not a sales tax, the Court held that "the Tax Act reasonably reflects the way that consumers purchase interstate telephone calls," and analyzed the tax like a sales tax.[106]

The *Goldberg* case is especially helpful in the analysis of Internet commerce due to the analogous workings of an Internet connection and a telephone call. Like an Internet connection, a telephone signal may pass through many states before reaching its destination point, but the traveling signal is not concerned with state boundaries.[107] Like an Internet connection, a direct path for the call is not predetermined. Instead, a computer routes telephone traffic to the least busy paths.[108] Finally, like an Internet connection, it is impossible to trace the paths taken by these signals.[109]

a. Internal Consistency

By definition, a traditional sales or use tax should always be internally consistent. If every state had an identical sales tax, the transaction could only be subjected to that sales tax by one state. This is so because a sale, as traditionally defined, can only occur in one state, making it impossible for another state to tax the same sale under an identical statute. Other states may impose use taxes, or income taxes, which result from the same sale, but these are not identical taxes, and therefore do not fall within the internal consistency analysis.

However, because purchasing goods over the Internet entails some of the same difficulties involved in taxing the purchase of goods via telephone, a tax similar to the one in *Goldberg* may be appropriate for Internet transactions. An Internet purchaser whose Internet connection either originated or terminated within the state and whose Internet service address was within the state could be subject to tax by that state.

In *Goldberg*, the Court found the statute to be internally consistent.[110] If every state passed an identical statute, only one state could claim either the origination or the termination of the telephone call and the service address of the same taxpayer; therefore, there would be no possibility of multiple taxation.[111]

105. *Id.*
106. *Id.* at 262.
107. *Goldberg*, 488 U.S. at 255.
108. *Id.*
109. *Id.*
110. *Id.* at 261.
111. *Id.*

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b. External Consistency

Rather than analyzing the effect of identical statutes in other states, the external consistency test analyzes the economic effect that similar, but not identical, statutes of other states have on interstate commerce.[112] *Oklahoma Tax Commission v. Jefferson Lines, Inc.*[113] provides a good analysis of the external consistency test as applied to a traditional sales tax.[114] Jefferson Lines challenged the validity of an Oklahoma statute, which taxed the gross charge of bus tickets.[115] Jefferson Lines collected the tax on all sales that originated and terminated within Oklahoma, but refused to collect the tax on tickets whose destinations were outside of Oklahoma on the grounds that the tax was not fairly apportioned.[116] The Court held that the Oklahoma statute was externally consistent.[117] Because a sale, by traditional definition, can only occur in one state, there is no real risk of multiple taxation by similar, but not identical, sales taxes in other states.[118] Jefferson Lines argued that even though there was no possibility of multiple taxation through another sales tax, there was ample opportunity for other states to levy other taxes that would have the same economic impact as taxing the same transaction more than once.[119] For example, under the Oklahoma statute, Jefferson lines would collect a tax on the full value of a trip from Oklahoma City to Dallas.[120] Texas could then impose a tax on the gross receipts for the portion of the trip occurring in Texas.[121] While this tax would be another tax related to the same transaction, the Court held that this type of "successive taxation" has never been prohibited but is the "accidental incident of interstate commerce being subject to two different taxing jurisdictions."[122] A holding to the contrary would prohibit a state from imposing an income tax on a transaction in which a sales tax was paid in another state.[123]

Despite the fact that a sales tax will almost always be externally consistent, the fact that an Internet transaction so closely resembles a telephone connection makes the analysis of external consistency in *Goldberg* helpful. In *Goldberg*, the Illinois statute was found to be externally consistent.[124] The Court concluded that only two states would have a sufficient nexus to

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112. *See* Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 192-95 (1995).
113. 514 U.S. 175 (1995).
114. Note that the sales tax in *Jefferson Lines* was not traditional in that it applied to services sales.
115. *Jefferson Lines*, 514 U.S. at 178.
116. *Id.*
117. *Id.* at 196.
118. *Id.* at 187. "[A]n internally consistent, conventional sales tax has long been held to be externally consistent as well." *Id.* at 188.
119. *Jefferson Lines*, 514 U.S. at 191-92.
120. *Id.* at 192.
121. *Id.*
122. *Id.* at 186, 192.
123. *Id.* at 188. Another example of a permissible successive tax is a severance tax collected on the removal of coal by the state of origin and a sales tax collected by the state of delivery. *Jefferson Lines*, 514 U.S. at 188.
124. *Goldberg*, 488 U.S. at 264.

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tax a telephone call.[125] The first would be a state taxing the "origination or termination of an interstate telephone call charged to a service address within that State."[126] The second would be a state taxing a telephone call billed or paid within the state.[127] While the Court acknowledged that the possibility for multiple taxation of the same telephone call existed if a call was billed in one state, but terminated in the state of the caller's service address, this concern was eliminated in the statute because it provided for a credit for any taxes paid to another state on the same telephone call.[128]

A tax on an Internet transaction that is internally consistent should be externally consistent, even if there is the slight possibility of multiple taxation, so long as the taxing state provides a credit for taxes paid in another state on the same transaction. All of the states that have use taxes currently provide such a credit.[129] Any new legislation for taxation of the Internet would need such a credit provision for taxes paid in other states on the same transaction if the legislation is to withstand a Commerce Clause challenge.

3. No Discrimination against Interstate Commerce

The third prong of the *Complete Auto* test prohibits taxes that "discriminate against interstate commerce."[130] A state statute may not be facially discriminatory by preferring in-state businesses over out-of-state businesses.[131] However, in addition to forbidding facially discriminatory tax statutes, the Commerce Clause may prohibit otherwise discriminatory tax statutes even though they "do not allocate tax burdens between insiders and outsiders in a manner that is facially discriminatory."[132]

Despite the possibility that a facially neutral tax statute might be invalid under the Commerce Clause, it is the rare case in which such a statute will be overturned. In *Scheiner*, the Court overturned a tax statute that placed a flat tax on all trucks operating on Pennsylvania highways.[133] The Court held that the statute discriminated against interstate commerce because it placed a disproportionate burden on interstate trucks that traveled more miles than intrastate trucks on Pennsylvania highways.[134]

However, the discriminatory situation found in *Scheiner* could almost never occur with a facially neutral sales tax. The tax in *Scheiner* was a tax

125. *Id.* at 263. The Court expressed doubt that "States through which the telephone call's electronic signals merely pass have a sufficient nexus to tax that call." *Id.* It also expressed doubt that "termination of an interstate telephone call, by itself, provides a substantial enough nexus for a State to tax a call." *Id.*

126. *Id.*

127. *Goldberg*, 488 U.S. at 263.

128. *Id.* at 264. An example of where double taxation would exist in the absence of a credit would be a collect telephone call. *Id.* at 258 n.10.

129. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 16.01[2].

130. *Complete Auto*, 430 U.S. at 279.

131. *See, e.g.*, Am. Trucking Ass'n v. Scheiner, 483 U.S. 266, 280-81 (1987).

132. *Scheiner*, 483 U.S. at 281.

133. *Id.* at 297.

134. *Id.* at 286.

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on the privilege of using Pennsylvania highways, while a sales tax is a tax on the privilege of purchase. In *Jefferson Lines*, the Court found this distinction determinative in holding that the Oklahoma sales tax on sales of bus tickets did not discriminate against interstate bus travel.[135] "Since Oklahoma facilitates purchases of the services equally for intrastate and interstate travelers, all buyers pay tax at the same rate on the value of their purchases."[136] Under this analysis the number of miles traveled in another state is irrelevant to the transaction taxed.[137] This reasoning should hold true for all sales taxes, including taxes on Internet sales. The *Goldberg* Court also distinguished *Scheiner*, holding that the tax did not discriminate against interstate commerce.[138] First, the economic burden of the tax in *Goldberg* fell on in-state residents, who could seek legislative change.[139] Second, it was impossible to measure the geographical paths traveled by the electronic impulses.[140] Both of these distinctions would hold true for an Internet tax.

In all probability, the discriminatory prong of the *Complete Auto* test will not render any sales tax on Internet commerce invalid, so long as the statute is not facially discriminatory. One possible exception may occur if a state's remote vendor tax base exceeded its in-state base. At this point, the facts would look more like *Scheiner*, where the out-of-state vendors were bearing a larger proportion of the taxes than in-state vendors. In this situation, the statute, as applied, would favor in-state vendors over out-of-state vendors, which is precisely what the Commerce Clause prohibits. While this scenario seems unlikely, there is no way to know the extent to which Internet commerce will replace traditional in-store purchases in the future.

4. Fair Relation

The fourth prong of the *Complete Auto* test requires that any tax on interstate commerce be "fairly related to the services provided by the State."[141] According to the Court, "The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State."[142] However, this test does not limit the state's ability to tax solely on the amount of services provided that directly relate to the taxpayers' activities within the state.[143] "On the contrary, interstate commerce may be required to contribute to the cost of providing *all* governmental services, . . . from which it arguably receives no direct 'benefit.'"[144] In *Goldberg*, the Court held that the tax on interstate telephone calls

135. *Jefferson Lines*, 514 U.S. at 198.
136. *Id.*
137. *Id.*
138. *Goldberg*, 488 U.S. at 266.
139. *Id.*
140. *Id.*
141. *Complete Auto*, 430 U.S. at 279.
142. *Goldberg*, 488 U.S. at 266-67.
143. *Id.* at 267.
144. *Id.* (quoting Commonwealth v. Edison, 453 U.S. 609, 627 (1981)) (internal quotation marks

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was fairly apportioned because Jefferson Lines' consumers received police and fire protection, and other essential services provided by the state.[145] These state protections of the vendor's consumers are essential to the vendor having an orderly marketplace to sell its goods; therefore, a vendor indirectly benefits from these services making a sales tax fairly apportioned.[146]

It seems doubtful that any sales tax, including a sales tax on Internet commerce, could be invalidated on the fairly apportioned prong of the *Complete Auto* test. If the vendor has a sufficient relationship with the taxing state to be taxed under the Due Process Clause, it seems nearly certain that any tax levied on sales would be proportional to services rendered directly to the vendor and indirectly through its customers. This is so because a sales tax is levied on a flat percentage of sales.

III. CONCLUSION

The extent in which Internet commerce will grow in the future is uncertain. It is even more uncertain to what extent any growth will displace traditional in-store commerce. Furthermore, the benefits or detriments to state and local economies that would arise out of taxing the Internet are uncertain. However, it is quite certain that state and local governments do want to tax interstate commerce.

The Supreme Court of the United States made it clear in *Quill* that it did not intend to judicially change the precedent of *Bellas Hess* and *Complete Auto*. However, the Court openly extended an invitation to Congress to legislate on the issue. Seeking legislative relief is the only avenue open to the states.

Congress, through the Advisory Commission on Electronic Commerce, has examined the issue of Internet taxation since 1998.[147] Congress and the Commission have been unable to reach a consensus over what proposals should be adopted. However, everyone seems to be in agreement on one point. If Congress is to require remote vendors to collect sales and use taxes, then the states must simplify their tax systems. However, there is little agreement on how the states should simplify their tax systems. The Streamlined Sales Tax Project is definitely a step in the right direction if the states want to see any favorable legislation.

If Congress ever decides to pass legislation requiring remote vendors to collect state sales and use taxes, it must make certain that the legislation does not violate the Due Process Clause. While Congress may legislate to burden interstate commerce, it cannot legislate away due process rights. Congress must think about the differences between mail order and Internet

omitted).

145. *Id.*

146. *See id.*

147. *See* Advisory Comm'n on Interstate Commerce, *Frequently Asked Questions*, at http://www.ecommercecommission.org/FAQs.htm (last visited May 1, 2003).

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commerce in passing legislation. It must make certain that the nexus requirement it establishes for the Commerce Clause is sufficient to establish the "minimum contacts" required by the Due Process Clause. For example, if Congress decides that an economic nexus is sufficient to require remote vendors to collect sales and use tax, Congress should consider excluding a de minimis economic presence so that the legislation can survive a due process challenge.

Additionally, Congress should keep all four parts of the *Complete Auto* test in mind when considering legislation. While Congress has the power to burden interstate commerce in any way it wishes, unduly burdening interstate commerce is unwise from an economic policy perspective. The *Complete Auto* test relates to policy concerns regarding interstate taxes. If the substantial nexus requirement becomes too insubstantial, it could have the effect of pushing many small businesses out of the Internet market because of tax compliance costs. If the state taxes are not fairly apportioned, multiple taxation of the same transaction might drive both large and small businesses out of the Internet market. Congress must strike a delicate balance between fostering an emerging Internet market and protecting states' powers to tax. While this will not be an easy task, it should be achievable. However, if it is determined that additional state taxes cannot be imposed on the Internet without significantly damaging the market, then no taxes should be allowed. To do otherwise would do great damage to the national economy, which is exactly what the Commerce Clause was intended to prevent.

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