# TAXATION OF ELECTRONIC COMMERCE AND MAIL-ORDER SALES

Electronic commerce can be defined as the exchange of goods or services between two or more parties using the Internet or some other electronic means. This industry is growing at an unprecedented rate, but there are diverse opinions concerning its monetary impact on commerce and how much tax consequence it may have on states and local governments.

Congress passed the Internet Tax Freedom Act in 1998 to encourage development of the Internet. However, it would be hard to imagine a more prosperous sector of our economy. The Internet Tax Freedom Act created a limited tax-free arena where businesses and people can freely transact business and, most importantly, access information. The act places a three-year moratorium on new taxes but does not preclude states from collecting sales and use taxes that were taxable before the act was passed. Because South Dakota was taxing Internet service providers when Congress passed the Internet Tax Freedom Act, South Dakota was grandfathered in by the act to continue taxing such providers.

There is a misconception among some Internet users concerning the provisions of the Internet Tax Freedom Act. Some Internet users believe that all purchases on the Internet are exempt from sales and use taxes while others are just unaware of the tax implications. Any goods or services purchased in or used, stored, and consumed in South Dakota are subject to sales and use taxes unless specifically exempted by statute. This applies to goods and services purchased over the Internet or through mail-order catalogs. The Internet Tax Freedom Act does not exempt purchases from sales and use taxes. For instance, if a South Dakota resident purchases a Gateway computer through the Internet, Gateway is obligated to collect and remit the sales tax to the state of South Dakota because it has a physical presence (nexus) in this state. If a South Dakota resident purchases a Dell computer from the Texas based company through the Internet, the purchaser is obligated to pay the use tax to the state.

The number of personal computers in the home is growing at an accelerated rate, especially in comparison to the introduction of radio and television. It took radio forty years to reach fifty million listeners, television thirteen years to reach fifty million viewers, and the Internet five years to reach fifty million users. In 1998 computers were found in forty-eight million homes and about seventy-five percent of those computers were connected to the Internet. It is estimated that by the year 2000 electronic sales of tangible goods and services will reach $15 billion, and by the year 2003 Internet sales to consumers will reach $43 billion and business-to-business sales may exceed $1.3 trillion. States presently lose about $3.5 billion to $4 billion a year in revenue from mail-order businesses; but it is very difficult to measure how much revenue is lost to electronic commerce because of the nature of the industry.

As people become more comfortable in completing transactions on the Internet, this market will continue to grow exponentially. However, states lack the capability to collect the taxes due on these goods or services for two primary reasons. First, the Supreme Court has ruled that a business must have substantial nexus in a state before the state may require the business to collect and remit the use tax for goods or services purchased on the Internet. Second, Congress has restricted the states' ability to adopt state laws by its moratorium on imposing new forms of taxation on Internet goods or services.

## Sales and Use Taxes

The primary source of revenue for the state of South Dakota and its municipalities is the sales and use tax. On a nation wide basis, the sales and use tax is second only to property taxes as a means to raise revenue for state and local governments. Approximately 24 percent of the total state and local tax revenue was generated by a general sales tax in 1995. In South Dakota, the general sales tax represented approximately 33 percent of the total state and local tax revenue in 1995. The sales and use tax base has been growing approximately four to seven percent a year in South Dakota. Obviously sales and use tax collections could be increased if all Internet and mail-order sales that are taxable were collected. But since this information goes unreported, it is difficult to estimate the true monetary impact to the tax base. Some experts believe that most goods and services purchased through electronic commerce are not subject to taxation in most states because of the nature of the purchase or that these sales occur between two businesses.

South Dakota, like most states, taxes goods and services purchased over the Internet or through mail-order catalogs. Any person who purchases goods or services from an out-of-state business owes a use tax on taxable purchases that would be equivalent to the sales tax that would have been paid if the purchase was made from an in-state business. This tax is difficult to collect unless the out-of-state business has a substantial nexus (a physical presence in a state) within the state and then the state can require such business to collect the tax. However, the purchaser rarely pays the use tax unless the purchaser is required to register or license the purchase within a state.

Businesses using the Internet to sell goods and services are very concerned about the difficulty of complying with the multiple sales and use tax schedules if Congress chooses to redefine nexus. This may be especially true for a start-up company that is attempting to enter the Internet market without being fully prepared for this event. However, programs have been developed using zip codes that would aid the seller in knowing the tax rate for various goods and services in each state and locality. In addition, these businesses are concerned that more than one state will claim that the sale is taxable within their jurisdiction and there are approximately 6,600 tax jurisdictions currently levying a sales and use tax.

## Constitutional Restraints

States are prohibited from imposing use tax collection responsibilities on an out-of-state business because of the standards required by the Due Process and Commerce Clauses, which require nexus with the state attempting to impose and collect a tax. The problem lies in how the United States Constitution was crafted to prevent discrimination against interstate commerce or out-of-state interests in favor of local commerce or in-state interests. The requirement of physical presence, or nexus, was established in a 1967 Supreme Court Case: *National Bellas Hess, Inc. v. Department of Revenue of Illinois*. The Supreme Court held that the Due Process and Commerce Clauses prohibited a state from imposing a use tax collection obligation on mail-order companies that did not have substantial nexus within the state.

In 1992 the Supreme Court reaffirmed the requirement for substantial nexus in *Quill v. North Dakota,* but on a narrower constitutional interpretation. The court ruled that some sort of physical presence was no longer necessary for jurisdiction under the Due Process Clause, but that the state's imposition of a tax violated the Commerce Clause. This means that 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."[1] Therefore, according to the *Quill* decision, Congress possesses the authority to define the nexus provision. But Congress has not acted on this issue except to pass the Internet Tax Freedom Act, which requires an advisory commission to study this issue and other issues related to electronic commerce.

Until Congress acts, the Supreme Court will uphold a challenge concerning the Commerce Clause based on whether the tax satisfies a four-prong test derived from the court case: *Complete Auto Transit v. Brady*. However, the issue concerning nexus remains as the most difficult part of that four-prong test to satisfy when a state is attempting to show compliance with the Commerce Clause.

The electronic commerce and mail-order industry argue that compliance with sales and use taxes is too difficult to administer and the industry prefers that Congress not revise the definition of nexus. But this position contradicts a 1997 report made by the *New York Times* that an agreement was reached between officials of several states and a trade group for the mail-order industry that would have established a system for collecting the use tax. Supposedly the agreement was negated in reaction to consumer protest and not in reaction in the ability to administer the tax. Computer software is available making it feasible for companies to calculate the hundreds of different sales taxes imposed by states, cities, and other local governments. Of course another unresolved issue is that more than one jurisdiction may claim the right to levy the tax on the same transaction.

**Moratorium on Internet Taxation**

Although millions of dollars are being expended and made though Internet services and transactions, Congress has decided to place a tax moratorium on states from taxing these services. Tax breaks are sometimes given to industries during their infancy to give the industry an opportunity to develop. It has been argued that taxes on the Internet might impede or discourage development or businesses from becoming involved, nor should information access be taxed. Congress, however, has not provided any income tax credits to this industry to further encourage its development; instead, Congress restricted the states' ability to tax electronic commerce as the means to encourage development of the Internet.

[1] *Quill v. North Dakota,* 504 U.S. 298 (1992) at 318.

When the cellular phone industry was getting started, the industry asked for preferential tax treatment and none was given. In 1996 there were approximately 35 million cellular subscribers served. The cellular phone industry managed to survive and prosper without preferential tax treatment.

When exclusions and exceptions are made for an industry, it becomes difficult to remove these exclusions and exceptions. If the industry is going to be taxed, it may be prudent to begin the tax closer to its infancy when it may be easier to educate the industry and consumers on how to comply with any regulation or tax. In addition, a new business entering the market will know the tax parameters it will have to comply with in operating its business. Meanwhile this moratorium potentially gives one industry a preference over the more conventional sources of information, goods, and services.

Even though there are computer programs that could be used to administer any tax levied on the Internet, there have been proposals for simplifying compliance with sales and use taxes. Currently, what is taxable in one state may be exempt in another and the rate schedule varies from state to state and community to community. States could lessen resistance for taxing electronic purchases by developing a more uniform schedule of taxable goods and services. Compromise between states and the industry may be beneficial in improving consumer understanding and industry compliance. Businesses which have nexus in each state are more likely to be interested in establishing a uniform tax system and in leveling the playing field with businesses that do not have nexus in each state. The tax could be based on the purchaser's billing address. If the location of the purchaser cannot be determined, then a throwback rule based on the principle place of business for the seller might apply.

**Advisory Commission**

The Advisory Commission on Electronic Commerce was created by the Internet Tax Freedom Act and assigned the responsibility for weighing the benefits of maintaining the current moratorium on Internet taxes or recommending reasonable alternatives for implementing taxes. Several specific duties have been assigned to the commission members ranging from "an examination of model State legislation that would provide uniform definitions of categories or property, goods, service, or information subject to or exempt from sales and use taxes" to "an examination of the effects of taxation, including the absence of taxation, on all interstate transactions. . . ."[2]

Senator Daschle has appointed two South Dakotans to the commission. One appointee is Gene N. LeBrun, who is President of the National Conference of Commissioners on Uniform State Law, and the other appointee is Ted Waitt, Chair and Chief Executive Officer, Gateway Inc. Mr. LeBrun is from Rapid City and Mr. Waitt is from North Sioux City.

**Conclusion**

Globalization of electronic commerce may weaken the current tax structure because businesses may locate almost anywhere if they only require a computer and telephone to operate. Globalization also makes it more difficult to determine where the taxes should be paid regardless of where the business is based. The Supreme Court's definition of nexus in

[2] Public Law 105-277 on October 21, 1998.

this digital age is rapidly becoming out of date. If the states and businesses are unable to negotiate an acceptable means to define taxable goods, then Congress may be called upon to do so.

Businesses involved in electronic commerce may avoid sales taxation and minimize income taxation because these two forms of taxation are constrained by geography. Unless Congress redefines nexus, electronic commerce may erode the sales tax base because businesses selling goods and services electronically are not volunteering to collect taxes for state and local governments. Also, these businesses are not willing to lose one of the incentives for their customers to purchase their goods via the Internet.

Shopping habits have changed substantially in the last 30 years from locally owned stores to national chain stores located in megamalls, and now electronic commerce may provide adverse competition for in-state businesses. Shopping the Internet allows the buyer to quickly compare prices and quality without dealing with traffic congestion and waiting in lines and currently the consumer generally avoids paying the state and local sales and use taxes.

Buyers of goods or services through the Internet or mail-order catalogs may cause a tax shift to other taxpayers or forms of taxation Simply put, most taxpayers firmly believe the best tax is a tax paid by another, and the Internet and mail-order catalogs provide that opportunity. Congress, not state legislatures, possesses the authority to expand, restrain, or otherwise prescribe the rules governing state taxation of electronic commerce or mail-order catalogs.

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**This issue memorandum was written by Fred Baatz, Senior Research Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.**

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