
**‘OLD ECONOMY’ TAX SYSTEMS ON A ‘NEW ECONOMY’ STAGE:
THE CONTINUING VITALITY OF THE ‘PHYSICAL PRESENCE’ NEXUS
REQUIREMENT**

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TABLE OF CONTENTS

I.	INTRODUCTION	2
II.	<i>QUILL’S PHYSICAL PRESENCE RULE FOR SALES TAXES</i>	7
	A. <i>National Bellas Hess and Quill</i>	7
	B. <i>Physical Presence in the New Economy</i>	10
III.	A BRIEF COMPENDIUM OF THE INEQUITABLE AND EVER-EXPANDING BURDENS INHERENT IN TODAY’S STATE AND LOCAL SALES AND USE TAX SYSTEMS ..	12
	A. <i>Introduction</i>	12
	B. <i>The Siren Song of Technology</i>	13
	C. <i>The Class Action Dilemma</i>	15
	D. <i>Where is my Customer? Treatment of Digital Goods</i>	15
	E. <i>Additional Issues</i>	16
IV.	EVALUATING THE STREAMLINED SALES TAX AGREEMENT	17
	A. <i>Background</i>	17
	B. <i>Elements of the Agreement</i>	19
	C. <i>COST’s Report Card on the Streamlined Sales Tax Agreement</i>	20
	1. <i>Background</i>	20
	2. <i>The Relevance of Business Activity Nexus Standards</i>	21
	3. <i>The COST Report Card</i>	21
	4. <i>Next Steps</i>	26
V.	GULLIVER AMONG THE LILLIPUTIANS: THE NEED FOR A PHYSICAL PRESENCE REQUIREMENT FOR BUSINESS ACTIVITY TAXES IN THE NEW ECONOMY	27
	A. <i>The ‘New Economy’ Question</i>	28
	B. <i>Corporate Income Tax Uniformity</i>	29
	C. <i>Multijurisdictional BAT Burdens</i>	29
	D. <i>The Revenue Question</i>	30
VI.	CONCLUSION	32

‘Old Economy’ Tax Systems on a ‘New Economy’ Stage: The Continuing Vitality of the ‘Physical Presence’ Nexus Requirement

by Douglas L. Lindholm¹

INTRODUCTION

Few issues in state taxation have been more hotly debated than the Supreme Court’s 1992 endorsement in *Quill v. North Dakota*² of the bright-line physical presence nexus requirement for collection of use taxes. The rule, derived from the Court’s holding in *National Bellas Hess v. Illinois*³ in 1967, was rescued from the proverbial jurisprudential dustbin (where numerous state legislators, academics and state tax officials had consigned it prior to 1992), then dusted off and enshrined as the centerpiece of Commerce Clause jurisprudence in the sales tax arena. The *Quill* Court’s decision to set forth on a new path by articulating different standards for Due Process nexus and Commerce Clause nexus has provided a stream of commentary from countless academic and legal commentators, and the passage of time has not stanching the flow.⁴ From a tax policy perspective, the decision has been no less of a catalyst. The *Quill* decision has sparked a national debate over collection of the sales tax by remote sellers that continues in earnest today — a debate that implicates such weighty and constitutional issues as fiscal federalism, states’ rights and global competitiveness. Indeed, the issue has achieved national prominence in publications outside of the state tax press, appearing regularly in the pages of the *New York Times*, *Wall Street Journal* and *USA Today*, among others. Finally, however, nearly eleven years after *Quill* was handed down, the issue appears ripe for resolution. Significant efforts to streamline sales tax systems, budget difficulties at the state level, the pending expiration of the moratorium on taxation of Internet access, and business concerns over business activity tax nexus may form the foundation for Congressional action on what has thus far proven to be an intractable problem.

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² 504 U.S. 298 (1992).

³ 386 U.S. 753 (1967).

⁴ During 2002 alone, 63 articles in State Tax Notes Magazine discussed the *Quill* case (based on an Internet search on Lexis). See, e.g., Debra S. Callihan, *Sales Tax Nexus and Remote Vendors*, STATE TAX NOTES, Sep. 23, 2002, p. 949; Robert Cline, *Can the Current State and Local Business Tax System Survive the New Economy Challenges?*, STATE TAX NOTES, April 15, 2002, p. 241.

The “problem,” at its most fundamental, is this: by some estimates, over \$20 billion in state sales and use taxes that are legally due from Internet and catalogue purchases remain uncollected annually⁵. Blame for this shortfall, rightly or wrongly, has been laid squarely at the feet of the physical presence rule for sales taxes laid down by *Quill*. Arguments for and against the utility of the rule are backed by compelling factors. Taxpayers are concerned not only about the legal and compliance burdens that a rule based on a strictly economic presence might engender, but also over implications for nexus standards for other types of taxes. From state tax officials and academicians, as might be expected, the majority of the commentary regarding the *Quill* decision has been critical.⁶ The criticism typically focuses on the Court’s “apologetic tone” in its reliance on *stare decisis*; its assertion that a “bright-line rule” creates more certainty; and the Court’s “failure” to acknowledge wholesale changes in the law and economy sufficient to repudiate *National Bellas Hess*. Finally, the creative jurisprudence engaged in by the Court as it tiptoed through its prior precedents to comport with its newly decoupled analytical framework for the Due Process and Commerce Clauses has raised some eyebrows.

⁵ See General Accounting Office, *Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-65 (June 2000) (The GAO developed lower and higher revenue loss scenarios for state and local revenue losses from all remote sales. “The rapid change in the Internet economy makes projections of Internet and total remote sales for future years considerably more uncertain than they are for 2000.” Based on varying assumptions, the GAO estimated that the total revenue loss on all remote sales could range from \$2.5 billion to \$20.4 billion in 2003.) By contrast, in April 2000, Professor Donald Bruce and William F. Fox produced a study that estimated revenue losses due to e-commerce in 2003. This study pointed out that states, limited by the *Quill* decision, are unable (or unwilling due to cost-prohibition) to enforce collection of use tax on remote purchases. It estimates approximately “\$10.8 billion in additional tax revenue losses nationwide in 2003” as a result of e-commerce. Donald Bruce & William F. Fox, *E-Commerce in the Context of Declining State Sales Tax Bases* (Apr. 2000), available at <http://ncsl.org/programs/fiscal/tclinks.html>; See also, Teri Rucker, *Dorgan Says Taxes From E-Commerce Would Help States*, NATIONAL JOURNAL’S CONGRESS DAILY, January 23, 2003 (Sen. Byron Dorgan (D-ND) told the U.S. Conference of Mayors that “[b]etween \$25 billion and \$30 billion in consumption taxes will be owed but not paid to state and local governments because the taxable goods are purchased online.”) Most recently, Frank Shafroth, director of state-federal relations for the National Governors Association, estimated that in 2004 there will be \$35 billion of state and local revenues from uncollected taxes on e-commerce and that the number will jump to \$50 billion in 2008, SATURDAY STATE-TIMES/MORNING ADVOCATE (Baton Rouge, L.A.), February 8, 2003.

⁶ See, e.g., Jerome R. Hellerstein & Walter Hellerstein, *State Taxation: Constitutional Limitations and Corporate Income and Franchise Taxes* ¶ 6.08 (3d ed. 1907-2000) (stating a corporation that regularly exploits state markets should be subject to its state income tax whether or not it is physically present); Michael T. Fatale, *State Tax Jurisdiction and the Mythical ‘Physical Presence’ Constitutional Standard*, 54 TAX LAW. 105, 131 (“In general, the state court cases determine that, when a taxpayer has income derived from a state’s economic market, the taxpayer is subject to that state’s income tax.”); John A. Swain, *Perspective: State Income Tax Nexus: Making the Case for an Economic Presence Standard in Light of Quill*, TAX MANAGEMENT WEEKLY STATE TAX REPORT, November 15, 2002. (The article looks to *Quill* and income tax nexus court decisions preceding *Quill* to support the conclusion that physical presence is probably not an income tax nexus requirement).

The criticism has been loud because the stakes are large and still growing.⁷ Although the decision rests partially on *stare decisis* grounds, state tax officials are still aggressively working the edges of the rule in the courts⁸ while at the same time emphasizing changes in technology and the economy that would justify a departure from *stare decisis*. And with legislative efforts at resolving the issue before Congress bearing little fruit thus far,⁹ political efforts to resolve the issue have focused, rightly, on reducing the administrative and compliance burdens the Court has indicated create undue burdens on interstate commerce.¹⁰ Over the past three years, state tax officials, with assistance from a broad spectrum of the business community, have undertaken a comprehensive effort to streamline state sales tax systems.¹¹ Ostensibly designed to induce voluntary compliance on behalf of remote sellers, the new “streamlined” system will inevitably become the basis for federal legislation that seeks to overturn *Quill* and its physical presence requirement. The *Quill* Court invited (pleaded for?) Congressional action on the issue over a decade ago. Despite much introduced legislation and numerous high-level efforts to address the sales tax collection issue, there is still no clear consensus regarding what degree of “simplification” is necessary to warrant overturning *Quill*; nor is there clear consensus on whether nexus standards for business activity taxes will be included in, or impacted by, such legislation.

⁷ Internet use grows at the rate of 10% to 20% per month, with 30 million users on the Internet worldwide. 56 ST. TAX REV. (CCH) 33, Aug. 14, 1995, at 8. In 1994, there were 10,000 vendors on the Internet with expert projections seeing this number reaching 1 million by the year 2000. See also Alan Reynolds, *The Futility of an Internet Sales Tax*, AMERICAN OUTLOOK, Winter 2000, at page 35 (estimating electronic commerce will grow by 1000 percent over the next four years, passing \$1.5 trillion dollars in revenue by 2003). According to Forrester Research, total receipts of online retailers reached \$78 billion in 2002, an increase of more than 50% over 2001.

⁸ See *In re Borders Online*, 2001 Cal. Tax LEXIS 604 (Sept. 26, 2001) (The California State Board of Equalization ruled that Borders, Inc., which was the Borders group's brick-and-mortar bookseller, was an in-state agent of Borders Online because Borders, Inc.'s California stores accepted return merchandise purchased from Borders Online. Accordingly, Borders Online had an obligation to collect use taxes from its California customers); *In the Matter of Barnes&Noble.com*, CA Bd. Of Equalization, Case ID 89872 (9/12/02) (The California Board of Equalization has determined that an out-of-state Internet company is subject to California sales and use tax collection responsibility when its in-state bricks & mortar affiliate distributes coupons on its behalf.)

⁹ See 1420 Tax Mgmt. Portfolio (BNA), Tax Management Portfolios Multistate Series 1420-1st : Limitations on States' Jurisdiction to Impose Sales and Use Taxes, 04. Legislative Efforts, C. Federal Legislative Efforts After *Quill*.

¹⁰ State government officials and administrators, with input from local governments and the private sector, created the Streamlined Sales Tax Project (SSTP). In November 2001, the Streamlined Sales Tax Implementing States (SSTIS or Implementing States), was organized to represent those states that had passed legislation committing to the streamlining effort. The recommendations adopted by the SSTP were then forwarded to the SSTIS, which voted on whether to include them in the multi-state compact known as the Streamlined Sales and Use Tax Agreement. On Nov. 12, 2002, the SSTIS adopted the agreement. TAX MANAGEMENT WEEKLY STATE TAX REPORT ANALYSIS, January 3, 2003.

¹¹ See Diane L. Hardt, Douglas L. Lindholm & Joseph R. Crosby, *A Lawmaker's Guide to the Streamlined Sales Tax Project*, JOURNAL OF STATE TAXATION, Volume 21, No. 2, Fall 2002.

If state legislatures are even moderately successful in streamlining their sales tax systems, they intend to ask Congress to overturn the *Quill* physical presence rule and authorize the states to compel remote sellers to collect use taxes on their behalf. It is the sense of many in the business community, however, that to repeal the only Supreme Court decision where the Court has approved such a rule may effectively repudiate its applicability to other taxes. To avoid that unintended consequence, such business interests will seek to require any federal legislative effort that overturns *Quill* to include an endorsement of the physical presence rule for business activity taxes. By any measure, the dollar value of uncollected use taxes the states would collect if *Quill* is overturned would far outweigh the budgetary impact of endorsing a physical presence rule for business activity taxes.¹² On its face, such an arrangement seems worth further exploration.

Current circumstances beg several questions: Did the *Quill* Court get it right? Is the physical presence standard a workable standard given our current level of technological sophistication? Is the physical presence requirement an appropriate rule for business activity taxes? With the legal arguments unresolved, commentators calling for the rule's demise from a policy perspective argue that it is amorphous, anachronistic, and an inappropriate measure of the presence of an entity that is essentially a legal construct with no real presence anywhere.¹³ Further, they argue that in today's cyberspace economy — marked by an ability to conduct business remotely via the Internet and other advanced telecommunications — it is much easier for corporations to exploit a state's marketplace, thereby deriving a benefit for which a state may ask something in return.¹⁴

Such commentators, however, have failed to observe a crucial factor evident on a larger scale. Over the last decade or so, the nation's economy has undergone a metamorphosis with no historical comparisons — a transformation so radical that economists today routinely differentiate between “new economy” concepts and “old economy” concepts.¹⁵ The “new economy” is marked by electronic commerce, real-time purchasing and inventories, broad-band speed and capacity, and intangible assets

¹² Compare dollar values at *supra* note 5, and *infra* note 92.

¹³ Michael T. Fatale, *State Tax Jurisdiction and the Mythical 'Physical Presence' Constitutional Standard*, 54 TAX LAW 105, 131 (“a corporation, though designated as a 'person' for purposes of various legal requirements including tax filings, is a mere legal construct that is not in fact present anywhere.”)

¹⁴ *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). While this is clearly a Due Process concept, it continues to resonate with state tax officials. See the Multistate Tax Commission's recent Business Activity Factor Nexus Proposal by Dan Bucks and Frank Katz, STATE TAX NOTES, September 30, 2002 at 1037.

¹⁵ See, e.g., *Can America's New Economy be Steered with an Old-Economy Compass?* THE ECONOMIST, (3-25-2000), 2000 WL 8141288; Mark D Partridge, *Did the New Economy Vanquish the Regional Business Cycle?*, CONTEMPORARY ECONOMIC POLICY, volume 20, 2002 (“The record economic expansion of the 1990s has led many to speculate that the United States is experiencing a New Economy.”); Alan Murray, *Accounting Rules Should Still Adapt To New Economy*, THE WALL STREET JOURNAL, July 23, 2002 (“There is a New Economy, in the form of companies whose value is determined far more by intangible assets than physical ones.”); Karl Albrecht, *Service America in the New Economy*, TRAINING, September 1, 2002, 2002 WL 11897941; Raymond C. Scheppach & Frank Shafroth, *Governance in the New Economy and State Strategies for the New Economy*, available at the National Governor's Association web site at <<http://www.nga.org>>.

— traits that even “old economy” industries (e.g., manufacturing) regard as essential to survival in today’s global economy. State tax systems, on the other hand, are almost universally recognized as outdated and obsolete.¹⁶ If states (and/or localities) are given free rein to impose tax burdens on any/every company that has customers within a taxing jurisdiction’s geographic boundaries,¹⁷ the potential for significantly interfering with the free flow of the new economy’s much-faster-paced interstate commerce becomes much greater. Consequently, the more our economy relies on speed, real-time applications and immediate access to digital information, the easier it is for our current geographic-based state tax systems, left unchecked, to impose burdens unacceptable under the Commerce Clause. An “economic presence” nexus standard as espoused by many commentators and state tax officials would not only impose an unjustifiable burden on interstate commerce, it would also unduly hinder the ability of U.S.-based companies to compete on a global basis with foreign competitors not forced to operate under such ponderous sub-national tax systems.¹⁸

The physical presence nexus standard is by no means the solution to the problems plaguing our state and local tax systems. However, it does provide some measure of certainty for taxpayers seeking to comply with incredibly complex sets of rules for both sales taxes and business activity taxes as they exist today. As a long-range solution, it would be far preferable to address these problems by seeking systemic reform of our national and sub-national tax systems in light of technological and competitive changes in the global economy. Assuming, however, that political will for such an effort is absent, Congress must nevertheless be careful to avoid jeopardizing the ability of our nation’s commerce to compete on a global basis. Part I of this paper discusses the legal latticework supporting the *Quill* Court’s physical presence requirement, and explores the ramifications of the decoupling of the Due Process nexus standard from the Commerce Clause nexus standard. Part II takes a closer examination

¹⁶ See, e.g., Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*, NEW ENG. ECONOMIC REV., volume 2001, page 27-43; Traci Gleason & Jesse Rothstein, *Taxes and the Internet: Updating Tax Structures for a Wired World*, 17 STATE TAX NOTES 491 (Aug. 23, 1999); Julie M. Buechler, *Virtual Reality: Quill’s “Physical Presence” Requirement Obsolete When Cogitating Use Tax Collection in Cyberspace*, 74 N.D. L. Rev. 479 (1998).

¹⁷ The Multistate Tax Commission has proposed a factor-based nexus standard which would allow a state to impose a business activity tax if a taxpayer has more than \$50,000 in payroll, \$50,000 in property OR \$500,000 in sales in a state. The MTC Executive Committee endorsed the MTC’s “Factor-Presence Nexus Standard” (sales alone in a state above a *de minimis* amount is sufficient to create nexus for income tax purposes). The Committee unanimously voted (with 3 abstentions) to pursue the standard in Congress as part of an effort to repeal PL 86-272, and as an alternative to the physical presence nexus standard contained in HR 2526. Under their proposal, in those states where the factor-based standard is adopted, PL 86-272 would be inapplicable.

¹⁸ See, e.g., Stephen Utz, *Tax Harmonization in Europe and America*, 9 Conn. J. Int’l L. 767, 769 (1994) (indicating that growing state tax burdens within the United States may influence the “rolling recessions” that afflict one region of the United States and then another); Klaus Vogel, *Worldwide vs. Source Taxation of Income: A Review and Reevaluation of Arguments, in Influence of Tax Differentials on International Competitiveness* (1990); Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector*, 14 Am. J. Tax Pol’y 361 (1997) (showing that the de facto assignment of consumption taxation to the states and localities is far higher in the U.S. than most other European and Asian countries.)

of the more onerous burdens and inequities imposed upon multistate taxpayers by current state sales tax systems, and will explore the shortcomings of current technology-based solutions. Part III reproduces the Council On State Taxation’s ‘Report Card’ on the recently approved Streamlined Sales Tax Agreement¹⁹ and discusses whether the proposed simplifications, if enacted by states, are sufficient to warrant federal legislation overturning *Quill*. Finally, Part IV discusses the need from a policy perspective for a physical presence nexus standard for business activity taxes, and why adoption of such a standard is an essential component of any federal legislation that proposes to overturn *Quill*.

PART I — *Quill*’s Physical Presence Rule for Sales Taxes

National Bellas Hess and Quill.

Justice Potter Stewart’s pointed reminder in *National Bellas Hess* that “[t]he very purpose of the Commerce Clause²⁰ [is] to ensure a national economy free from . . . unjustifiable local entanglements”²¹ serves as an effective backdrop when analyzing the efficacy and usefulness of the *Quill* physical presence rule. Under long-standing Commerce Clause jurisprudence, the Court has determined that the Commerce Clause, although an explicit grant of power to Congress, implicitly carries a “negative sweep” as well. “The Clause . . . ‘by its own force’ prohibits certain state actions that interfere with interstate commerce.”²² In the state tax context this “negative” or “dormant” Commerce Clause jurisprudence has evolved considerably, reaching relative stasis in the Court’s 1977 decision in *Complete Auto Transit v. Brady*²³ and its progeny. Under *Complete Auto*’s four-prong test, a state tax will be sustained “against a Commerce Clause challenge so long as 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.’”²⁴ If the Court finds that a state tax scheme unduly burdens interstate commerce, however, it is squarely within Congress’ purview to determine whether such undue burdens are acceptable, based on policy or other considerations.²⁵

When the Court first considered a physical presence rule for collection of use taxes in 1967 in *National Bellas Hess*, the issue was not new to the Court nor to public debate. In the aftermath of the

¹⁹ See *supra* notes 10 and 11.

²⁰ U.S. CONST., art. I, § 8, cl. 3

²¹ *National Bellas Hess v. Department of Revenue of State of Illinois*, 386 U.S. at 760 (1967).

²² *Quill*, 504 U.S. at 309, citing *South Carolina State Highway Dept. v. Barnwell Brothers, Inc.* 303 U.S. 177.

²³ 430 U.S. 274 (1977).

²⁴ *Quill*, 504 U.S. at 311, citing *Complete Auto Transit v. Brady*, 430 U.S. 274, at 279.

²⁵ *Quill*, 504 U.S. at 305, 318.

adoption of P.L. 86-272 in 1959,²⁶ Congress established the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary (known as the “Willis Commission,” after Edwin Willis (D-La), its Chairman). In 1965, after nearly six years of fact finding and deliberations, the Willis Commission released its recommendations with regard to state taxation of interstate commerce. Although primarily concerned with state corporate income taxes, the Commission report contained recommendations regarding collection of use taxes as well. Under uniform rules applicable to all states, the report recommended not allowing states to compel remote (out-of-state) sellers to collect use taxes on sales into a state unless the seller: a) owned or leased property in that state; b) had employees in the state providing services performed entirely in the state; and c) made regular deliveries into the state using company owned vehicles or a private delivery service to make deliveries to private residences.²⁷ Congress ultimately demurred on the legislation in response to the states’ insistence that they were capable of resolving the complexity and lack of uniformity surrounding state corporate income taxes themselves.²⁸ Nevertheless, the Commission recommendations and earlier passage of P.L. 86-272 clearly had some influence on the *Bellas Hess* decision.²⁹

In *National Bellas Hess*, the Court held that a state could not impose the duty of use tax collection and payment on a seller whose only connection with customers in the state was through a common carrier or the U.S. mail.³⁰ National Bellas Hess, a mail-order house located in Kansas City, Missouri, was licensed to do business in Missouri and Delaware (its state of incorporation) and conducted its mail-order business by means of catalogues and occasional advertising flyers mailed to past and potential customers nationwide, including those in Illinois. Although the company maintained neither outlets nor sales representatives in Illinois, the Illinois Department of Revenue sought to impose a collection duty based on its statutory definition of retailer, which included any retailer “[e]ngaging in soliciting orders within this State from users by means of catalogues or other advertising, whether such orders are received or accepted within or without this State.”³¹ National Bellas Hess argued that the liabilities imposed on the company violated the Due Process Clause of the 14th Amendment and created an unconstitutional burden on the free flow of interstate commerce.

In its majority opinion the Court, noting that the tests for determining violations of the Due Process Clause and the Commerce Clause were similar, held that the imposition of a collection duty on

²⁶ P.L. 86-272, codified at 15 U.S.C. §§ 381-84.

²⁷ Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, H.R. Rep. No. 565, 89th Cong., 1st Sess. (1965); and H.R. Rep. No.2013, 89th Cong., 2d Sess. (1966). See also W. Val Oveson, *Lessons in State Tax Simplification*, 23 State Tax Notes 283 (Jan. 28, 2002).

²⁸ Oveson, *id.* at 285.

²⁹ See *National Bellas Hess*, *supra* note 3.

³⁰ *National Bellas Hess*, 386 U.S. at 753.

³¹ *Id.* at 755. It is interesting to note that the language in the Illinois statute that delineates taxable activities is remarkably similar to language in P.L. 86-272 that describes activities *protected* from income taxation (*e.g.*, solicitation of orders, *etc.*).

National Bellas Hess was unconstitutional, largely because of the burden imposed by the complexity of state sales tax systems. The Court found that the many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle the company's interstate business "in a virtual welter of complicated obligations."³² The Court noted with approval the sharp distinction in its prior cases between mail-order sellers with retail outlets, personnel, and property in a state and those doing no more than communicating with customers in a state by mail or common carrier.³³

Part of the current polarization over the sales tax collection issue can be traced to the fact that in the 25 years between *National Bellas Hess* and *Quill*, numerous state legislatures and tax officials simply chose to ignore the decision completely. Convinced that the decision was anachronistic based on changes in the economic and legal landscape, officials in numerous states began adopting "anti-*Bellas Hess*" statutes and/or regulations that focused on strong language in the *Bellas Hess* dissent.³⁴ The dissent opines as to whether the activities of National Bellas Hess are sufficient to create nexus absent a physical presence: "There should be no doubt that this large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market is a sufficient 'nexus' to require Bellas Hess to collect from Illinois customers and to remit the use tax..."³⁵ With regard to the potential compliance burden on remote sellers, the dissent effectively dismisses it by suggesting "...it is, indeed, hardly more of a burden than it is on any ordinary retail store in the taxing State."³⁶ Armed with such language and emboldened by such reasoning (however flawed), tax officials in the late eighties were quick to point to the growth in the economy and improvements in computer technology as justification for casting *National Bellas Hess* by the wayside.³⁷ It was such blatant disregard for the Court's earlier decision that brought the issue back to the High Court in 1992 in *Quill v. North Dakota*.

³² *Id.* at 760.

³³ *Id.* at 758.

³⁴ For a listing of state statutes that were enacted in bold disregard of the Supreme Court's decision in *National Bellas Hess*, see Douglas, *State Officials Determined to Tax Interstate Mail-Order Sales*, 47 Tax Notes 1048 (1990); Rothfeld, *Mail Order Sales and State Jurisdiction to Tax*, 53 Tax Notes 1405 (1991) ("At least 34 states have enacted laws imposing use tax liability on direct marketers who lack an in-state physical presence.") At least 19 states imposed a use tax collection obligation on mail-order firms that regularly or systematically solicited sales in the state by mail or electronic means of communication — AZ, AR, CT, FL, GA, KS, LA, MA, MN, MO, NC, ND, OK, PA, RI, TN, UT, VT & WA. Three other states imposed tax obligations on firms that took orders by mail or solicited business via in-state by catalogs — MS, NJ & SC. Eleven states imposed tax obligations if the mail-order firm regularly solicited business in-state and, in addition, benefitted from in-state financial services, telecommunications, marketing activities, or service facilities — CA, ID, IL, IA, KY, NE, NV, OH, TX, VA & WV. Finally, one state imposed tax obligations on firms "attempting to exploit its markets" (NM).

³⁵ *National Bellas Hess*, 386 U.S. at 761.

³⁶ *Id.* at 766. (As discussed in Part II, *infra*, there is a significantly greater burden imposed on the remote seller as compared to the in-state retail store.)

³⁷ *Supra*, note 34.

In *Quill*, the Court addressed the same issue based on essentially the same facts: May a state compel an out-of-state retailer to collect use taxes on sales to customers in that state if its only contacts with the state are via U.S. mail or common carrier? In answering that question, the Court for the first time found that a tax was constitutional under the Due Process Clause but not the Commerce Clause.³⁸ Although the Court acknowledged that they had “not always been precise in distinguishing the two, [the two clauses] are analytically distinct” and “pose distinct limits on the taxing powers of the states.”³⁹ The Due Process Clause, the Court notes, is concerned with fundamental fairness of governmental activity and is premised on whether a taxpayer has notice or fair warning that a tax may be imposed. The Commerce Clause, on the other hand, is concerned with whether a given tax unduly interferes with the free flow of interstate commerce.⁴⁰ Based on this distinction, the Court then noted, based on its prior decisions, that the appropriate nexus standard under the Due Process Clause was “minimum contacts” while the standard for passing Commerce Clause muster was “substantial nexus.”⁴¹ Further, the Court noted that a mail-order house such as *Quill* may indeed have the minimum contacts required for nexus under the Due Process Clause, yet lack the substantial nexus with the state required by the Commerce Clause. In affirming its Commerce Clause holding in *National Bellas Hess*, the Court specifically overruled its earlier holdings “to the extent [they] indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax.”⁴²

Physical Presence in the New Economy

The *Quill* Court’s decision to affirm the *National Bellas Hess* physical presence rule on the basis of the Commerce Clause, yet overrule *Bellas Hess* on Due Process grounds marked a significant break from its earlier handling of the two clauses. In most cases, the two clauses were treated as inseparable; *i.e.*, if a tax was found to be fundamentally unfair, that fact alone created an undue burden on interstate commerce.⁴³ Although it is clear that part of the reason for the Court’s separate Commerce Clause ruling was to clear the way for Congress to act, the Court’s action has implications beyond the immediate issue of use tax collection. The dormant Commerce Clause is implicated whenever there’s an “undue” burden on interstate commerce. The Court found such a burden in *National Bellas Hess*, and reaffirmed that such a burden still existed in *Quill*, in spite of the “the

³⁸ *Quill*, 504 U.S. at 305.

³⁹ *Id.*

⁴⁰ *See Quill*, 504 U.S. at 312.

⁴¹ *Id.* at 313.

⁴² *Id.* at 308.

⁴³ *See Quill*, 504 U.S. at 306, citing *International Harvester Co. v. Department of Treasury*, 322 U.S. 340, 353 (1944).

tremendous social, economic, commercial, and legal innovations” of the intervening twenty-five years.⁴⁴ With the advent of the Internet and its ability to facilitate remote transactions, it is fair to assume that the changes over the past decade (post-*Quill*) were much greater than in the pre-*Quill* era.⁴⁵ Indeed, the technological changes over the past decade have been so fundamental that they are collectively credited with giving rise to an entirely ‘new’ economy, characterized by speed, real time capabilities and an ability to operate in ‘cyberspace’ — free of geographic constraints. It is against this backdrop that the continuing vitality of the physical presence rule must be evaluated.

Many commentators are quick to point to improvements in technology as a reason for abolishing the physical presence rule. They argue that such a rule, grounded in geographic limitations, has no place in today’s Internet and software driven economy.⁴⁶ This, however, is an old refrain: the dissent in *National Bellas Hess* argues that the majority decision “vastly underestimates the skill of contemporary man and his machines” in their ability to collect use taxes on remote transactions without unduly burdening interstate commerce.⁴⁷ What these commentators fail to take entirely into account, however, is the ‘skill of contemporary man and his machines’ in designing and operating new forms of commerce that further complicate the remote collection burden. It is a fundamental truth that state tax systems will constantly be playing catch-up to technological improvements in the market place.⁴⁸ Unless and until a new system of state taxation is devised that is not based entirely on geographic boundaries, we will continue to face the inherent conflict of ‘old economy’ tax systems imposed upon ‘new economy’ commerce. The *Quill* Court’s elegant response to that conflict — separating Due Process (where Congress may not act) from the Commerce Clause (where Congress may act), acknowledges the burden and places responsibility for it squarely where it should be — before Congress.

Indeed, now that the Court has clearly delineated a distinction in its analyses of the two Clauses, it will find it difficult to ever again address them in a similar manner. The reason appears obvious: the tremendous growth of the ‘new’ economy, in terms of speed, precision and increased

⁴⁴ *Quill*, 504 U.S. at 301, citing the North Dakota Supreme Court’s decision to ignore *National Bellas Hess*, 470 N.W.2d 203, 208 (1991).

⁴⁵ See *supra* note 15.

⁴⁶ See e.g., Julie M. Buechler, *Virtual Reality: Quill’s “Physical Presence” Requirement Obsolete When Cogitating Use Tax Collection in Cyberspace*, 74 N.D. L. REV. 479 (“Historical justifications for maintaining the traditional physical presence requirement no longer comport with cyberspace’s new and rapidly changing technologies and commercial methodology.”); Kathleen P. Lundy, *The Taxation of E-Commerce: The Inapplicability of Physical Presence Necessitates an Economic Presence Standard*, 8 RICH. J.L. & TECH. 12. (“Two of the reasons for *Quill*’s retention of a physical presence standard, the ease of a bright-line test and the prevention of an undue burden on interstate commerce, appear to be diminished by an increasingly diverse e-commerce business and the evolution of modern technology.”)

⁴⁷ *National Bellas Hess*, 386 U.S. at 766.

⁴⁸ See generally, Matthew N. Murray, *Competition, Complexity, and Constraints: The Evolving Nature of State and Local Tax Systems*, STATE TAX NOTES, January 20, 2003 at 221.

competitiveness, will continue to outpace the ability of geographic-based state tax systems to fit seamlessly within that economy. A physical presence rule, therefore, is necessary for precisely the reason commentators are calling for its demise. It must exist in order to limit state geographic-based systems from unduly interfering with ‘new economy’ commerce. *Quill* notes that the physical presence rule is “artificial at its edges”⁴⁹ and is criticized for not actually effectively reducing the compliance burden.⁵⁰ While this argument may have some merit with regard to the rule’s precise effectiveness, the rule nevertheless offers taxpayers the choice as to where and whether to shoulder complex state compliance burdens, instead of leaving it in the hands of their customers. As Part II of this paper illustrates, the precise nature of current burdens visited upon today’s economy by state tax systems becomes critical to the need for the physical presence rule.

PART II — A Brief Compendium of the Inequitable and Ever-Expanding Burdens Inherent in Today’s State and Local Sales and Use Tax Systems

Introduction. The only way to truly understand the daunting complexity of today’s state sales tax systems is to actually experience the mind-numbing difficulty of managing the sales tax cycle in a large corporation — from developing and maintaining taxability matrices; to managing sales tax exemptions and resale certificates; to placing the correct numbers on actual tax returns; to electronic filing and payment of such returns; and, ultimately through audits, assessments and appeals. This complexity grows with the number and types of products sold and/or purchased by a company, the number of wholesale/retail transactions involved, and the number of jurisdictions where the company is potentially present. Many commentators without such experience who have called for the demise of the physical presence rule (*e.g.*, academicians, economists and jurists)⁵¹ tend to view the sales tax collection problem through the prism of a typical remote transaction — *i.e.*, an individual consumer shops via Internet or catalogue, orders taxable tangible personal property and has it shipped to his or her home address. Apart from inherent limitations noted below, such a ‘typical’ transaction does not create insurmountable tax compliance problems for large remote sellers, although compliance costs are significant. It is the myriad of atypical transactions — drop shipments, gift purchases, sales of digital property/services, returns & allowances, exempt transactions, leases, etc. — that generate the greatest compliance complexity. The majority of these atypical sales transactions (which exceptions are quickly becoming the rule) may fairly be characterized as ‘new economy’ transactions, and are expected to

⁴⁹ *Quill*, 504 U.S. at 315

⁵⁰ Swain, *supra* note 6. “It is difficult to argue, for example, that *Quill*’s compliance burden would be less if it periodically sent sales representatives into the state, or had a small office in Bismarck.”

⁵¹ *See, e.g.*, Swain, *supra* note 6; *See also* Kathleen P. Lundy, *The Taxation of E-Commerce: The Inapplicability of Physical Presence Necessitates an Economic Presence Standard*, 8 Rich. J.L. & Tech. 12, Fall 2001 (“Internet companies may generate sales without the presence of employees or agents within a state. Similarly, their website displays their products and thus, they do not need stores to market their products. Yet Internet purchases are analogous to mail-order sales in that tangible purchases are delivered via the mail or common carrier...”).

grow with globalization and use of the Internet.⁵²

With respect to whether existing sales tax compliance burdens provide continuing justification for the physical presence rule, two key points must be considered. First, it is important to emphasize that the liability for the sales tax, though ostensibly imposed upon the purchaser, shifts to the vendor if a compliance error results in over-collection. If the vendor mistakenly collects the wrong amount of tax or remits such tax to the wrong jurisdiction, the vendor itself is legally liable for the difference. Second, a close reading of *Quill* indicates that the Court is not so much concerned about the burden created by the imposition of sales taxes themselves as they are by the administrative costs of tax compliance.⁵³ This distinction is often seized upon to suggest that if a collection allowance is offered by states, the burden would simply cease to exist. Collection allowances are certainly essential compensation for asking sellers to conduct the States' tax collection obligations. However, they cannot possibly come close to adequately compensating for the full costs of collection, even apart from the liability risk of under-collection or the class action risk of over-collection.⁵⁴ Set forth below are just a few of the more egregious burdens imposed upon all companies (remote or physically present) by today's sales tax systems. Such burdens illustrate the continuing need for a physical presence rule, even eleven years after *Quill*.

The Siren Song of Technology. Improvements in computers and technology have often been cited as justifications for imposing a collection duty on remote sellers.⁵⁵ While significant advances in

⁵² See Robert J. Cline and Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*; Presentation to the federal Advisory Commission on Electronic Commerce, September 8, 1999. Available at <<http://www.ey.com>>.

⁵³ *Quill*, 504 U.S. at 313 n. 6: "North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* [physical presence] rule, a publisher who included a subscription in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, would all be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions."

⁵⁴ See, Cline & Neubig, *supra* note 52, Figure 4 ("For firms selling nationally with collection responsibilities in all 46 states, the compliance costs range from 14 percent of sales taxes collected for large retailers, to 48 percent for medium retailers, and 87 percent for small retailers." Of the 46 states that impose sales taxes, only "twenty-seven states currently offer vendor discounts...Furthermore, many states use a tiered discount system, with the discount rate falling as sales increase. Six states have a discount rate of at least 3% with the highest rate being 5% in Alabama's first tier. Arizona allows the largest dollar amount of vendor discount at a rate of 3.3% with no dollar limit. Florida allows the smallest discount amount with a \$30 per report maximum allowance. These vendor discounts are relatively small compared to the estimated retailer's costs of collecting sales and use taxes. For a retailer with \$52,000 of annual taxes, for example, the vendor compensation in Virginia, one of the most generous states, would be \$96. Using an estimate of annual compliance costs for this size retailer of \$1,931, the discount is only 5% of collection fees. In Texas the discount would cover less than one percent of this retailer's compliance costs. In Washington and California, there is no discount at all.")

⁵⁵ See *Quill*, 504 U.S. at 303; Lundy, *supra* note 46.

sales tax collection software and electronic filing and payment capability are indisputable, such technology has inherent limitations as applied to state sales tax systems that prevent it from reaching the degree of effectiveness its proponents advocate. First, the technology cannot possibly determine the internal composition of products sold by specific vendors, a current requirement of numerous sales tax statutes. Some examples: certain beverages may be exempt if they contain a certain percentage of real juice; taxability of shoes may depend on whether they are deemed clothing, sportswear, protective, or cleated; certain machinery and equipment may be exempt based on specific usage; certain therapeutic items may qualify for a medical exemption based on specified applications, etc. The list of such product and use distinctions is nearly endless. Accordingly, the taxability determination with respect to specific products is one that may be made only by the manufacturer/seller⁵⁶ who has intimate knowledge of product composition and is decided only after a careful weighing of the cases, statutes and regulations in each jurisdiction in which an item may be sold. This limitation is created by definitional differences in sales tax systems, and is not curable by any degree of technological sophistication.

To accommodate this limitation, most large companies that use sales tax collection software packages start with a “taxability matrix”⁵⁷ offered by the software provider. This matrix is then significantly modified to reflect the sale of specific items sold (or used) by the company, after an evaluation of their taxability is completed by company legal staff. The challenge then, of course, is to keep the proprietary matrix current. This in turn requires tracking and evaluating on a real-time basis every sales tax case, statutory change or regulatory proposal in all states where products may be sold, to include following through on audits, assessments and appeals when state department of revenue audit staff disagree with a taxability determination. The sheer manpower commitment is significant, particularly for a retailer operating in all states. Based on the foregoing, it is quite easy to see how elimination of the physical presence rule would significantly increase the burden on a remote seller with a presence in only a few states.

Second, the technology cannot adequately identify the applicable sales tax rate corresponding to every possible address in the United States to which a product may be shipped. Sales tax collection software must look to the five-digit zip code (or if lucky, zip+four) on a shipping address to determine the applicable rate. The total sales tax rate at a specific location usually comprises at least two components, a state rate and a local rate, typically imposed at the option of the locality.⁵⁸ In many cases, however, the total rate is composed of a hodge-podge of overlapping tax districts established to fund stadiums, schools, special transportation projects, etc.⁵⁹ Because these local and special taxing districts almost never comport with zip code boundaries, it is nearly impossible, even with modern technology, to determine the actual rate at a specific location with any accuracy. As a result, in order to

⁵⁶ *i.e.*, the entity liable for payment of the tax if the tax is not properly collected.

⁵⁷ A listing of all products sold in each jurisdiction with applicable rates.

⁵⁸ Thirty-one states allow imposition of a local rate. *See* Cline & Neubig, *supra* note 52, at 14, Table 2.

⁵⁹ *See* Cline & Neubig, *supra* note 52, at 26, Figure 5.

avoid collection liability, retailers with a collection duty in a state have a tendency to collect at the highest rate in that zip code. While this is unfair to consumers, certainly, it also makes the retailer vulnerable to class action lawsuits ostensibly seeking to return the over-collected sales taxes to the appropriate customers.

The Class Action Dilemma. Because retailers are legally liable for any under-collection of sales taxes, the technological limitations expressed above have placed retailers twixt Scylla and Charybdis⁶⁰ with respect to sales tax collection. If they under-collect, they owe the state; if they over-collect in a location, they're susceptible to class action lawsuits filed on behalf of consumers by class action attorneys specifically targeting quirks in the sales tax law. To cite one egregious example: South Carolina recently enacted a sales tax exemption for all of its citizens 85 years of age or older — a noble gesture on behalf of the state legislature, and a blatant attempt to lure “halfback” retirees⁶¹ from Georgia and North Carolina. Because of the obvious difficulty of complying with a statute that forced retailers to risk insulting their customers, however, the law was widely ignored and soon became the subject of a class-action suit.⁶² This example is just one of numerous ways that the nearly opaque complexity of sales tax statutes can come back to haunt retailers. Due to the dollar amounts involved, the rise in class action lawsuits is particularly burdensome to the larger retailers and those industries subject to special transaction taxes, such as telecommunications companies.⁶³

Where is my Customer? Treatment of Digital Goods. The sale of digital goods and services over the Internet are raising particularly thorny problems for retailers. Digital goods include items that are always in digital form (such as software) and also items that are “digitizable,” such as books, magazines, newspapers, music and videos. Because state sales tax systems are generally destination-based (*i.e.*, imposed at the point of consumption), digital products that may be downloaded to any computer at any location are nearly impossible to accurately account for under the current system. Such goods also create unique definitional problems: Is a downloaded newspaper subject to the same exemptions as its tangible counterpart? Is downloaded software tangible property, a non-taxable service or an undefined intangible? If a second copy of software is made, does the nature of the transaction change from a purchase to the grant of a license to reproduce? Many of these questions are simply unanswerable under current sales tax laws, leaving both states and retailers frustrated at the

⁶⁰ Or a rock and a hard place.

⁶¹ A recent phenomenon describing retirees from the Northeast and Midwest who find Florida too hot, expensive or crowded and thus return halfway back to locate in northern Georgia, North Carolina or South Carolina.

⁶² To the best of the author's recollection, this issue was resolved by the intercession of the legislature, which absolved retailers from liability if they posted a notice (“no sales tax if you're 85 or older”) at checkout lines. (This did nothing, however, for the class of elderly *remote* purchasers.)

⁶³ For a detailed discussion of the transaction tax burden on telecommunications companies, *see* 2001 State Study and Report on Telecommunications Taxation by the Telecommunications Tax Task Force of the Council On State Taxation (COST) available at <<http://www.statetax.org>>.

lack of guidance.⁶⁴

Additional Issues. State sales and use tax statutes also create a host of special compliance problems that are too detailed to explore in depth for this paper. A partial list would include: accurately assessing use taxes on internally produced property; maintaining and producing valid exemption certificates; assuring that such exemption certificates are offered in “good faith” by the purchaser; sourcing rules for taxable services and digital property; compliance with locally administered sales tax systems; compliance with sales tax holidays; treatment of returns, bad debts and allowances; differing electronic payment and electronic filing methodologies (or lack thereof); duplicate state and local audits; differing state direct payment provisions; and early or estimated filing requirements imposed to help balance state budgets. This list is by no means exhaustive, but it frames the portrait of the fundamental burdens and inequities of state sales tax systems limned above.

Taxpayers, practitioners and state tax officials that work with state sales tax systems on a daily basis recognize that the burdens on interstate commerce identified in *National Bellas Hess* and *Quill* are still pervasive eleven years after *Quill*. Indeed, there is ample evidence to support the notion that new economy commerce has increased the burden.⁶⁵ Although the physical presence rule may be somewhat of a blunt instrument in its effort to protect the free flow of interstate commerce, the rule’s continued vitality is essential for a supremely practical reason as well — it is forcing states to finally take a serious approach to collectively addressing the complexity inherent in state sales tax systems. As described below, it has taken countless hours on the part of taxpayers and tax officials alike, through endless rounds of negotiations, numerous cases challenging the rule, and dozens of attempts to enact federal legislation dealing with the issue. The Streamlined Sales and Use Tax Agreement,⁶⁶ as approved last November by participating state delegates, marks the furthest point yet achieved in this effort. Although not perfect, widespread state adoption of the Agreement could act as a catalyst for finally resolving the remote sales tax collection issue. Much work remains, however. Part III, below, describes events leading up to the formation of the Streamlined Sales Tax Project and subsequent approval of the Streamlined Agreement. It then includes a point-by-point evaluation of the effectiveness of the agreement prepared by the staff of the Council On State Taxation.⁶⁷

⁶⁴ See Cline & Neubig, *supra* note 52, at 15.

⁶⁵ *Id.* at 13.

⁶⁶ Available at <<http://www.streamlinedsalestax.org>>. See *supra* notes 10 and 11.

⁶⁷ The Council On State Taxation (COST) has been an active participant in the negotiations leading up to, and resulting in, adoption of the Streamlined Sales Tax Agreement. The COST Board has approved three Policy Statements to guide COST’s participation in this effort. They are: 1) *Simplification of the State and Local Sales and Use Tax System*: “A sales and use tax should be easily administered by both vendors and taxing authorities, widely understood by consumers, and nondiscriminatory between similarly situated vendors and goods. State governments relying on a sales and use tax should make it a priority to ensure these criteria are met.” (Includes a listing of simplification criteria). 2) *Jurisdiction to Tax — Constitutional*: “In order for a State to impose a business activity tax on a business, that business must have a physical presence in that State.” 3) *Obligation to Collect State and Local Sales and Use Taxes*: “If Congress chooses to remove existing federal limitations on the authority

PART III — Evaluating the Streamlined Sales and Use Tax Agreement

Background. In the several years following *Quill*, numerous pieces of legislation seeking to overturn the decision and compel use tax collection were introduced in Congress, with little success.⁶⁸ A significant effort to negotiate an agreement for mail-order sellers during this time was made by representatives of several states and the Direct Marketing Association. Although a tentative voluntary compromise was reached at the negotiating table, it failed through lack of sufficient participation by remote sellers. By the mid- to late 1990s, a new variable — electronic commerce via the Internet — had entered the debate and raised the ante, particularly for state tax officials. Although the tax issues remained the same, the growth of the Internet and its ability to facilitate remote transactions took the debate (and the amount of forgone revenue) out of the distinct and quantifiable catalogue and mail-order industry and into uncharted territory, both politically and economically.

As the potential impact of the Internet on remote sales became clearer, several efforts to bring together the various stakeholders in the issue to resolve the use tax collection issue were undertaken. In late 1996, the National Tax Association sought to bring together representatives of business, state and local governments, professional organizations, and academia to discuss the impact of changes in telecommunications law and technology and the development of the Internet on federal, state, and local tax systems. That meeting spawned the NTA Communications and Electronic Commerce Tax Project (the NTA Project), which quickly focused its debate on whether and how state and local taxes, particularly sales and use taxes, should be applied to electronic commerce.⁶⁹

As public acceptance and use of the Internet grew in the mid- to late 1990s, multiple state and

of States to compel remote vendors to collect sales and use tax, Congress should also: (a) require the States to radically simplify and reform the sales and use tax system for all vendors; and (b) formally recognize that a state has no right to impose a business activity tax on any business that does not have a physical presence in that jurisdiction.” The full policy statements are available at <<http://www.statetax.org>>.

⁶⁸ See Cline & Neubig, *supra* note 52, at 13, 15.

⁶⁹ NTA Project Final Report, on File with Author. The goal of the NTA 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 tax officials regarding the application of such taxes. The NTA Project met nine times for the next two and one-half years and ultimately produced a final report nearly one hundred pages long. Although the final report contained several recommendations that garnered varying degrees of consensus among participants, there were numerous issues on which participants could not reach agreement, including how and whether to expand the duty to collect use taxes to remote sellers, an adequate definition of telecommunications, and how to avoid spillover to other taxes (such as business activity taxes) if the *Quill* sales and use tax nexus standard was changed. At the outset of the NTA Project, participants agreed on a caveat underlying all work of the NTA Project: Nothing is agreed to until everything is agreed to. Consequently, the final report’s recommendations must be viewed through the prism of this caveat, that is, ultimately as part of a non-agreement. Despite the lack of agreement, the NTA Project served a valuable purpose. It forced participants to examine opposing viewpoints and explore complex tax issues at a previously unexplored depth. The knowledge and technical foundations gained thereby have been extremely helpful in the work of the Streamlined Sales Tax Project.

local taxation of Internet access (e.g., America Online's monthly charge) was one of the early justifications given for the enactment of the Internet Tax Freedom Act (ITFA). Several groups argued that, since the underlying telephone service was already taxed via state and local telecommunications taxes, Internet access delivered via telephone should be granted an exemption from sales tax. Further, because many consumers accessed the Internet from points throughout the country using a single Internet access account, it was difficult to determine which state or local government was entitled to tax the monthly access charge. Finally, state and local taxing authorities had strained the application of preexisting sales tax statutes to apply them to Internet access. Beginning October 1, 1998, and expiring October 31, 2001, the ITFA placed a three-year moratorium on multiple taxes, discriminatory taxes, and taxes on Internet access. Existing access taxes were grandfathered. In November 2001, President George W. Bush signed a two-year extension of the ITFA moratorium, through November 1, 2003.⁷⁰

Although the ITFA preempted mainly the states that sought to impose new taxes on Internet access, many in the media and the general public misconstrued the legislation as a blanket prohibition on all taxes imposed on sales over the Internet. Use taxes, imposed on a purchaser if the product was used in a location different from the location of the sale, are still due from customers on most retail transactions over the Internet, even if states are not in a position to enforce such taxes. Thus, the ITFA was more about limiting new taxes on Internet access than it was about keeping the Internet "tax free." The ITFA added a significant factor to the sales tax collection debate, however: the creation of the Advisory Commission on Electronic Commerce (ACEC).⁷¹

⁷⁰ See H.R. Rep. No. 107-240 (2001), 2001 WL 1239646, at *2, 11-12. Passage of the moratorium had little effect on existing state revenues. Under the legislation, a multiple tax is a tax imposed on electronic commerce that is also subject to tax in another jurisdiction without a credit mechanism. (Nearly all states grant such a credit, however, if the question of liability is resolved.) In addition, a discriminatory tax under the ITFA is a tax imposed on electronic commerce that is not imposed on other forms of commerce - a scheme that was present in very few state statutes at the time, if any. The ITFA's definition of discriminatory tax also includes a limitation on the ability of state and local taxing authorities to consider the maintenance of a Web site as the sole factor in determining a remote seller's tax collection obligation - also a rarity among state nexus statutes.

⁷¹ See Advisory Commission on Electronic Commerce, Report to Congress (on file with Author.) To garner the support of state and local government leaders, the ITFA called for a commission to conduct an eighteen-month study of the impact of electronic commerce on all forms of taxation and called specifically for an examination of the issues surrounding the state and local taxation of transactions over the Internet. To ensure a balanced inquiry, a two-thirds supermajority was required to reach agreement on any finding or recommendation. On April 3, 2000, the ACEC delivered its final report to Congress. Ultimately, the ACEC was able to gain two-thirds consensus to offer recommendations in only three areas: the digital divide, privacy implications of the Internet, and international trade and tariffs. The remainder of the majority report failed to achieve the two-thirds vote necessary for findings and recommendations contemplated by the ITFA. Nevertheless, the report included a list of "majority" policy proposals, including the following: 1) Extend the ITFA moratorium on multiple and discriminatory taxes for five years, coupled with a five-year prohibition on sales taxation of digital goods and their tangible counterparts; 2) enact a permanent moratorium on Internet access taxes; 3) recommend the states simplify their sales and use and telecommunications tax systems; 4) create bright-line nexus standards for sales and use tax collection and business activity taxes; and 5) eliminate the three percent federal excise tax on telecommunications services.

The origins of the Streamlined Sales Tax Project can be traced to September 1999, during proceedings of the ACEC, when Utah Governor Michael Leavitt (R), an appointed commissioner and then-Chair of the National Governors Association, noted that, “The existing system is a mess... [and] it needs to be radically simplified.” He suggested putting the states’ tax experts across the country to work towards the development of a radically simplified system. In response, state governments organized the Streamlined Sales Tax Project, staffed primarily by sales tax experts at state departments of revenue, with input from several business organizations.⁷² The project was also endorsed and adopted by the National Conference of State Legislatures’ Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce. The NCSL Task Force initially developed model state legislation that authorized state revenue departments to work together on the Project. It has since maintained an oversight role to the Project.

All states that had adopted authorizing legislation became the Streamlined Sales Tax Implementing States (SSTIS). The purpose of the SSTIS was to vote on the many difficult issues left unresolved by the consensus-gathering process of the Project, and to adopt a final version of the Agreement for adoption by state legislatures. The “final” Agreement was adopted by SSTIS in November of 2002.⁷³

Elements of the Agreement. Section 102 of SSUTA sets forth the “Fundamental Purpose” of the agreement, as follows:

“It is the purpose of this Agreement to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance . The Agreement focuses on improving sales and use tax administration systems for all sellers and for all types of commerce through all of the following:

- A. State level administration of sales and use tax collections.
- B. Uniformity in the state and local tax bases.
- C. Uniformity of major base definitions.
- D. Central, electronic registration system for all member states.
- E. Simplification of state and local tax rates.
- F. Uniform Sourcing rules for all taxable transactions.
- G. Simplified administration of exemptions.
- H. Simplified tax returns.

⁷² For an overview of the Streamlined Sales Tax Project, *see* Diane L. Hardt, Douglas L. Lindholm & Stephen P.B. Kranz, *A Lawmakers Guide to the Streamlined Sales Tax Project*, The Deloitte & Touche Center for Multistate Taxation, University of Wisconsin-Milwaukee, January, 2003.

⁷³ The Streamlined Sales and Use Tax Agreement is available at <<http://www.streamlinedsalestax.org>>. Although dubbed the “final” agreement, as of January 2003 several issues remain unresolved. The Streamlined Sales Tax Project will continue working on rules for bundled transactions, the definition of digital property, implementation requirements for centralized registration, uniform tax returns and remittances, sales tax holiday rules, audit and certification standards, and a uniform exemption certificate. Definitions for telecommunications services and other products are also likely to be developed by the SSTP for consideration by the SSTIS at subsequent meetings.

- I. Simplification of tax remittances.
- J. Protection of consumer privacy.”⁷⁴

COST’s Report Card⁷⁵ on the Streamlined Sales and Use Tax Agreement

Background. The Streamlined Sales and Use Tax Agreement (SSUTA), if legislatively adopted by the states, will define the manner in which businesses collect and pay sales and use tax throughout the country. In some states the Agreement will require minor changes; in others, radical modifications of the sales and use tax law will be necessary for compliance. In all states the Agreement would represent a major step towards a uniform and simpler sales and use tax structure. The question arises then whether the sales tax structure under the Agreement is sufficiently simple and uniform to justify congressional action permitting conforming states to require remote vendors to collect their sales and use tax. If so, it is essential that Congress simultaneously act to protect remote businesses from states’ overreaching imposition of business activity taxes. The Council On State Taxation (COST) has prepared a report card to indicate whether the SSTA Agreement meets the standard of radical simplification, to identify areas of concern that remain, and discuss the relationship between business activity tax nexus standards and sales tax collection by remote vendors.

While the sales tax should be nondiscriminatory – i.e., imposed on similarly situated vendors and goods, remote vendors must not be subject to the burden imposed by thousands of taxing jurisdictions with thousands of disparate rules. Only if states have a truly simple, uniform system can remote vendors be required to collect their taxes. Radical simplification of the current sales tax is therefore required before Congress should consider removing existing limitations on the authority of states to require remote vendors to collect sales and use tax. The Agreement defines the level of simplification and uniformity required of states in a *voluntary* collection system.⁷⁶ Should Congress consider making this system mandatory it must require states to meet the radical simplification standard and must uphold the standard over time by imposing an independent review of state compliance. The report card therefore indicates the necessity for federal oversight of state compliance with, and governance of, the Agreement should Congress require remote vendors to collect sales and use tax. The report card compares the Agreement with COST’s Policy Statement on Simplification of the State and Local Sales and Use Tax System.⁷⁷ The report card judges whether the requirements of the Agreement provide radical simplification of the current sales and use tax structure. In some instances

⁷⁴ *Id.* at 6.

⁷⁵ COST Report Card on the Streamlined Sales Tax Implementing States’ Agreement, October 11, 2002. Available at <<http://www.statetax.org>>.

⁷⁶ The current Agreement anticipates that remote vendors will voluntarily collect sales and use tax for each member state if that state’s laws are consistent with the Agreement and the state provides a reasonable level of vendor compensation.

⁷⁷ *Supra* note 67.

the report card indicates that work is still being performed or that the assigned grade would change pending methods chosen to implement the requirement.

The Relevance of Business Activity Tax Nexus Standards. Should Congress act to remove existing limitations on the authority of states to require remote vendors to collect sales and use tax, it is essential that it also formally recognize that a State has no right to impose a business activity tax on any business that does not have a physical presence in that jurisdiction. Businesses are concerned that the elimination of current protections for sales tax collection would encourage and abet the already inappropriate state efforts to impose business activity taxes on out-of-state companies with no physical presence in the state. To prevent overreaching by states, Congress should specifically recognize that states may not impose a business activity tax on a business unless that company has substantial nexus as a result of physical presence in the State (*i.e.*, when the company is receiving the benefits and protections offered by the state). Sales tax simplification and the propriety of requiring remote vendors to collect sales tax cannot be evaluated in a vacuum. Should Congress choose to address sales tax collection responsibility, it must consider and address the implications for business activity tax nexus. This report card does not seek to evaluate current proposals for business activity tax nexus clarification; it simply articulates the need for congressional resolution of the business activity tax nexus issue along with sales tax collection responsibility.

The COST Report Card.

COST commends the state government executive branch officials participating in the Streamlined Sales Tax Project (SSTP) and the delegates to the Streamlined Sales Tax Implementing States (SSTIS). This simplification effort has gone further and made a more sincere effort to simplify our complex sales and use tax system than have all previous groups that have grappled with this issue. State officials have listened to COST's concerns and have modified many of their proposals as a result of these comments. We recognize the genuine effort that state participants have made and applaud it.

The following report card evaluates the difficult substantive and administrative issues that must be addressed to realize a truly simple and uniform sales and use tax system. The tax simplification proposals included in the SSTIS version of the Agreement are compared against COST's policy position on state and local sales and use tax simplification. The provisions of the Agreement which govern the interstate compact aspect of this effort are analyzed based on COST's experience and understanding of similar multistate efforts, both tax and non-tax. COST has graded the various elements within each category on an A-F scale. The following is a description of the meaning behind each grade:

A — Radical⁷⁸ simplification

⁷⁸ The word "radical" is used throughout the Report Card because it conveys the level of change necessary to simplify the extraordinarily complex sales tax system we have today. As noted by Utah Governor Michael Leavitt, delegate to the Advisory Commission on Electronic Commerce on September 15, 1999: "The existing system is a

- B — Significant simplification
- C — Some simplification
- D — Insignificant simplification
- F — Not addressed by the Agreement, no simplification, or new complexity
- Incomplete — Addressed by the Agreement, but too early to grade

What constitutes an acceptable grade? From the standpoint of simplification alone, any grade better than “D” indicates an improvement over the current system and thus ought to receive consideration. Thus, under a voluntary system, COST would support any real state effort to reduce complexity in the sales tax arena. If the context is not simplification for its own sake but instead Congressional legislation to permit states to impose a sales tax collection obligation on remote sellers, then a grade of B+ or better — meaning radical simplification — is necessary.

Uniform Tax Base Definitions (Grade: B). The Agreement includes product definitions for items typically sold at retail for final consumption. Although the definitions result in occasionally ludicrous results (i.e., candy does not include licorice), they provide bright-line guidance necessary for retailers to make taxability decisions. The Agreement requires that member states develop and provide retailers with a taxability matrix, which, if used, will hold them harmless. The Agreement however does not require that states adopt definitions by statute and requires only that each states’ law use substantially the same language as that adopted by the SSTIS. Numerous definitions, including “digital goods,” are still under development. This grade would change from B to F if these definitions are overbroad. The Agreement also fails to adequately discourage states from using simplification as a justification for expanding their tax base.

Uniform Exemption Rules (Grade: A). The Agreement provides radical simplification of exemption administration by eliminating the good faith requirement, shifting the burden to the states to monitor improper claims of exemption. This grade would change from A to F if the states implement the new exemption system by requiring vendors to keep, electronically, line-item detail on every exempt purchase.

Uniform and Centralized Administration (Grade: B / Incomplete). The Agreement provides significant simplification of sales tax administration. While many of the implementing details have not been resolved, the Agreement provides a basic framework for administration that could significantly ease the burden on multistate sellers. Our grade would change from B to F based on the quality of implementation of the administrative provisions; specifically, the Agreement lacks current funding for administrative processes and standards are not yet developed for audits, returns, and centralized registration. The Agreement protects sellers from imposition of business activity taxes based on the sellers’ registration, but not their activities during registration, under the Agreement. Congress

mess...[and] it needs to be radically simplified.” According to Webster, “radical” means fundamental; marked by a considerable departure from the usual or traditional; tending or disposed to make extreme changes in existing institutions.

should not require remote collection if the states fail to adequately fund and implement the administrative simplifications.

One Rate Per State (Grade: B-). The Agreement limits local taxing jurisdictions to a single tax rate, constrains their ability to change rates without proper notice, and eliminates all caps and thresholds unless their burden is borne by the consumer (except under sales tax holidays). The Agreement limits states to a single sales tax rate on tangible personal property and allows states to have a second rate only on food or drugs. While a single rate per state is preferable, it is unlikely that some of the larger states could participate if such a rule were adopted. The Agreement provides for a uniform rounding rule and makes tax boundaries coincident with nine-digit zip code boundaries. These simplifications could be improved by restricting state rate changes similar to local rate changes, mandating five-digit zip code jurisdictional boundaries or mandating a single tax rate per state (including local taxes). Congress should not require remote collection until the states have developed address-based jurisdictional databases and after the phase-out on caps and thresholds is complete.

One Base Per State (Grade: B / Incomplete). The Agreement requires state and local tax bases to be identical by 2006. While such a phase-in may be necessary in a voluntary agreement, Congress should not require remote collection until the phase-in is complete. States should also be prohibited from moving complexity out of the sales tax to transaction taxes not covered by the Agreement. Congress should not require remote collection if the states simply shift the complexity to new taxes. Rules for bundling, allocation of discounts, shipping and handling, and treatment of returns are not complete. Congress should not require remote collection until these issues are resolved.

Uniform Sourcing Rules (Grade: B+). The sourcing rules in the Agreement represent a significant advance over current practice by providing uniformity in a critical area. These rules would benefit from clarifying any due diligence standards relating to the maintenance of addresses in general business records; and clarifying that payment processors and other third party participants in a transaction are not required to provide information to the vendor for sourcing purposes.

Bad Debt Deduction/Refund (Grade: B). Uniform provisions for bad debts are a necessary part of simplification, and the Project worked closely with industry to find the least objectionable language possible. As a matter of policy, though, the bad debt provisions remain inequitable in that they do not require bad debt assigned to a third party to be treated in the same way as debt held by the original vendor.

Uniform Direct Pay Permits and Registration Requirements (Grade: A). The Agreement requires member states to allow businesses to direct pay their sales tax liability on their own purchases. The Agreement also provides for a single point of registration. Each of these requirements constitutes radical simplification.

Technology Certification (Grade: B / Incomplete). The Agreement allows for certification of proprietary software in addition to certification of third party service providers who can administer a

vendor's sales tax responsibility. Unfortunately, the software certification standards remain undefined. Reasonable vendor compensation (see below) must still be addressed to compensate vendors who have invested in such systems.

Hold Harmless Provisions (Grade: A-). The Agreement protects vendors from liability for under-collected tax and now provides a remedy for customers who have been over-charged sales or use tax, requiring customers to utilize a specific procedure to seek a return of the tax before filing a class-action suit against the seller. In addition, the Agreement creates a presumption that a vendor's use of a certified system constitutes a reasonable business practice, making it more difficult for consumers to bring frivolous class-action suits. In summary, the Agreement radically simplifies the burden on vendors by holding them harmless from under-collection and providing protection for vendors who have inadvertently over-collected tax. The Agreement could be improved by requiring member states to allow customers the right to obtain a refund from the state.

Vendor Allowance (Grade: F / Incomplete). The Agreement fails to explicitly mandate a reasonable vendor allowance for all vendors based on the findings of the Joint Collection Cost Study (JCCS)⁷⁹. Were it not for the SSTP's participation in the JCCS, this category would receive a straight F. Congress should not require remote collection without requiring that vendors receive a reasonable allowance. The cost of credit card processing alone is at least 2.5% - 3% and could be adopted today as a minimum base for vendor compensation. Because any vendor allowance should also be based on the complexity of the sales tax system, a mandated allowance should provide a built-in incentive to further reduce residual complexity.

Governance (Grade: A- / Incomplete). The Agreement contains an acceptable governance mechanism, keeping in mind that the Agreement is currently a voluntary association of states and vendors. Congress should not require remote collection without providing for federal oversight of state compliance and governance of the Agreement. The current system allows taxpayers and interested government groups to have input into the decision making process; open meetings and public comment are required. While the current Agreement provides a solid, basic structure for governance, our grade would change from A- to F based on the quality of implementation. Without adequate state funding the governance mechanism will not work. Further, because the governance provisions are written for a voluntary Agreement, and should be rewritten if Congress mandates collection by remote vendors, we have indicated that the governance structure for a mandatory system is incomplete. Congress should not require remote collection without defining a governance model that provides for limited but

⁷⁹ The Joint Collection Cost Study is a joint effort of government and business to commission a study to determine the cost to business of collecting sales and use taxes under current law and under a proposed simplified sales tax for use by the Simplified Sales Tax Project and by state legislatures. The group includes all interested persons from business (with "business" defined to include individual businesses and organizations that represent business interests including but not limited to COST, DMA, NRF, NASRE and other, similar organizations) and government (which is defined to include state and local governments or government agencies and organizations that represent government interests, including but not limited to FTA, MTC, NCSL, NGA and other similar organizations). The JCCS project is still awaiting funding.

meaningful federal oversight.

Interpretation (Grade: A- / Incomplete). The Agreement contains an acceptable mechanism for taxpayers to obtain interpretations of definitions or other provisions of the Agreement itself. Any person may request an interpretation or request that additional definitions be developed. While the current Agreement provides a solid, basic structure for issues of interpretation, our grade would change from A- to F based on the quality of implementation. Without adequate state funding the interpretation mechanism will not work. Further, because the interpretation provisions are written for a voluntary Agreement, and should be rewritten if Congress mandates collection by remote vendors, we have indicated that the interpretation structure for a mandatory system is incomplete. Congress should not require remote collection without defining an interpretation process that will resolve questions on a timely basis without drastically infringing on state sovereignty. Limited but meaningful federal oversight is necessary to ensure timely uniform application of interpretations.

Issue Resolution Process (Grade: A- / Incomplete). Questions of state membership, matters of compliance, the possibility of sanctions, and issues of amendments and interpretation of the agreement, including differing interpretations among member states, can be brought by any person before an issue resolution process. This process includes independent review by a neutral third party or non-binding arbitration. While the current Agreement provides a solid, basic structure for issue resolution, our grade would change from A- to F based on the quality of implementation. Without adequate state funding the issue resolution process will not work. Further, because the issue resolution provisions are written for a voluntary Agreement, and should be rewritten if Congress mandates collection by remote vendors, we have indicated that the issue resolution procedures for a mandatory system are incomplete. Congress should not require remote collection without defining an issue resolution model that provides for limited but meaningful federal oversight.

Replacement Taxes (Grade: F). The Agreement fails to discourage member states from shifting sales tax complexity into other transaction taxes. For example, Minnesota generally exempts clothing but taxes clothing made from fur. Because the Agreement does not provide a separate definition for clothing made from fur, Minnesota had to exempt such items from sales tax if it wanted to continue to exempt clothing. The State's "solution" was to create a separate "fur tax" identical to the previous sales tax. The Agreement also allows states to exclude certain sales taxes from coverage. Alabama has indicated that it will exclude its rental tax from the provisions of the Agreement. The result is additional complexity and the potential for double taxation. The Agreement fails to prohibit states from employing tactics so contrary to the goal of simplification.

Expansion of Existing Tax Bases (Grade: C). The Agreement fails to discourage member states from using simplification as a reason for expanding their tax base. While the Agreement itself, and utilization of the uniform definitions required by the Agreement will undoubtedly have some minor revenue impact, and states are within their sovereign right to achieve revenue neutrality by increasing taxes or expanding the base, states should avoid the temptation to raise additional revenue by expanding their tax base as part of the simplification effort. The Agreement currently indicates that it is not the intent of the Agreement to indicate whether states should tax or exempt any particular product.

This language should be strengthened to discourage states from expanding their tax base under the guise of simplification unless required incident to complying with the Agreement.

Next Steps

Having approved the Agreement on November 12, 2002, the Streamlined Sales Tax Project and Streamlined Sales Tax Implementing States continue to move forward with the simplification effort with numerous unresolved issues on the table. Items identified for future meeting agendas include an overview of digital property and telecommunications, final work group meetings on registration and returns, sourcing rules for drop shipments and florists, sales tax holiday definitions and guidelines, bundling, and audit and exemption certificate processes. As the meetings continue and as state legislatures address streamlined legislation, the National Conference of State Legislatures (NCSL) Task Force monitoring the effort will discuss the potential congressional linkage of business activity tax protections with the November 12 Agreement. At the state level, legislatures are busy drafting legislation to bring individual state law into conformity with the Agreement. The NCSL has estimated that 25 states will introduce such legislation during their upcoming sessions. The Agreement does not become effective (even as a voluntary system) until 10 states with more than 20% of the population are certified to be in compliance with the terms of the Agreement.

Assume, in an absolute best-case scenario, that the Agreement is successfully modified to deal with its remaining outstanding issues, and that half of the states substantially conform to the terms of the Agreement as modified. Those conforming states then have three choices. They can either: 1) hope that the partial adoption of the Agreement encourages sufficient additional voluntary participation to generate a substantial increase in state revenues; 2) seek federal legislation overturning *Quill* for those states that conform, or 3) begin assessing out-of-state retailers for non-collection under the theory that conformity to the Agreement has reduced the burden on interstate commerce to the point of constitutional insignificance. Given the polarization of the parties with vested interests in this issue, options one and three are likely to meet with significant opposition from remote retailers and substantial portions of the business community, and thus are unlikely to generate significant revenues for cash-starved states. Thus the only viable option remaining is to seek federal legislation overturning the *Quill* physical presence requirement for sales tax collection. Any such legislation, however, must acknowledge the implications such legislation would have on taxes other than sales taxes. For to overturn the only Supreme Court case to set forth a physical presence rule, even if limited to sales taxes, gives state taxing authorities carte blanche to assert an *economic* presence rule for all other taxes. Part IV discusses why the physical presence rule is appropriate for taxes other than sales tax collection — from legal, practical and policy perspectives.

PART IV — Gulliver Among the Lilliputians: The Need for a Physical Presence Requirement for Business Activity Taxes in the New Economy



Impact of the Economic Presence Rule on the 'New Economy'

The *Quill* decision leaves unanswered the single most pressing question in state tax jurisprudence today — whether the physical presence nexus standard applies (or should apply) outside of the sales tax arena; namely, to corporate income, franchise and other “business activity” taxes.⁸⁰ From an analytical standpoint, it is useful to consider this question from two different angles. First, would the *absence* of a physical presence rule for business activity taxes (*i.e.*, the imposition of an

⁸⁰ The term “business activity taxes” was coined to draw a distinction between taxes imposed upon and measured by business activity, and transaction taxes such as sales taxes. *See, e.g.*, S. 664 (3-29-2001), which would prohibit states from imposing business activity taxes unless the entity has a substantial physical presence in the state; “Business activities tax” is defined in HR 2526 as “a tax imposed on, or measured by, net income, a business license tax, a business and occupation tax, a franchise tax, a single business tax or a capital stock tax, or any similar tax or fee imposed by a State or subdivision thereof on a business for the right to do business within the State or subdivision or which is measured by the amount of such business or related activity.” HR 2526 (7-17-2001).

economic presence standard) create administrative and other burdens on taxpayers and the economy that would unduly interfere with interstate commerce? Second, from a practical standpoint, how would a clear physical presence standard impact state coffers if enacted by Congress? The first question looks to whether the burdens created by an economic presence standard are at least as compelling as those enunciated by the Court in *Quill*. The second question must be considered carefully by states (and other opponents of such a rule) when considering whether a physical presence rule for business activity taxes should be part of federal legislation that seeks to implement a streamlined sales tax system and overturn *Quill*.

The ‘New Economy’ Question. As noted in Part I, *supra*, today’s economy is radically different from the economy when the Court handed down *Quill*. The Internet has transformed today’s economy into a creature undeniably faster, more innovative and more competitive, on both a national and global basis, than just a decade ago.⁸¹ State tax systems, on the other hand, have not kept up with the e-commerce revolution — not through lack of effort by state tax administrators, but because the systems are inherently based on geographic borders, a concept that is simply ineffective in a borderless electronic economy. Like Gulliver secured by the Lilliputians, an economic presence rule would allow any state to impose its business activity taxes based solely on the presence of a company’s *customers*, instead of on the presence of the company itself. This is contrary to the well-established notion that the economic burdens of a tax should be borne by those that receive protections and benefits from the taxing jurisdiction.⁸² If an economic presence rule were truly in effect today, it would create a compliance burden of truly Brobdingnagian complexity.⁸³

Commentators who unfavorably compare the relative burdens imposed by state business activity tax systems to the burdens imposed by state sales tax systems invariably focus on two distinctions. First, perceived uniformity for corporate income taxes: most states have adopted the Uniform Division of Income for Tax Purposes Act⁸⁴ (UDITPA) which provides for apportionment of corporate income according to the location of a corporation’s property, payroll and sales. A comparable statute (prior to the Streamlined Sales & Use Tax Agreement) has never been drafted for

⁸¹ See Note 15, *supra*. The dot.com bust of 2000-2001 had little impact on the growth of the new economy. Consider for a moment how the Internet has transformed every aspect of our everyday lives. Indeed, it is difficult to think of a single industry or occupation that has not improved its business processes through use of the Internet. It is this adoption of ‘new economy’ concepts by ‘old economy’ industries that has truly made the Internet and electronic commerce revolutionary.

⁸² See, e.g., *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940). *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

⁸³ For a glimpse of the complexity surrounding nexus-creating activities for corporate income taxes, see TAX MANAGEMENT, MULTISTATE TAX REPORT, *2002 Survey of State Tax Departments*, April 26, 2002. The survey asked states to comment on whether certain activities created nexus: “The survey found a wide disparity as to whether nexus could result from general business activities such as registering to do business, maintaining an in-state phone listing, or having a Web site server located in the state.”

⁸⁴ Also known as UDITPA, the model statute was developed in the mid-fifties by the National Council of Commissioners for Uniform State Laws, and is the centerpiece of the Multistate Tax Compact, the enabling statute for the Multistate Tax Commission.

sales and use taxes. Second, the disparity in the number of jurisdictions capable of levying an income tax vis-à-vis those capable of levying a sales tax is frequently cited as ‘proof’ that the complexity of business activity tax compliance is less than for sales and use taxes.⁸⁵ However, neither distinction offers compelling evidence that the burdens visited upon interstate commerce by imposition of an economic presence rule for business activity taxes are not unconstitutional.

Corporate Income Tax Uniformity. For over thirty-five years the Multistate Tax Commission has been tilting at the windmill of uniformity⁸⁶ with only limited success, at best. By some accounts, the MTC’s efforts to foster uniformity have been an abject failure.⁸⁷ In fact, for several years states have been trending away from uniformity, as more and more states moved from three-factor equally weighted formulas, to formulas that double weight the sales factor, and finally to single sales factor formulas.⁸⁸ The reasons for this trend cannot in all fairness be laid at the feet of the Multistate Tax Commission.⁸⁹ Indeed, much of the blame can be placed on state legislatures responding to the parochial self-interests of in-state corporate taxpayers. Nevertheless, it was precisely this type of concern over the impact of such local self-interests that led to the need for the Commerce Clause in the first place.⁹⁰

Multijurisdictional BAT Burdens. Although nearly all states impose some type of business activity tax (and numerous localities), the number pales in comparison to the 7,000+ jurisdictions capable of imposing a sales tax, as does the number of returns required for business activity taxes compared to sales taxes. However, compliance with business activity taxes, particularly corporate income taxes, requires a series of value judgements — usually different from state to state — that

⁸⁵ See Swain, *supra* note 6; Dan Bucks & Frank Katz, Explanation of the Multistate Tax Commission’s Proposed Factor Presence Nexus Standard, 25 STATE TAX NOTES 1037 (Sept. 30, 2002).

⁸⁶ With apologies to Cervantes.

⁸⁷ See Oveson, *supra* note 27, at 285. Mr. Oveson is a former Chair of the Multistate Tax Commission. Accordingly, his opinion is particularly relevant.

⁸⁸ See McLure, Charles E. Jr., *Does Sales-only Apportionment of Corporate Income Violate International Trade Rules?*, 25 STATE TAX NOTES 779 (Sept. 9, 2002) (“Over the past quarter-century there has been a pronounced change in the formulas states use to apportion the income of multistate corporations. In 1978, the year the U.S. Supreme Court sustained the constitutionality of Iowa’s single-factor apportionment formula based on sales (at destination) of tangible personal property, almost all the states that imposed corporate income taxes placed equal weight on property, payroll, and sales. Now almost three-fourths of the states that have corporate income taxes place at least half the weight on sales, and eight base apportionment solely on sales. It seems reasonable to believe that this trend will continue and that other states will adopt sales-only apportionment formulas in an effort to improve their competitive positions.”)

⁸⁹ According to the Multistate Tax Commission Website (www.mtc.gov), 45 states participate in the MTC. The MTC has four different member categories. For purposes of a uniformity discussion, 21 states are “Compact Members” that have adopted the Multistate Tax Compact. However, even among these 21 states, the statutory differences among respective compact provisions are significant. For a state-by-state listing of differences, see Healy, John C. and Schadowald, Michael S., 2003 Multistate Corporate Tax Guide Volume I, Corporate Income Tax, Aspen Publishers (2003).

⁹⁰ See Federalist Papers, No. 22, December 14, 1787.

create immense complexities for taxpayers and tax administrators alike. In spite of the daunting complexity of sales tax compliance, the ultimate decision is usually “tax it or don’t tax it.” On the other hand, accurately filing state corporate income tax returns requires an educated assessment of the relative merits of oft-conflicting case law on numerous substantive tax issues in all applicable states. A short list of the areas where such difficult determinations are commonplace includes the following:

- # Definition of a unitary business. This is always a fact-specific determination that varies from company to company and often from state to state.
- # Determination of business/nonbusiness income. Case law and statutes with respect to what constitutes business income is all over the map and is continually the subject of litigation.
- # Joyce/Finnegan issues. The question “who is the taxpayer?” in the context of a unitary group (the unitary group or each separate company) has implications for credits, throwback, and applicability of PL 86-272. California’s flip-flop on this issue is indicative of its problematic nature.
- # Expense Attribution. Most states attribute expenses to exempt or untaxed income according to complex regulatory rules that are different in each state and that are frequently adjusted under audit.
- # Federal Conformity. Although most state returns start with Line 28 or Line 30 from the federal return, states are routinely decoupling from federal statutes that impact state revenues, often taking different approaches to alternatives. States also routinely conform to different versions of the Internal Revenue Code (by date).
- # Net Operating Losses. States differ as to whether NOL deductions are taken pre- or post-apportionment, are based on the federal NOL, or require state-specific computations. Carryforward and carryback periods differ in nearly every state, requiring separate calculations and tracking for each state.
- # Dividends-Received Deductions. Numerous disparities exist between federal and state DRD statutes, and are complicated by differing treatment of the foreign tax credit, subpart F income, Section 78 gross-up and expense attribution.
- # Related Party Transactions. Several states have recently enacted statutes that deny a deduction for certain expenses paid to related parties, usually premised on whether a transaction or corporate structure has a valid business purpose or economic substance, but in some cases deniable at the discretion of the Commissioner.
- # Sourcing of income to the sales factor in the apportionment formula. States apply widely divergent rules for the inclusion of income from intangibles, services and even specific transactions.

This list is far from complete. When considered collectively, the complexity and difficulty in resolving such issues from state to state, for numerous corporate entities, through filing, audits and appeals, can quickly rival or even exceed the complexities of state sales tax systems.

The Revenue Question. There is considerable disagreement over the true impact a physical presence rule would have on state revenues. June Summers Haas, testifying on behalf of the Multistate

Tax Commission on H.R. 2526 before Congress,⁹¹ indicated that a physical presence rule (as defined in the bill) would cost the states \$9 billion annually. Subsequent discussions with MTC staff economists regarding the survey methodology used to derive that figure leaves the issue in considerable doubt, however.⁹² The Multistate Tax Commission is convinced that the current nexus standard for business activity taxes is a “doing business” standard that looks to whether income is derived from sources within the state (such as customers within a state) regardless of a company’s physical presence. Most large taxpayers, on the other hand, are equally convinced that the proper nexus standard for business activity taxes is physical presence. State court cases, to date, bear out this difference of opinion. To date, only courts in South Carolina and New Mexico have found that an economic presence is sufficient for business activity tax nexus,⁹³ while several other state cases have found that physical presence is indeed the rule.⁹⁴ Regardless of whether this issue reaches the Supreme Court, it is quite clear that very few large taxpayers are filing returns in states based on an economic presence standard.

⁹¹ Testimony of June Summers Haas, Commissioner of Revenue, Michigan Department of Treasury, on H.B. 2526, Internet Tax Fairness Act of 2001, before the U.S. House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law (September 11, 2001). Ms Haas, now in private practice, is also the former Director of the Multistate Tax Commission’s National Nexus Program.

⁹² Conversation between Elliott Dubin, Director of Policy Research, Multistate Tax Commission and Joseph R. Crosby, Legislative Director, Council On State Taxation (August 17, 2001). According to Mr. Dubin, the legislation pending before Congress does not define “business activity taxes” nor does it define “substantial physical presence.” Consequently, the MTC’s survey directed the states to define BAT in any way they wanted and to define companies lacking “substantial physical presence” as those whose property and payroll factors were “low” relative to their sales factors. The survey reported those having little presence based on their “low” property and payroll factors as a percentage of total corporate returns. Approximately 30 states responded, and those responses varied widely from the standpoint of defining BAT (*e.g.*, some states considered even their sales tax to be a BAT). Mr. Dubin included in the estimate only those taxes which were included on most of the responses. Those taxes are: 1) corporate income, franchise, net worth and similar taxes; 2) utility gross receipts taxes; and 3) insurance gross premiums taxes. According to Mr. Dubin, the total amount of revenue collected by the states from these three categories of taxes is \$50+ billion annually. He then divided the responses into three pools based on the percentage of tax revenue that would be lost if companies with “low” presence were not subject to state taxation (the pools were low, median, and high). Mr. Dubin took the median response from each of the three pools and averaged them, achieving an overall rate of 16%. Thus, the MTC predicts that a minimum of 16% of the existing \$50+ billion in revenue from the taxes named above will be lost if any of the pending BAT nexus proposals are enacted (\$8+ billion). The MTC’s assumptions seem to be less than sound. Clearly, none of the BAT physical presence nexus proposals are directed at utility gross receipts taxes or insurance premiums taxes (insurance companies do not have Commerce Clause protection under federal statutes). That reduces the \$50+ billion total to roughly \$30+ billion. Also, none of the proposals would define “substantial physical presence” to preclude the states from taxing companies that have greater than a *de minimis* level of property or payroll in a jurisdiction. This reduces the 16% to something close to zero. Of course, a very small percentage of \$30 billion is a lot less than \$9 billion. Any company that is already paying BAT to a state has accepted that they have much more than *de minimis* physical presence in the state and thus wouldn’t be affected by any federal legislation. Further, few major companies would submit to a “doing business” or “economic presence” nexus standard outside of the state of South Carolina.

⁹³ *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert denied*, 510 U.S. 992 (1993); *Kmart Properties, Inc. v. Tax. & Rev. Dep’t, N.M. Ct. App. No. 21,140* (Nov. 27, 2001).

⁹⁴ See *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert denied*, 531 U.S. 927 (2000); *Cerro Copper Products, Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep’t of Revenue, Dec. 11, 1995), *reh’g denied*, 1996 Ala. Tax LEXIS 17 (Ala. Dep’t of Revenue, Jan 29, 1996); *Rylander v. Bandag Licensing Corp.*, 18 SW 3d 296 (Tex. App. - Austin, 2000, *pet. denied*).

As further indication of current filing postures, numerous state challenges have arisen to the passive-investment company structure, whereby an out-of-state company licenses the use of trademarks, tradenames, patents or other intangibles to an in-state company. With a few exceptions,⁹⁵ where such challenges have been successful they have focused on the legitimacy of the corporate structure or the transaction itself, and *not* on the economic presence of the intangible. Accordingly, one would think the states would find it difficult to argue that they're losing revenues they aren't actually currently receiving.⁹⁶

Ultimately, the debate over whether the physical presence rule applies to business activity taxes will continue until one of two scenarios emerges. Either Congress, exercising its plenary power under the Commerce Clause, will specifically apply such a rule through legislative action, or the Supreme Court will decide the issue by taking one of several cases currently working up through state courts.⁹⁷ With regard to the second scenario, given the Court's reticence to hear state tax cases generally (and their denial of cert in *Geoffrey* and *J.C. Penney National Bank* specifically), it is doubtful that such a resolution is within a five-year horizon. With regard to the first scenario, if state sales taxes are indeed radically simplified through state adoption of the Streamlined Sales and Use Tax Agreement and Congress considers overturning the *Quill* physical presence rule as it applies to sales taxes, it makes eminently practical sense to address business community concerns over business activity tax nexus standards.⁹⁸

CONCLUSION

The state tax community is met at a fortuitous confluence of disparate circumstances. Last November, the Streamlined Sales Tax Project participants, through hard work and dogged determination, substantially came to terms on an Agreement to present to state legislatures for their consideration. Over the past several years, increasingly aggressive attempts by state tax officials to impose an economic presence nexus standard for business activity taxes have been creating serious

⁹⁵ *Geoffrey, Inc. v. South Carolina* and *Kmart Properties v. New Mexico*; *Id.*

⁹⁶ See Eugene Corrigan, *Letter to the Editor: States Should Consider Trade-Off on Remote-Sales Problem*, TAX ANALYSTS, STATE TAX TODAY, February 13, 2003: "It seems to me that the states need to face the reality that most of them are generally incapable of enforcing the "doing business" standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general — and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway." Mr. Corrigan is former legal counsel for the Illinois Department of Revenue, former Executive Director of the Multistate Tax Commission, and a former consultant to Ernst & Young, LLP.

⁹⁷ Cases in New Mexico, Maryland, Louisiana, Massachusetts and Missouri all have the potential for reaching the High Court. See Note 94, *supra*.

⁹⁸ Corrigan; *id.*, note 96. "It seems to me that those same [tax] officials should think about the great advantage to be gained by acquiring a major prize in return for giving up very little in this instance. That prize consists of the huge amounts of currently lost use tax revenue on sales by remote sellers."

concerns and increased litigation for multistate corporate taxpayers. Current economic conditions are creating unprecedented shortfalls in state budgets, forcing legislators to consider drastic cuts in spending or to cast ever wider nets in search of additional revenues. Finally, next November the federal moratorium on Internet access taxes created by the extended Internet Tax Freedom Act is scheduled to expire. At the intersection of these disparate (and desperate) circumstances lies a once-in-a-lifetime opportunity for states, taxpayers and consumers. The grand solution to these issues lies in carefully crafted federal legislation that balances the needs and concerns listed above. But it will not be easy to achieve.

First, state legislatures and governors must strictly adhere to the provisions of the Streamlined Sales Tax Agreement, as adopted and as amended, even at the cost of some short-term revenues. Second, to avoid the specter of “complexity creep,” those same state legislatures and governors must be willing to cede a slice of sovereignty to a federal law that provides effective and uniform oversight of a federally mandated streamlined sales tax system. Third, remote sellers must be willing to start collecting tax on remote purchases in exchange for the benefits of simplification and a reasonable collection allowance. Fourth, large corporate taxpayers must both agree among themselves and work together with state tax officials on an acceptable and workable definition of physical presence for business activity taxes if *Quill* is overturned. Such a discussion should include appropriate treatment of P.L. 86-272 in a ‘new economy’ setting. Fifth, the “no-new-taxes” crowd (in Washington and in state legislatures) must recognize that an expanded collection duty for remote sellers coupled with radical simplification is *not* a tax increase, but simply a more effective sales and use tax compliance methodology. Finally, given the public’s perception of the sanctity of the Internet, all parties ought to accede to a permanent extension of the Internet Tax Freedom Act’s ban on taxes on access charges, and on multiple and discriminatory taxes on the Internet. Not because it’s good tax policy, necessarily, but for a purely practical reason. The current ban actually has very little impact on state revenues anyway,⁹⁹ and the permanent extension legislation can be the vehicle that carries the rest of the package home.

As difficult as these objectives may seem, the key to a successful outcome is to convince the parties at interest that all involved will be far worse off if Congress does nothing. States will forego the immediate benefit of billions of dollars of uncollected sales tax revenues at a time when they can least afford it. In an effort to recoup at least some of the revenues, those states that have adopted at least some form of the Agreement can be expected to begin levying assessments on remote sellers in spite of *Quill*, under the theory that even some simplification is sufficient to reduce the burdens on interstate commerce. Remote sellers and other corporate taxpayers, likewise, can be expected to fiercely resist such assessments, arguing that partial simplification is actually no simplification at all, and in fact creates *greater* complexities. Consumers will likely be facing higher state and local taxes, with the added attractions of inefficient government and spiraling private sector litigation costs. And the Supreme Court has made it abundantly clear in *Quill* that they have no desire to ever revisit this issue. The status quo does not present a pretty picture. However, imperfect as the proposed compromise outlined above may seem, if such a solution is achieved it will certainly carry the hallmarks of a ‘perfect’ legislative creation. No one will be particularly happy with it.

⁹⁹ See *supra*, note 70.

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