TO TAX OR NOT TO TAX? FOREIGN AND DOMESTIC TAXATION OF THE INTERNET

Ken Griffin, University of Central Arkansas
Mark McMurtrey, University of Central Arkansas
LeaAnn Smith, University of Central Arkansas

ABSTRACT

What do the governors of forty five states, the European Economic Union, The World Trade Organization, and the United Nations have in common? They all want to tax the Internet. This paper discusses the jurisdictional basis for domestic taxation of the Internet and concludes with pending foreign proposals to tax Internet transactions. The question of foreign taxation of the Internet is a serious one because both an agency of the United Nations and a committee of the World Trade Organization have proposed taxing international E-commerce and E-mail to fund development activities in underdeveloped countries.

INTRODUCTION

The obvious motive of the advocates of Internet taxation is to raise revenue. It is estimated by the United Nations that a BIT tax on E-mail in the European Union would have raised $10 billion dollars in 1998 (Kopel, Holder, 2001). State and local governments could have collected $13.3 billion from sales taxes on online purchases in 2001 and the predicted amount rises to $45.2 billion by 2006 (Bruce, Fox, 2001). There are also several practical concerns about Internet taxation. Some of the most often raised (Griffin, Whitehead, 1998) are (1) the Internet global network that crosses state and national borders, and is inherently a matter of interstate and foreign commerce within the sole jurisdiction of the Congress under the commerce clause; (2) the internet operates independently of state and national borders and Internet transmissions insensitive to physical distances and can have multiple geographical addresses; (3) Internet transmissions use packet-switching technology that makes it impossible to determine with any degree of certainty the precise geographic route or endpoints of specific transmissions and infeasible to separate intrastate from intrastate and foreign from domestic transmissions; (4) taxes imposed on the Internet by state, local, and foreign governments will be inconsistent and cannot be fairly apportioned among the various jurisdictions. This inconsistency will subject consumers, businesses, and users engaged in foreign commerce to multiple, burdening, and confusing taxation that will impede the use of the Internet; (5) because the Internet was developed after traditional notions of jurisdiction for taxation were developed, their application to the Internet is unintended. Unpredictable policy will threaten every Internet user, access provider, vendor, and interactive computer service provider; (6) The Internet provides services, products, and ideas that are especially valuable to senior citizens, the disabled, rural residents, educational institutions, charitable groups, and developing small businesses; (7) It is possible for consumers, businesses, and others engaging in interstate or foreign commerce over the Internet to be subject to more than 30,000 separate taxing jurisdictions in the United States alone; and (8) a consistent and coherent national policy concerning taxation of the Internet is governed by Article I, section 8, Clause 3 of the U.S. Constitution that says, "The Congress shall have the power to…regulate commerce with foreign nations and among the several states…" Having raised the constitutional issues let us turn first to the issues concerning domestic taxation of the Internet.

DOMESTIC TAXATION

Any discussion of domestic taxation of the Internet must commence with the Supreme Court's landmark decision in Quill v. North Dakota (1992). The case involved the state's attempt to require an out-of-state mail order house that had neither outlets nor sales representatives in the state to collect and pay a use tax on goods purchased for use in the state. Quill solicited its business by catalog or flyers and delivered its goods to North Dakota customers by mail or common carrier. It was the sixth largest vendor of office supplies for the state. North Dakota imposes a use tax on property purchased for use in the state and requires every retailer to collect the tax and remit it to the state. The definition of retailer includes "every person who engages in regular or systematic solicitation of a consumer market in the state." Regular or systematic solicitation means "three or more advertisements within a twelve month period." Quill fell within the statutory definition of those required to remit a use tax.

The U. S. Supreme Court considered whether the State's use tax scheme violated either the Due Process Clause or the Commerce Clause of the Constitution. The Due Process Clause requires some minimum contact between a State and the person it seeks to tax. The "income attributed to the state for tax purposes must rationally be related to values connected to the taxing State." Referring to the fact that much business is conducted by mail or wire the High Court held that "if a corporation avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's jurisdiction even if it has no physical presence in the State." Since Quill had purposefully directed its activities at North Dakota, the magnitude of those contacts was sufficient for due process purposes to hold that the State was not barred from enforcing its tax scheme against Quill. North Dakota won on the due process issue. But the issue is not settled until the Commerce Clause is also consulted.

The Commerce Clause expressly authorizes Congress to "regulate commerce… among the several States." The Clause, "by its own force" prohibits certain state actions that interfere with interstate commerce (South Carolina v. Barnwell Brothers, 1938). The High Court ruled in a previous case (Complete Auto v. Brady, 1977) that it would sustain a tax 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 services provided by the State." North Dakota cleverly argued that that if Quill's activities in the state satisfies the due process "minimum contacts" test then the corporation also meets the Commerce Clause "substantial nexus" test. The Supreme Court disagreed saying that due process concerns fundamental fairness of government activity. Justice Stevens pointed out that it had adopted "notice" and "fair warning" as the analytic touchstone of the due process analysis. Next we turn to the court's approach to substantial nexus.

The Commerce Clause, and its nexus requirement, unlike the Due Process Clause, are concerned not so much with issues about fairness for the individual defendant as by questions about the effects of state regulation on the national economy. The framers intended the Commerce Clause as a cure for the well-known structural ills of the Articles of Confederation (The Federalist No.7, 11). As a result the Court has long decided that the Clause prohibits discrimination against interstate commerce and bars state regulations that unduly burden interstate commerce. Justice Stevens wrote that this case, like National Bellas Hess v. Department of Revenue, 1967, involved a state's attempt to require an out-of-state mail order house that neither has outlets or sales representatives in the State to collect and pay a use tax on goods purchased for use within the State. In Bellas Hess the Court ruled that the state statute violated the Commerce Clause. The Court said, a "seller whose only connection with customers in the state is by common carrier or the United States mail" lacked the requisite nexus with the state. The Court believed that its decision furthers the ends of the Commerce Clause to promote economic activity between the states and fosters investment by businesses. Further, the ruling provides predictability by providing a safe harbor for vendors whose only connection with customers in the taxing state is by common carriers or the U.S. mail. It is worth noting that North Dakota's statute clearly demonstrates how a state tax might unduly burden interstate commerce. Recall that the statute imposes a collection duty on any vendor who advertises in the state three times in a single year? Thus, absent the holding in Quill, anyone who advertised over the radio, in a magazine, on TV would be subject to a collection duty. More important, the same obligations might be imposed in the Nations 30,000 taxing jurisdictions. The burden would be unmanageable.

FOREIGN TAXATION

International politicians have joined the forty governors in chasing the Internet golden goose. The 1999 United Nations Report on the Human Condition bemoaned the difference between the "haves" and the "have nots" and proposed a BIT tax to raise funds from those who have technology with the proceeds used to extend technology to all (Kopel, Holder, 2001). On June 5, 2001, the European Union adopted a directive to level the playing field for E-commerce by introducing a value added tax on E-commerce and items sold over the Internet. In May, 2001, the director-general of the World Trade Organization said, "E-commerce is such a growing activity that there is a need for a clear-cut framework of rules." Finally, the UN has planned a world conference in Monterrey, Mexico, in March 2002, to consider recommendations about financing for development of poor countries. One of the proposals is to create an International Tax Organization to collect and administer aid to developing countries (Lamb, 2001). Among the ideas to be considered are a "Tobin Tax" on fuels and currency and a tax on the Internet. Much of the preparatory work for the conference enjoyed the support of the Clinton administration. Robert Rubin, the Secretary of the Treasury, represented the U.S. on the committee (Lamb, 2001). President Bush's approach is unclear. Perhaps, as with the Kyoto Protocol, he will place the interests of American commerce first. One thing is for sure, if we remain passive while foreign governments impose taxes and rules that stifle E-Commerce, the economic health of the global community will be impacted. The world's poor aren't shut out of economic opportunities because the UN and EU don't have enough tax revenue; they are shut out because the leftist and kleptocracies ruling them are already stealing so much (Kopel, Holder, 2001).

STREAMLINED SALES TAX PROJECT

The Streamlined Sales and Use Tax Agreement (Agreement) is an agreement among all states providing for simplification of the nation's varying sales tax laws. The agreement is an effort by 45 states, the District of Columbia, local governments and members of the business community to develop measures radically simplifies sales and use tax collection and administration by retailers and states. The simplified system reduces the number of sales tax rates, brings uniformity to definitions of items in the sales tax base, significantly reduces the paperwork on retailers, and uses new technology to upgrade many administrative procedures. The goal is to allow taxes to be collected for e-commerce sales (Ward and Siprio, 2004).

CONCLUSIONS

The Internet Tax Freedom Act of 2007 extended the moratorium on no new Internet taxes until 2014. While this might reduce the pressure to tax commerce on the Internet in the short run, it is still a national problem. Those in favor of Internet taxation point to the loss of tax revenue regardless of whether it is bricks and mortar sales are clicks over the Internet. Those opposed to Internet taxation point to increasing taxes and fees will result in more expense for the consumer and thus will restrict the growth of Internet use and e-commerce. It is estimated that by 2011 the revenue loss from non taxation of e-commerce will be 54.8 billion dollars (Bruce, Fox, 2004). This is a tremendous force driving the efforts to tax e-commerce. Any effort to tax remote vendors must address the requirements of the Due Process Clause of the Commerce Clause of the United States Constitution. The current tax collection system is not viable for e-commerce and the The Streamlined Sales Tax and Use Agreement is an effort to minimize the confusion of e-commerce sales tax collections and would bring some certainty to tax collections.

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