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Mahesh S. Raisinghani
University of Dallas, mraising@gsm.udallas.edu

Dan S. Petty
North Texas Commission, dan@ntc-dfw.org

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E-Commerce Taxation Issues: A Balanced Perspective and Options for Resolution

Mahesh S. Raisinghani, Graduate School of Management, University of Dallas,
mraising@gsm.udallas.edu

Dan S. Petty, North Texas Commission, dan@ntc-dfw.org

Abstract

This paper is designed to give the reader a balanced perspective on some of the issues surrounding the current discussions related to state and local taxation of Internet access fees and sales transactions on the Internet. The paper will attempt to describe the issues being discussed and present several viewpoints from interest groups on both sides of the issue.

The paper is being written at an interesting time, since the Advisory Commission on Electronic Commerce is scheduled to meet in two weeks in Dallas and shape its final recommendations to Congress, which are due in April 2000.

Taxation of Internet access and transactions on the Internet is one of the most complicated public policy issues of our time, affecting over 30,000 state and local taxing jurisdictions and literally thousands of businesses and customers worldwide. The paper will develop a next steps strategy to be considered by policy makers.

The Issues on Internet Taxation

Electronic commerce has had a profound affect on the way business is conducted worldwide. The impact of the Internet on the economy of the United States has benefited U.S. citizens in all walks of life. The growth of electronic commerce has helped create thousands of jobs that are highly-skilled and high-paying, and this phenomenal growth has provided the consumer with access to goods and services at competitive prices.

Many interest groups such as The Internet Tax Fairness Coalition and the e-Freedom Coalition feel that the growth of the economy has created sufficient taxes to fund the basic needs of state and local governments, and that taxation of transactions on the Internet creates an unnecessary burden on business activities (The Internet Tax Fairness Coalition, 2000; The e-Freedom Coalition). These groups point out that state and local governments have provided services to their constituents without Internet transaction taxes and that the Supreme Court of the United States has long held that vendors have a sales tax obligation only when the buyer and seller are in the same state, or the seller has a "nexus", or physical presence, in the buyer's state. These coalitions and others feel that the best way to ensure long-term economic prosperity, quality services and the continued growth of Internet business is to continue to support the Internet as the new engine driving the new economy and reduce, not

increase, barriers to entry for companies not yet taking advantage of electronic commerce.

The coalitions point out the complexity of the state and local tax systems, with over 30,000 taxing jurisdictions in the United States and the prospect of multiple jurisdictions requiring collection and payment of taxes on transactions. They point out that main street retailers collect taxes from their customers at a single rate, prepare and file a single tax return and file tax returns at one place. Taxation of on-line transactions would require the vendor to identify all taxing jurisdictions and send in forms and collections to all relevant jurisdictions. Also, changes in local sales tax rates and the items subject to taxation varies from jurisdiction to jurisdiction, causing a great deal of confusion for the buyer and the seller. The complicated, complex and ever-changing maze of state and local tax policies and laws makes application of a sensible, fair and easily understood Internet transaction tax policy virtually impossible under the present circumstances. James Plummer, a policy analyst at Consumer Alert, wrote "Nefarious new taxes and regulations will kill many new start-up e-businesses before they even start up; denying consumers their chance to find the specialized products and services for their needs" (Kolasky, 2000).

But state governors seem to disagree. The anti-tax community and coalitions mentioned above have a strong adversary in the National Governors Association in that the Governors are worried that brick and mortar stores such as the main streets and malls of America are jeopardized by the popularization of Internet commerce, particularly if it is tax-free commerce (National Governors Association - overview, 2000). The Governors suggest that if consumers only had to pay taxes when they bought from main street and mall stores but not when they bought goods from Internet stores, that this would discriminate against the main street and mall stores and put them at a competitive disadvantage based solely on government tax policy. Also there has been an argument put forth that while net tax leniency may help spread the Internet more rapidly, it is bad social policy because the people who shop on the Internet come from disproportionately upper rings of the economic ladder and are the least in need of a tax break. Andy Reinhardt claims that tax-free net shopping benefits mostly well-off people and makes the already regressive structure of sales taxes even more unbalanced. It might even be called corporate welfare for tiny start-ups with gigantic market capitalization, while, at the same time, the net-based

economy has plenty of traction. In fact, Reinhardt suggests that such a policy seems too generous a helping hand, especially when it's the poor who carry the load (Reinhardt, 2000).

The Advisory Commission on Electronic Commerce

Because of the complex issues and murky state and local policies regarding taxation on the Internet, a bill was enacted by Congress in 1998 entitled the Internet Tax Freedom Act. The Act imposed a three year moratorium on *new* Internet taxation. The Act also established the Advisory Commission on Electronic Commerce and charged it with the responsibility to address the issues related to Internet taxation (Advisory Commission on Electronic Commerce, 2000).

The Advisory Commission is composed of three representatives of the federal government, eight representatives of state and local governments and eight representatives of the electronic commerce industry. The Commission is charged with conducting a thorough study of federal, state, local and international taxation and tariff treatment of transactions using the Internet and Internet access, and other comparable intrastate, interstate, or international sales activities. The Commission's recommendations are to be submitted to Congress no later than April 2000.

The Act also placed a three-year moratorium on taxes on Internet access in order to give the Commission time to review the issues and make its recommendations. The Commission has met three times and is scheduled to have its final meeting March 20-21, 2000 in Dallas. The Commission has received volumes of testimony and comments on the issues before it and is reviewing, among other things, barriers imposed in foreign markets on U.S. property, goods or services sold on the Internet, how such barriers affect U.S. consumers, the collection and administration of consumption taxes on the Internet in the U.S. and abroad, the impact of Internet taxes, model state legislation, the effects of Internet taxation on interstate commerce, and ways to simplify federal, state and local taxes imposed on telecommunications services.

The National Governors Association Perspective

Today, 46 states have a sales tax of some sort. All of the 46 states that have a sales tax also have what is called a complementary use tax. The consumer pays both of these taxes. Consumers pay the sales tax when they buy goods and services in their own state. When goods are purchased from out of state, consumers are supposed to pay a use tax. Double taxation is avoided because the consumer only pays the tax in his or her place of

residence and taxes are only owed to the state where the consumer lives.

The merchant is responsible for collection of the tax and remitting it to the consumer's state. When the consumer buys from an out of state merchant, such as mail order or the Internet, the merchant, under existing law, is required to collect the tax and send it to the consumer's state only if the merchant has a physical presence (nexus) in the consumer's state. A physical presence may be a store, a distribution center, or a sales force. If the merchant does not have a physical presence in the consumers' state, the U.S. Supreme Court has ruled, in the 1967 *National Bellas Hess* and the 1992 *Quill* decisions, that the merchant cannot be required to collect the use tax and remit it to the state of residence of the consumer (National Governors Association - facts, 2000). However, the consumer still has the legal responsibility to remit the use tax to the state of his or her residence under present law.

Consumers, then, are responsible for paying taxes on goods they purchase through mail-order catalogues and over the Internet, just as they are responsible for paying sales taxes on goods bought in main street and mall stores. If consumers only had to pay taxes on goods bought from main street and mall stores, and not from goods purchased over the Internet, this would discriminate against the main street and mall stores and put them at a competitive disadvantage based solely on government tax policy. The Governors Association believes that government tax policy should not be picking winners and losers by subsidizing one category of businesses at the expense of their competitors.

The Governors have suggested a Streamlined Sales Tax System for the 21st Century. The proposed system would retain current law with regard to nexus and move toward a uniform system over the long term (National Governors Association - proposal, 2000).

Some of the features of the Governors' proposed Streamlined System include:

- Eliminate the burden for firms to collect state and local sales taxes.
- Maintain the current definitions of nexus.
- Simplify the current system of exemption administration.
- Enact the system by the states without any action by the federal government.
- Offer the system a phased-in approach to all sellers on a voluntary basis.
- Eliminate the cost of compliance, tax returns and payments and tax audits.
- Eliminate tax-rate monitoring and implementation, and eliminate record keeping requirements for the sellers.

- Eliminate any requirement for sellers to police the intent or status of purchasers asserting special exemptions.
- Eliminate risks for sellers exercising reasonable care.

The states would implement uniform laws, practices, technology applications, and collections systems to achieve these goals. The goals, when implemented, would achieve the first step of the streamlined system. The second step would be for all state and local governments to adopt the same classification systems, definitions and audits. In order for states to collect sales taxes, states would have to conform to the uniform, nationwide system; those that did not conform would be denied the ability to collect taxes on remote sales until they adopted the uniform system. All merchants should reap the benefits of a uniform system with simple and fair practices.

The overall concept of the Streamlined System is as follows:

- Reduce the cost and burden of sales tax compliance for participating sellers through shifting sales tax administration to a technology-oriented business model operated by Trusted Third Parties (TTP's).
- Simplify sales land-use tax laws and administrative procedures.
- Make states assume responsibility for the costs of the system, so sellers would not be charged for participation in the streamlined system. The streamlined system would be implemented by a combination of uniform legislation and multi-state agreements among the participating states.

The e-Commerce Coalition Perspective

The e-Commerce Coalition is a broad based, national coalition dedicated to providing sound policy information on electronic commerce taxation. Its members include AOL, Bank One, Cisco Systems, Andersen Consulting, Citi Group, Microsoft, Wal-Mart, Intuit and others (e-Commerce Coalition).

The Coalition believes that sales tax compliance costs result in significant expenses for large and small companies, and that simplification of the system is crucial if any progress is to be made towards addressing the issues surrounding the taxation of remote commerce, including leveling the playing field for all commerce.

The Coalition's goals follow closely those of the National Tax Association. Both organizations suggest that improving the current system is preferred. Improvements should be made through a series of substantive and procedural changes to the existing procedures that an interstate seller uses with each state in which it collects taxes. Each state would be responsible for administration

of its own tax system and therefore much could be achieved toward achieving their mutual goals (National Tax Association, 1999).

The Coalition urged that simplification of the current sales and use system is absolutely crucial if meaningful progress is to be made towards addressing the many issues relating to e-commerce. Simplification must come before technology can play a major role in a solution. Time is of the essence because of the speed at which this industry is growing and changing. The Coalition believes that rather than trying to make a complex and broken existing system fit a new economic environment, it is time for states and localities to make the sales and use tax system less complex by simplification measures and help level the playing field for all types of commerce.

Governor James Gilmore's Perspective

Governor James Gilmore of Virginia is Chairman of the Advisory Commission on Electronic Commerce. Governor Gilmore submitted a proposal to the Commission on November 8, 1999 entitled "No Internet Tax" (Gilmore, 1999).

The Governor basically describes the enormous positive impact that the Internet has had on the economy in creating job and new business opportunities. He concludes that the Internet changes everything, including government, and that government must change its policies as well as the way it operates.

Governor Gilmore's proposal outlines several suggestions for the Commission and the Congress to address:

- Congress should prohibit all sales and use taxes on business-to-consumer Internet transactions.
- Congress should protect companies from unfair income and business activity taxes imposed upon them due to their virtual presence in states.
- The Tax Freedom Act should be amended to prohibit all taxes on Internet access.
- Congress should abolish the federal 3% excise tax on telephone service.
- There should be no international tariffs or taxes on e-commerce.
- States should be permitted to spend federal funds for temporary assistance to needy families to buy computers and Internet access.

The Governor believes that American public policy should embrace the Internet and the borderless economy it creates rather than impose old ways of thinking and antiquated locus-based tax structures upon it.

Tandy Corporation/RadioShack Perspective

The Tandy Corporation/RadioShack Perspective was presented to the Advisory Commission on Electronic

Commerce at its meeting September 13-15, 1999 in New York City by Ronald L. Parrish, Vice President for Industry and Government Affairs (Parrish, 1999).

Tandy's comments were essentially presented in two parts, dealing with whether remote sales of goods on the Internet should be subject to sales and use taxes and the subject of taxes on Internet access.

Tandy supported the passage of the Internet Tax Freedom Act of 1998 and the creation of the Advisory Commission. The issue in Tandy's eyes is one of equal treatment between retailers who must legally collect taxes on remote commerce and those who do not. Retailers with nexus in many, if not all, states find themselves at a competitive disadvantage to retailers and some who even ignore the laws that are on the books. Tandy believes that no more than one tax rate for each state should be implemented with uniform classifications of goods subject to taxation. Also, Tandy believes there is no justification for a federal gross receipts tax, the creation of a new federal agency to collect sales taxes or a private tax clearinghouse to collect taxes.

Tandy feels that the existing moratorium on Internet access fee taxes should be extended indefinitely.

Tandy's suggested guiding principles for Congress include:

- All retailers of remote commerce should be treated equally, regardless of nexus or lack thereof.
- Sales taxes should be applied to Internet/remote commerce in a consistent manner to brick and mortar retailers.
- No more than one sales tax rate per state should be applied to Internet sales.
- The states should adopt uniform principles of taxation for categories of goods to be taxed and exempted.
- No new federal gross receipts tax on Internet sales should be imposed and no new federal agency to collect Internet taxes should be created.
- The current moratorium on Internet infrastructure taxes and access fees should be extended permanently.

Internet Taxation Issues in Texas

The e-Commerce business community in Texas listened to Lt. Gov. Rick Perry at the first meeting of his newly appointed Advisory Council on the Digital Economy say that the state should not impose any NEW taxes on the Internet (Stutz, 2000). There is widespread assumption in Texas that sales taxes on online sales are illegal for three years because of the Federal Internet Tax Freedom Act of 1998. That is a misunderstanding of the federal law, which bars states from imposing *new* taxes on

those transactions, but leaves the existing Texas laws in place. If you buy something online from a Texas company, you have to pay sales tax, since the seller is located in the state. If you buy something from a company that does not have a physical presence (nexus) in the state, that company does not have to collect the tax or send those taxes to the comptroller's office in Austin. The Texas buyer legally still owes the tax to the State of Texas. However, it is generally felt that most individual buyers probably don't report these sales or pay the use tax owed. Most businesses do pay the use taxes. Governor Perry doesn't seem to want the state to impose a *new* tax on online sales, and he doesn't appear to see a need right now to change the existing state tax law or develop any new interpretations of how that law might be enforced differently.

At the federal campaign level, it appears that Gov. Bush will develop his position on these issues after he has reviewed the final report of the Advisory Commission to Congress (LaGessee, 2000). Governor Bush does seem inclined to extend the current moratorium.

The Advisory Commission seems to be hung up on how these issues will play internationally. A free trade cyberspace thrills trade negotiators and at the same time a tax-free cyberspace makes tax collectors miserable. The European Union has worked out a system where all 15 members impose hefty value-added taxes and all retailers must collect the tax for all sales within the union. For example, an Internet purchase made in Germany by a customer in Portugal gets taxed at the VAT rate for Portugal; the German seller collects it. United States negotiators are working with groups internationally to come to some understanding regarding these complex issues (Landers, 2000).

Summary of Options For Resolution of Internet Taxation Issues

After reviewing some of the information available on this very complex subject of Internet taxation, it appears that an interim solution might evolve from the final report and recommendations of the Advisory Commission on Electronic Commerce. Any recommendation would probably include an extension of the moratorium on taxes on Internet access.

It must be acknowledged that use of the Internet and transactions on the Internet have precipitated a great deal of dialogue on taxation issues. Although there are serious and complex issues, it appears that a resolution can be constructed that addresses most of the issues and does not disrupt what is clearly one of the most significant economic engines of modern, and perhaps all, time.

A solution, or solutions, will need to respect the needs of state and local governments which depend on sales taxes to provide funds for basic state and local

governmental services, and at the same time support electronic commerce as a mechanism for enhancing our economy and quality of life. It seems that states and local governments can develop systems with innovative concepts and procedures which allow them to collect taxes due without creating an unnecessary bureaucracy and roadblocks to the normal expansion of the electronic commerce business growth and development. There can be a combination of workable solutions, including technology being applied to the collection process, standardization of tax systems, utilization of private sector partners and assumption by state and local governments of the responsibility to pay the costs of newly developed and technologically sophisticated collection systems.

A version of the electronic commerce technology for tax administration, developed and operated by a major U.S. company, is being used in Europe to collect transactional value-added taxes at the time of sale (The Internet Tax Fairness Coalition, 2000). This system contains most of the features that states would find necessary for the proper and efficient collection of their taxes. Additional features that would be desirable are within technical reach and are under development by at least one other company. The technology of electronic commerce is itself a major resource for helping solve the long-standing sales and use taxes issues.

Another key element of the solution will involve interstate standardization and simplification of key features of sales and use tax systems. State and local governments have acknowledged that their system of sales and use taxes must change in a substantial manner if they are to remain viable in the 21st century (National Tax Association, 1999). Taxing authorities are now moving toward the development of multi-state systems that will help remove complexity and add simplicity to the process. This simplicity movement will provide a foundation for changes in tax laws and procedures necessary to enable the technology for tax administration to work effectively and efficiently for electronic commerce. The two most prevalent areas involving simplification are local option taxes and exemption administration.

The United States Supreme Court, in its Quill decision, made it clear that states cannot impose the obligation of use tax collection on remote sellers whose contacts with states are limited in nature because of the burden of collection for those sellers. Thus, it seems if sales and use taxes are to be equitably collected at the time of sale, state and local governments will need to assume the costs and burden of collection for remote sellers who are constitutionally protected. Therefore, state and local governments, working in concert with the private sector, could incorporate the Court's direction into a solution for sales and use tax collection issues.

It seems that a new system of sales and use tax administration could be designed around the needs of electronic commerce. What is really required to resolve the sales and use tax issues, more than just technology and simplifications and financing, is leadership among state and local officials, technology companies and interstate marketers that would provide the vision and imagination to move forward in developing a new system of administration. The new system could accomplish the collection of taxes on an equitable and efficient basis without burdening remote sellers. In the end, both state and local governments, the growing electronic commerce industry, and taxpayers and consumers can benefit from the creative genius of the leaders of our time.

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