



NEW MEXICO
TAX RESEARCH
INSTITUTE

**State Taxation of
Electronic Commerce**

A Report to the

**State of New Mexico
Blue Ribbon Tax Commission**

By

**Jim Eads
Executive Director
New Mexico Tax Research Institute**

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Thank you, Mr. Chairman and members of the Commission. My name is Jim Eads and I am the Executive Director of the New Mexico Tax Research Institute (NMTRI). My remarks today are my own and do not necessarily reflect the views of the New Mexico Tax Research Institute.

New Mexico Tax Research Institute

The Institute was organized as a non-profit public policy research institute in October of 2002. Our designation as a Section 501(c) (3) organization was just approved by the Internal Revenue Service.

The goal of the New Mexico Tax Research Institute is to improve New Mexico's tax and fiscal policies through programs of research, communication and citizen education, making it a continuing resource of objective, non-political research and accurate and unbiased information about tax and fiscal policy in New Mexico. Membership is open to any individual or business organization with interests in New Mexico.

NMTRI has adopted the following "Principles of State and Local Taxation"

- State and local taxes should be adequate to provide an appropriate level of those goods and services best provided by the public sector, such as education, public safety, law enforcement, streets and highways, and the courts.
- State and local tax policy should do the least harm to the private economy. Therefore, tax bases should be as broad as possible so that tax rates can be as low as possible in order to raise the necessary revenues.
- State and local tax policy should be fair and equitable towards individuals and businesses similarly situated. Individuals with the same income level should be taxed the same. Businesses engaged in similar commercial activities should be subject to the same level of taxation.
- State and local tax policy should not be costly to administer and should be easily understood by taxpayers so as to minimize taxpayer compliance costs.
- The state and local tax burden should be evaluated on the basis of the impact of all taxes levied on a given taxpayer, not just a single tax or tax rate.
- Deviations from established tax policy in pursuit of economic development, social or other goals should be well-reasoned and pursued only when established tax policies are not significantly undermined and the results of such deviations can subsequently be measured and evaluated.

These are the principles that will guide our organization, our research and our outreach.

Jim Eads Experience

Although I have only recently moved to New Mexico to take this position, I have over 25 years experience in state and local taxation. Prior to accepting this position last month, I was Director of Electronic Commerce, International, of the Large and Mid-Size Business Division of the Internal Revenue Service. I served as the primary IRS spokesperson on these issues and represented the IRS in international projects and meetings such as those undertaken by the Organization for Economic Cooperation and Development in Paris.

I have also been a partner in the National Tax Department of Ernst & Young where I lead the state & local telecommunications tax and electronic commerce tax policy practice. I have also been a Senior Attorney and Government Relations Counsel with AT&T Corp.; Senior Tax Attorney with Sears, Roebuck & Co.; and Chief Counsel of the Arkansas Department of Finance & Administration. I am a past President of the National Tax Association, former Chairman of the Council on State Taxation Electronic Commerce Task Force, Chairman of the American Retail Federation State & Local Tax Committee and Chairman of the Federation of Tax Administrators Attorneys Section.

I have a Bachelor of Science degree in Business Administration and a Juris Doctor degree, both from the University of Arkansas.

Electronic Commerce

I will attempt to review for you, in a very summary form, some of the issues relating to state and local taxation of "electronic commerce". This summary will include a definition of electronic commerce; the federal actions which circumscribe state and local taxation of interstate commerce; some of issues identified by businesses, some of the issues identified by state and local tax authorities, some recommendations by a group of academicians interested in the issue and finally some of my own views.

You could probably get many definitions of "electronic commerce" if you asked the average citizen, average tax administrator or average lawyer what the term means. The definition I will use is the one used in the Federal legislation which addressed the issue of state taxation of the internet, the Internet Tax Freedom Act.¹ The term "electronic commerce"

¹ Title XI of P.L. 105-277, the Omnibus Appropriations Act of 1998. Extended until November, 2003 by Public Law 107-75)

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.² This definition obviously includes the provision of services, intangible and tangible personal property and perhaps something that could be described as a hybrid of those, a “digitized product”.

Sales, Gross Receipts and Compensation Use Taxes

Because sales tax type taxes have been the focus of the debate for the past several years I will focus on those issues. I include in this category the New Mexico Gross Receipts and Compensating Tax.³ Forty-five states, the District of Columbia, and thousands of local governments in the United States impose sales and use taxes on the retail sales or use of tangible personal property and some services within their borders.⁴ Retail sellers of tangible personal property and services are generally required to collect sales tax from retail customers in a jurisdiction where the seller has a business location, employees or agents and the customer takes delivery of taxable goods or service in that location.

The compensating use tax is as you know, a complementary tax to the sales or gross receipts tax, generally imposed on the use, storage, or consumption of tangible personal property and selected services purchased from out-of-state sellers not subject to the sales or gross receipts tax. If a retailer makes a sale outside of the buyer’s state, and the retailer is subject to the taxing jurisdiction of the buyer’s state, the retailer generally will be required to collect use tax from the purchaser and remit the tax to that state, much like collecting the sales tax if the sale had been made in the taxing jurisdiction. If the out-of-state retailer is not subject to the state’s taxing jurisdiction, because the seller does not have a store, employees or agents there, the retailer is not required to collect and remit sales or use tax on sales to customers located in the state. Although the purchaser would be legally obligated to pay the use tax directly to the taxing jurisdiction, most non-business purchasers do not comply with this requirement and enforcement against individuals is spotty and effectively non-existent.

The power of a state to impose sales/use tax collection and reporting requirements on a retailer is limited by provisions of the Constitution of the United States. In order for a state to impose a sales/use tax collection and reporting requirements on a business, that business entity must have

² *Id.*, Section 1104 (3)

³ Gross Receipts and Compensating Tax Act, Chapter 7, Article 9 NMSA 1978

⁴ The states of Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose sales or use taxes

a sufficient *nexus* (connection) with the state under both the Due Process and Commerce Clauses of the United States Constitution.

U.S. Constitution and Statutory Limitations

This limitation on the ability of the tax jurisdiction to require collection is made specific in two cases decided by the Supreme Court of the United States. The Court first stated the requirement that a business must be physically present in a jurisdiction before it can be required to collect and remit sales and use taxes in *National Bellas Hess v. Illinois*.⁵ Later, it affirmed that requirement under the Commerce Clause in *Quill Corporation v. North Dakota*.⁶ Although the Court could change the law in a subsequent decision or Congress could change the law under its power to regulate interstate commerce⁷, there is no reliable way to predict when or if any of these changes might occur. Legislation has been introduced in the Congress to overturn these court decisions over the last several years, but the bills have not progressed. This is relevant because electronic commerce is a part of this larger debate. States have been anxious to overcome these principles since the *National Bellas Hess* decision in 1967.

As electronic commerce exploded in the latter half of the 1990's, state and local governments became ever more concerned about what they saw as growing revenue that was escaping their taxation system. Multistate catalog sellers and in particular internet sellers saw the Supreme Court decisions as protection from a state and local tax system that was hopelessly complex when viewed on a national basis and therefore represented a huge barrier to their entry, indeed their very existence, in the global marketplace. The issue of complexity is still current. A recent issue of *U.S. News online* contains the following news item: "Buy a U.S. flag in Pennsylvania and you won't pay sales tax. A flag packaged with a pole? The entire kit is taxable. Taxware, a Salem, Mass., firm that helps retailers navigate the wilds of sales tax, recently highlighted some of the tangles. Among them: Nuts are tax free in Texas; add a candy or chocolate coating and the snack turns taxable. A cake decoration in Minnesota is taxable-unless it's edible. Thirsty in New Jersey? Naturally sparkling water is tax free. Artificially carbonated club soda? That's taxable."

In response to the exploding internet commerce phenomenon Congress acted in a very limited way by adopting the Internet Tax Freedom Act, (ITFA) which was signed into law on October 21, 1998.⁸ It imposed a

⁵ 386 U.S. 753 (1967).

⁶ 504 U.S. 298 (1992).

⁷ U.S. Const., art. I, § 8, cl. 3 (provides that "[t]he Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, among the several States, and with the Indian Tribes . . .").

⁸ Title XI of P.L. 105-277, the Omnibus Appropriations Act of 1998. Extended until November, 2003 by Public Law 107-75)

three-year moratorium on taxes on Internet access (unless such tax was generally imposed and actually enforced prior to October 1, 1998) and on multiple or discriminatory taxes on electronic commerce, and prohibited the states from treating Internet access providers as agents of remote vendors because they host web sites or process orders for vendors. The ITFA also established the Advisory Commission on Electronic Commerce to study issues relating to state and local taxation of electronic commerce and make recommendations to Congress. That Commission submitted its report to Congress in April, 2000⁹ and several bills were introduced to implement various suggestions contained in the report. None of the bills have been enacted into law. It is important to note that, although the Internet Tax Freedom Act may be cited by some as the reason that sellers do not have to collect tax as a result of sales completed over the Internet, the act left the law, as stated by the cases cited above, undisturbed. Sellers who make taxable sales over Internet are governed as to tax collection by the case law, not in any meaningful way by the ITFA.

Business and Government Views

One of the first comprehensive reports to address electronic commerce tax issues was the National Tax Association Communications and Electronic Commerce Tax Project. The National Tax Association Communications and Electronic Commerce Tax Project (the "Project") was organized to bring together representatives of the business community, state and local governments, professional organizations, and academia who shared an interest in identifying possible solutions to the state and local tax issues raised by electronic commerce.

The purpose of the Project was "to develop a broadly available public report that identified and explored the issues involved in applying state and local taxes and fees to electronic commerce and that made recommendations to state and local officials regarding the application of such taxes."¹⁰ I had the privilege of serving on the steering committee of that project. The report ultimately reflected the widely different views of the many participants. There was no definitive answer provided to the many questions because the issues were complex and the participants held their views strongly.

Although with many caveats, the group did agree that *"there should be one tax rate per state which would apply to all commerce involving goods or services that are taxable in that state. Provision must be made to ensure protection and equitable distribution of revenues to local jurisdictions. The*

⁹ http://www.ecommercecommission.org/acec_report.pdf

¹⁰ National Tax Association Communications and Electronic Commerce Tax Project, Final Report, Approved September 7, 1999. The Final Report can be viewed at <http://www.ntanet.org/>

details of how to encourage or require states, local governments, and businesses to participate in this new system need further study". This recommendation obviously was of significant concern to local governments represented on the Project. In the end the goal of simplification was thought to worth the consideration of the recommendation. Clearly, an overriding issue for the Project participants was the number and complexity of the states and localities tax scheme as seen cumulatively. Forty-five States and the District of Columbia levy sales and use taxes and as of May 2000, approximately 7,500 local jurisdictions levied a sales tax.¹¹ The lengthy report is too long to cover here, but I commend it to you as one of the best reviews of the issues.

An Academic View

It has been suggested that there is a broad consensus among academic tax specialists regarding the general principles that should guide any effort to deal with sales and use taxation of electronic commerce. This assertion is based on a presentation to the United States Senate Finance Committee. These principles are embodied in an "Appeal for Fair and Equal Taxation of Electronic Commerce" endorsed by more than 170 academic tax economists and professors of law.¹² The principles are:

1. Electronic commerce should not permanently be treated differently from other commerce. There is no principled reason for a permanent exemption for electronic commerce. Electronic commerce should be taxed neither more nor less heavily than other commerce.
2. Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has a physical presence in the state. In limited cases, where it is impossible to determine the destination of sales of digital content to households, it may be necessary to substitute a surrogate system. In no case should taxation of remote electronic commerce be limited to origin-based taxation, which would induce a "race to the bottom" and, in effect, no taxation at all.
3. There must be enough simplification of sales and use

¹¹ Congressional Research Service, RL30667, *Internet Tax Legislation: Distinguishing Issues* (January 11, 2001) at 3. See also Joint Committee on Taxation, *Overview of Issues Related to the Internet Tax Freedom Act and of Proposals to Extend or Modify the Act* (JCX-64-01), July 30, 2001.

¹² *Federalism in the Information Age: Internet Tax Issues: Hearing Before the Senate Comm. on the Budget*, 106th Cong. (2000) (attachment to statement of Charles E. McLure, Jr., Senior Fellow, Hoover Institution, Stanford University).

taxes to make destination-based taxation of sales feasible. Such simplification might include, for example, unification of the tax base across states, unification of tax rates within states, and/or sourcing of sales only to the state level, as well as simplification of administrative procedures.

4. A means must be found to eliminate burdens of compliance on sellers making only small amounts of sales in a state. These might include software-based systems made available at state expense, more realistic vendor discounts, and/or de minimis rules. [5](#)

But how would such reform be accomplished? One of the brightest and best legal minds in this area, my friend Professor Walter Hellerstein of the University of Georgia, has suggested that “any effort to design a solution to the problems raised by state taxation of electronic commerce will almost certainly require congressional action of some kind. Most of the proposals for reform in this area have suggested that the states should be required to adopt uniform definitions of goods and services in taxing or exempting goods and services sold in electronic commerce and to impose only one rate per state. It is difficult to imagine that this result can be achieved without congressional legislation. Similarly, many observers believe that any sensible approach to taxation of electronic commerce must modify the rule of *Quill Corp. v. North Dakota*, that out-of-state vendors without physical presence in the state may not be compelled to collect use taxes on sales to local consumers, regardless of the nature or extent of their sales into the state. Congressional action will almost certainly be required to alter the rule of *Quill*, except in the unlikely event that the Court would revisit and reverse its *stare decisis* based decision in that case”. ¹³

Moreover, as if Professor Hellerstein were talking to this group today he ended his article by saying “The problems raised by state taxation of electronic commerce have spawned an enormous interest in -- and controversy over -- an area of the law that the Supreme Court has characterized as a “quagmire.”¹⁴ The most promising prospects for resolving these problems reside today in the legislative branches of government at both the federal and state levels. One can only hope that as Congress and the state legislatures turn their attention to these issues, their decisions are informed by sound principles of tax policy.”

¹³ SYMPOSIUM: DEBATING THE PROSPECT OF E-COMMERCE TAXATION: ARTICLE POLICY COMMENTARY: Deconstructing the Debate Over State Taxation of Electronic Commerce, Walter Hellerstein, Francis C. Shackelford Professor of Taxation, University of Georgia School of Law *13 Harv. J. Law & Tec* 549, Summer, 2000

¹⁴ *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)

The European Solution

The Commission of the European Communities, on June 7, 2000, issued a proposed Council Directive on applying value added taxes ("VATs") to services delivered by electronic means. A VAT is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. The VAT taxable base is generally defined as the amount of value added, which is the difference between the value of sales (outputs) and purchases (inputs) of an enterprise. The proposed directive was designed to level the playing field for European Union ("EU") and non-EU vendors, such as U.S. vendors, of digital products. Under existing EU laws, an EU vendor must charge VAT on digital products sold to a customer, regardless of whether the customer is located in the EU or elsewhere.

A U.S. vendor, however, is not obligated to charge VAT on digital products sold to a private customer in the EU. The proposed directive would remove the obligation of the EU vendor to charge VAT on the sale of digital products to a customer outside the EU. It also would impose the obligation to charge VAT on the sale of digital products by a U.S. (or other non-EU) vendor to a private customer in the EU if the U.S. vendor's annual sales to private customers of digital products in the EU exceeded 100,000 euros. To facilitate registration, a U.S. vendor would need to register in only one of the EU member countries to conduct business in the entire EU and would apply tax at the rate of VAT levied by that country.

The European Union has moved forward with this Directive and it is scheduled for implementation on July 1, 2003. U.S. businesses objected mightily to this directive, but the EU would not be dissuaded. If business can comply with this regime, maybe the issue of burden will become less persuasive in the United States.

Conclusion

The controversy is alive and well today. Reuters news service reported recently that California tax authorities are auditing barnesandnoble.com to determine whether the retailer improperly avoided collecting state sales tax on Internet sales. "Our decision sends a message to national retailers: do not try to use the Internet as a tax haven for your California stores that constitute one eighth of our great nation's retail market," said Carole Migden, chair of the Board of Equalization, the state tax agency. Barnes & Noble, the bookstore chain, has 84 stores across California, but maintains that barnesandnoble.com, an entity in which it owns a 38-percent stake, does not have a physical presence in the state.

In addition, just last week it was reported that U.S. retail sales on the Internet are expected to climb by 26 percent to about \$96 billion this year, according to a study released by The Shop.org and Forrester Research¹⁵ The survey of more than 130 retailers found that online retail sales jumped 48 percent to \$76 billion last year. The sum was about 3.6 percent of total U.S. retail sales. For 2003, online sales are expected to account for 4.5 percent of total U.S. retail sales.

“Last year was about breaking even. 2003 is about generating profits,” said Kate Delhagen, consumer markets research director with Forrester. Last year, online retailers collectively broke even, versus a decline of 6 percent in 2001. For so-called clicks-and-mortar retailers with both online and offline stores, the study found 46 percent of customers who shopped online also purchased goods at stores, while 17 percent of offline customers also shopped on company Web sites. Sears, Roebuck and Co., a major online retailer through its Lands’ End and Sears Web sites, said last week its Internet division was profitable in 2002, a year earlier than it expected.

Recognizing the rapid rate of passage of what has been called “internet time” I am now of the opinion that the term “electronic commerce” has become virtually outdated as a concept in the debate about taxes. Ecommerce is just commerce. Was the development of moveable type that lead to the printing of the Gutenberg Bible such a radical development that the entire scheme of taxation had to be revamped? Was the steam engine such a change that transportation by horse and wagon could no longer be taxed? No, electronic commerce merely facilitates the conduct of business and while tax systems may have to recognize the change and adjust, no new radical scheme of taxation is needed.

¹⁵ May 15, 2003, 10:15 a.m. Reuters News Service