New England
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Should Internet Sales Transactions Be Taxed?

By Daniel G. Swaine and Robert Tannenwald

Over the past three years, electronic commerce has grown explosively at rates of 200 to 300 percent per year. After spending just $2.4 billion over the Internet in 1997, consumers transacted about $25 billion in Internet sales in 1999, according to an estimate by Ernst & Young. The firm predicts that the value of on-line transactions will double to $50 billion in the current year. By 2004, says Forrester Research, Internet sales to consumers will reach $184 billion, an annualized growth rate of 49 percent over the five-year period from 2000 to 2004.

Nationwide, sales taxes generate nearly 40 percent of state tax revenues. Understandably, state policymakers are concerned that the rapid growth in Internet transactions will erode their sales tax base, making it difficult for them to raise revenues in the future. Exacerbating their concern is the informal recommendation of the *Advisory Commission on Electronic Commerce* to extend a recently imposed moratorium on the taxation of Internet-based transactions for another five years. This moratorium – known as the Internet Tax Freedom Act of 1998 – prohibits states from imposing a sales tax on e-commerce, except in limited circumstances.

The question of whether/how e-commerce should be taxed raises a host of policy issues. Underpinning these issues are legal questions relating to the taxation of all remote sales, including mail-order sales, telephone sales, and television shopping channels. In this issue of *Fiscal Facts*, we examine basic constitutional and tax enforcement considerations central to the taxation of e-commerce. In two subsequent issues, we plan to address aspects of fairness and economic efficiency in e-commerce taxation, as well how the Internet contributes to the economic infrastructure of the nation.

The Thorny Problem of Use Taxation

Sales taxes were first enacted during the Great Depression, when many state and local governments had difficulty balancing their budgets. Tangible goods purchases by consumers were primarily in-state sales transactions conducted at retail outlets. Since that time, sales taxes have remained an important source of revenue for state governments. With far fewer merchants than consumers, collecting sales taxes from in-state merchants is relatively easy. The governmental tasks of administering and enforcing a sales tax system are manageable.

In contrast, collecting taxes from sales transactions conducted across state borders is an administrative nightmare. When a state's residents purchase tangible products from out-of-state merchants for use back home, the home state loses the tax revenues from these interstate transactions because state taxing power over merchants ends at the state border. However, these so-called border effects work both ways. When out-of-state consumers purchase tangible products from a state's merchants for their use back home, the state gains the tax revenue from these interstate sales transactions, providing the state with an opportunity to export part of its tax burden to the residents of other states.

The question of whether a state government registers a net gain or a net loss of sales tax revenues from cross-border retail transactions depends on whether in-state sales of retail products to out-of-state residents exceed out-of-state purchases of retail products by the state's residents, or vice versa. Fearful of being a net loser of sales tax revenues, most state governments have tended to emphasize the loss side of the interstate retail trade equation. Most have enacted a companion use tax.

The companion use tax is imposed on residents who purchase a tangible product from an out-of-state retail merchant for use back home. The resident is responsible for remitting the tax to the home government. However, the resident is required to remit the tax only if the sales tax paid to the out-of-state government is less than the sales tax the resident would have paid if the purchase had been made in the home state. The resident pays the difference in the sales tax to the home state government. For example, the sales tax rate in Massachusetts is 5 percent, while New Hampshire has no general sales tax. A Massachusetts resident who purchases a desktop computer in New Hampshire for use in Massachusetts is required to pay the Commonwealth a use tax of 5 percent of the purchase price of the computer.

As one can imagine, use taxes are extremely difficult to enforce, since the state cannot collect the tax from the merchant, but only from the consumer making the purchase. The unenforceability of this tax is illustrated by the fact that most consumers are completely unaware of their responsibility to pay use taxes. The difficulty of collecting, administering, and enforcing use taxes is at the crux of the debate over e-commerce taxation, as well as taxation of all other remote sales that occur across state borders, including mail-order sales, telephone sales, and television shopping channels.

The U.S. Constitution, the Supreme Court, and the Use Tax

A serious effort to enforce use tax collection from consumers would be astronomically costly. An alternative would be for states to compel out-of-state merchants to collect use taxes at the point of sale. However, the U.S. Constitution ensures that, in general, state taxing power ends at the state border. Any attempt by a state government to collect taxes from out-of-state transactions violates the U.S. Constitution on two grounds:

(1) It is a restraint on interstate trade; and

(2) It subjects both merchants and consumers to multiple and discriminatory taxation of the same transaction – a circumstance that has been interpreted as an overreaching of state government power.

Resolving disputes from interstate transactions necessarily involves the U.S. Constitution, the U.S. Congress, and the U.S. Supreme Court. The commerce clause of the U.S. Constitution delegates the power to regulate interstate and international trade to the U.S. Congress. However, Congress has rarely exercised this power with respect to interstate commerce, preferring to allow unfettered free trade across state borders for the purpose of developing national markets. Because Congress has been silent on interstate trade, state taxation of interstate sales transactions has been left to decisions of the U.S. Supreme Court.

All U.S. Supreme Court decisions addressing the issue have aimed to define a legal term – nexus – that represents a connection between the state and a merchant. The existence of nexus, the Court has ruled, allows a state government to collect taxes from an out-of-state merchant on sales made to in-state consumers. The relevant Supreme Court cases all concern mail-order sellers, but the issues decided by the Court are applicable to all forms of remote sales transactions. There are six relevant cases: the two companion cases of *Nelson* v. *Sears and Roebuck & Co.* (1941) and *Nelson* v. *Montgomery Ward & Co.* (1941), *Scripto Inc.* v. *Carson* (1960), *National Bellas Hess Inc.* v. *Department of Revenue* (1967), *Complete Auto Transit Inc.* v. *Brady* (1977), and *Quill Corp.* v. *North Dakota* (1992).

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State Budget Timetables

Annual Budgets
Massachusetts
Rhode Island
Vermont
FY00: July 1, 1999 to June 30, 2000
FY01: July 1, 2000 to June 30, 2001

Biennial Budgets
Connecticut
Maine
New Hampshire
FY00-01: July 1, 1999 to June 30, 2001

In the two companion cases of *Nelson* v. *Sears and Roebuck & Co.* (1941) and *Nelson* v. *Montgomery Ward & Co.* (1941), both Sears and Montgomery Ward operated retail outlets in Iowa as well as an out-of-state mail-order business that sold merchandise to Iowa consumers. The Supreme Court ruled that Iowa could require these two merchants to collect a use tax on the mail-order sales that were made to Iowa consumers because the two merchants had a "physical presence" in the state that stemmed from their retail operations.

In the case of *National Bellas Hess Inc.* v. *Department of Revenue* (1967), the Supreme Court clarified the "physical presence" definition of nexus. Bellas Hess was a "pure" mail-order business that sold merchandise across the country. The state of Illinois attempted to impose use tax collection on all sales that Bellas Hess made to Illinois consumers. The court ruled that this tax was an unconstitutional restraint of interstate commerce, because Bellas Hess had no physical connection with the state of Illinois, except through the U.S. mail or some other common carrier.

In *Scripto Inc.* v. *Carson* (1960), the court ruled that a "physical presence" did not mean that a company had to own the "physical" property (i.e., retail operation, office, warehouse, or other place of business) to have a sufficient nexus – nexus could be acquired through an agency relationship. Scripto used ten wholesalers within each state to solicit sales orders for the Scripto account in that state. The court ruled that the use of the wholesalers to solicit sales orders constituted an agency relationship sufficient to give Scripto a physical presence in the state.

In *Complete Auto Transit Inc.* v. *Brady* (1977), the Supreme Court established a four-part test for whether a use tax violates the commerce clause. To not be in violation, the tax (1) must be applied to an activity with a substantial nexus within the taxing state; (2) must be fairly apportioned to in-state activity; (3) cannot discriminate against interstate transactions relative to in-state transactions; and (4) must be related to the services funded by the taxing state. Substantial nexus refers to the physical presence test developed by the court in the three earlier cases.

In *Quill Corp.* v. *North Dakota* (1992), the Supreme Court upheld its earlier ruling in Bellas Hess, despite protestations that the Bellas Hess decision was obsolete. Quill was a Delaware state corporation selling office equipment nationwide by mail-order solicitation and had no physical presence in the state of North Dakota. The Supreme Court ruled that Quill did not have the substantial nexus (that is, physical presence) required for North Dakota to impose use tax collection. North Dakota's imposition of a use tax was a restraint of interstate commerce that violated the commerce clause of the U.S. Constitution.

These Supreme Court rulings imply that state governments cannot collect use taxes from an out-of-state merchant on remote sales made to in-state consumers unless the merchant maintains a physical presence within the state in one of two ways: (1) through the ownership of a place of business (retail operation, warehouse, or office), or (2) through an agency relationship that constitutes a *de facto* in-state physical presence. Thus, the Supreme Court interprets the commerce clause of the U.S. Constitution as restricting the collection of state taxes to within a state's borders – the state's taxing power ends at the border. These rulings do not imply that state use taxes are unconstitutional, but only that the state cannot collect the tax from out-of-state merchants who lack an in-state presence. The decisions also imply that the appropriate place to collect the use tax is from in-state consumers that engage in interstate transactions.

The Internet Tax Freedom Act

The U.S. Congress became involved in electronic commerce taxation in 1998 through enactment of a temporary moratorium on "new" Internet taxes. The Internet Tax Freedom Act (ITFA) placed a three-year moratorium on any additional (i.e., "new") taxation of Internet access services, such as America Online and other Internet service providers.[1] The moratorium also prohibited multiple and discriminatory taxes, such as the taxation of on-line sales of tangible goods and services by more than one state, or any tax that discriminates against electronic commerce. The collection of use taxes from consumers is not prohibited by the ITFA, although for all practical purposes, use tax collection is unenforceable. The moratorium was designed to give policymakers time to consider the issues involved in taxing electronic commerce.

The ITFA also established a nineteen-member commission, the Advisory Commission on Electronic Commerce, to make recommendations concerning the taxation of all Internet-based transactions. The Commission was required to submit a report to Congress on any findings and recommendations that were backed by at least two-thirds of commission members.

[1] Ten states (Connecticut, Wisconsin, Iowa, North Dakota, South Dakota, New Mexico, South Carolina, Tennessee, Texas, and Ohio) had already imposed taxes on Internet service providers. A grandfather clause exempts these states from this provision of the act.

Unfortunately, the Commission went out of business on April 21, 2000, unable to reach this two-thirds consensus. However, a simple majority voted to issue a report containing the following four recommendations: (1) extend the moratorium on Internet taxes through 2006, (2) ban permanently all taxes on Internet access, (3) repeal the federal excise tax on telephone communications, and (4) codify with federal legislation the U.S. Supreme Court decisions in *National Bellas Hess, Complete Auto Transit,* and *Quill.*

Because the Quill decision settled the legal issue of whether states could impose use tax collection on out-of-state merchants, codifying the decisions may seem unnecessary. However, federal legislation would allow Congress to exercise its right to regulate interstate commerce as delineated in the commerce clause of the Constitution.[2]

Conclusions

The preceding discussion makes three key points:

• First, existing laws, including the ITFA, do not prohibit the collection of use taxes on consumers' Internet sales transactions. However, from an administrative and tax enforcement perspective, use tax collection is impractical.

• Second, according to U.S. Supreme Court interpretation, collecting use taxes on remote transactions from out-of-state merchants is prohibited, since a state's taxing power ends at the border. The sole exception is when an out-of-state merchant has established nexus, that is, a "physical presence," within the taxing state. Then, a state can compel the out-of-state merchant to remit use taxes on remote sales transactions.

• Third, in the absence of nexus, congressional action through the ITFA prohibits any current solution that circumvents the aforementioned Supreme Court rulings.

The taxation of e-commerce raises more than just legal issues. Considerations of fairness and economic efficiency are relevant as well. In the next issue of *Fiscal Facts*, we will discuss these economic concerns and consider the pros and cons of a variety of approaches for dealing with e-commerce taxation, including the ITFA's current exemption of e-commerce from sales taxation. **FF**

[2] The clauses of the Constitution relating to interstate commerce are the following:
• Article 2, Section 8, the commerce clause: "The Congress shall have Power to regulate Commerce with foreign nations, and among the several states, and with Indian Tribes."
• Article 2, Section 9: "No tax or duty shall be laid on articles exported from any state. No preference shall be given by any regulation of Commerce or revenue to the ports of one state over those of another: nor shall vessels bound to, or from, one state be obliged to enter, clear, or pay duties in another."
• Article 2, Section 10: "No state shall, without the consent of Congress, lay any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws: and the net produce of all duties and imposts, laid by any state on imports or exports, shall be for the use of the treasury of the United States; and all such laws shall be subject to the revision and control of Congress."

Across *the* Region

Revenue growth across the region moderated in FY00 from the extremely fast pace of recent years, primarily as a result of the phase-in of previously enacted tax cuts. Even with this moderating growth, however, five of the six New England states enjoyed operating budget surpluses that ranged from 1.5 percent to 4.6 percent of expenditures. Policymakers have elected to use these budget surpluses to fund a variety of one-time projects and tax cuts. New Hampshire was the only state to record a budget deficit for FY00, mainly because of the inability of policymakers to agree on a method of fully financing the state's education reform.

Appropriations growth for FY01 is quite modest in Connecticut, Massachusetts, New Hampshire, and Vermont, ranging from 2.7 percent to 3.9 percent. Maine's budget for FY01 is up by 8.7 percent over FY00 appropriations, while Rhode Island's is up by 8.6 percent.

Enacted Appropriations for FY2000 and FY2001[a]

(Excluding Federal Dollars)

	FY2000	FY2001	Percent Change
	Millions of Dollars		
Connecticut	9,773.1	10,152.5	3.9
Maine	2,574.4	2,798.4	8.7
Massachusetts	17,299.0	17,788.9	2.8
New Hampshire	2,028.4	2,083.3	2.7
Rhode Island [b]	2,965.0	3,221.2	8.6
Vermont [c]	1,427.2	1,473.4	3.2

[a] Unless otherwise noted, includes general fund and transportation fund appropriations only. Excludes expenditure of federal grants and reimbursements.
[b] Includes general revenue and other unrestricted funds.
[c] Includes Act 60 education fund spending.
Sources: Official budget documents, state financial statements, and conversations with state budget officials.

Six-State Review

Connecticut

Connecticut collected taxes totaling $8.8 billion in FY00, up 5.7 percent from the previous year. Personal income tax collections grew by 10.7 percent, outstripping projections by 5.5 percentage points. Sales tax collections recorded healthy growth of 5.9 percent – in line with forecasts. The extraordinary growth in income tax revenue helped generate a tax revenue surplus of $468.3 million for FY00.[1] However, net supplemental appropriations totaled $97.7 million, leaving an FY00 operating budget surplus of $370.6 million.[2] Of this budget surplus, $105.1 million is to be maintained as reserve balances ($34.9 million in the rainy day fund and $70.2 million in the transportation fund), and the remainder, $265.5 million, is to be spent on one-time school construction projects. In early May, the legislature enacted and Governor John Rowland signed into law an FY01 own-source revenue budget of $10.2 billion, up $379.4 million, or 3.9 percent, over FY00 appropriations.[3] The budget contains new spending initiatives as well as a host of tax cuts. Highlights of the budget are as follows:

1 A tax revenue surplus is the amount of tax revenue collected in excess of the estimate that was enacted with the budget.

2 Net supplemental appropriations include the following: an enacted budget deficit of $63.3 million, plus supplemental appropriations of $71.6 million, plus an accounting adjustment of $3.8 million, less non-tax surplus revenues of $41 million.

3 Own-source revenues are the revenues raised by state sources and exclude federal funds and reimbursements. Similarly, own-source revenue expenditures is the spending financed with the state's own revenue sources. For the state of Connecticut, this is general fund expenditures plus transportation fund expenditures, less all federal funds.

Spending ($55.4 million):

- Spending for new health-care initiatives is increased by $33.3 million.
- Spending to correct for overcrowding in state prisons is increased by $22.1 million.

Tax cuts ($338.2 million):

- Many sales tax exemptions are added or expanded, at a cost of $44 million. Most substantially, the exemption for clothing purchases is increased from $50 to $75, at a cost of $29 million.
- The method of apportioning corporate income to the state is changed to a single-factor formula. This will cost $53.6 million.
- The hospital gross receipts tax is eliminated, at a cost of $75 million.
- The gift tax is phased out over a six-year period, at a cost of $57.3 million.
- The gasoline tax is reduced by 7 cents per gallon, from 32 cents to 25 cents. The cost is $94.2 million.
- A new tax credit for HMOs is projected to cost $10.5 million.
- The tax on movie theater admissions is reduced from 8 percent to 6 percent, a change that will cost $3.6 million.

Maine

Maine collected an estimated $2.6 billion in tax revenues in FY00, up 5.2 percent from FY99 (using a base-to-base comparison). Although individual income tax revenues grew 7.0 percent, the total revenue collection from this tax was 2.2 percent less than anticipated. In contrast, both sales tax and corporate income tax revenues grew faster than expected, at rates of 4.1 percent (using a base-to-base comparison) and 3.5 percent, respectively.

Despite the modest growth in tax collections, Maine realized an estimated operating budget surplus in the general fund of about $45.1 million. Of these surplus funds, $9.2 million will be allocated to the rainy day fund, $4.6 million will be used to offset state pension liabilities, $20 million will be spent on education technology, and the remaining $11.3 million will be used to cushion new demands for appropriations in the upcoming fiscal year.

For FY01, the legislature enacted a $2.8 billion own-source revenue budget, up 8.7 percent over FY00 appropriations. FY01 budget highlights are as follows:

Tax cuts ($40.5 million):

- The snack tax will be eliminated effective January 1, 2001, costing $16 million in lost revenues.
- Income tax brackets will be indexed to inflation. This will be fully effective in 2003 and will cost $6.5 million in lost revenues.
- The first $6,000 of private and government pensions will be exempted from the state income tax, costing $17 million.
- An earned-income tax credit will be created, costing $1 million.

Education spending ($79 million):

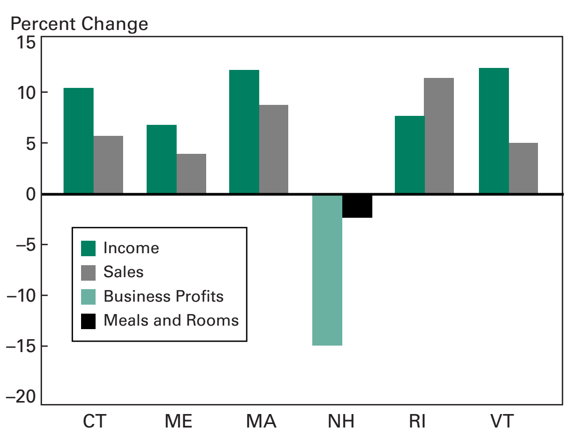
- Aid to local education is increased by $42.1 million, or 6.8 percent.
- Spending for higher education is increased by $36.9 million, or 17 percent.

One-time capital improvements ($109 million):

- $50 million is to be invested in education technology.
- $27 million is provided for school renovations.
- $21 million is allocated for road improvements.
- $11 million is allocated for railroad improvements.

Revenues from the Two Largest Taxes in Each New England State

July through June, FY2000 Compared with FY1999



Source: Official budget documents, state financial statements, conversations with state budget officials.

Massachusetts

The Commonwealth collected $15.6 billion in tax revenues in FY00, up 9.7 percent from the preceding year and significantly in excess of the 3.9 percent growth that was projected when the FY00 budget was enacted in November 1999. Revenue collections were led by strong growth of 12.5 percent in personal income tax collections, growth of 12.2 percent in corporate income tax collections, and growth of 9.0 percent in sales tax collections. These extraordinary gains produced a tax revenue surplus of

$827.6 million for FY00. The legislature promptly spent this surplus by enacting six different supplemental appropriation bills totaling $864.9 million.

In late July, the legislature enacted a $17.8 billion own-source revenue budget for FY01, up 2.8 percent from FY00. The new budget contains the following initiatives:

- An increase of $450 million in K-12 education spending, with $187 million of this increase allocated as direct local aid to school districts.
- An increase of $494 million in the budget for the University of Massachusetts.
- A tax credit of $164 million for charitable giving.
- An increase of $90 million in health care spending, including $25 million to subsidize health insurance premiums for state workers and funding for prescription drugs for senior citizens.
- An expenditure of $33 million for affordable housing.

Also incorporated in the budget is a change in the state's commitment to fund special education. Currently, the state provides a "maximum feasible benefit" for special-needs students. In FY02, the Commonwealth will adopt a federal standard that requires a "free and appropriate" education for these students. A McKinsey & Company study commissioned by the legislature suggested that this change in language will save the Commonwealth $8 million to $36 million per year. An additional provision in the special education act will tighten the eligibility criteria for special education programs – a change that could disqualify as many as 30,000 special-needs students, but could save the Commonwealth an estimated $125 million per year.

New Hampshire

New Hampshire collected $1.26 billion in tax revenues in FY00, up 32.1 percent from the previous year. However, this increase is due primarily to tax changes related to education finance reform. If collections are adjusted for these tax changes, tax revenues were essentially flat in FY00. Adjusted revenues for the two largest taxes – (1) the combined business profits and business enterprise tax, and (2) the rooms and meals tax – declined by 15.1 percent and 2.3 percent, respectively. Because of lower than expected revenue growth and because the increase in state education spending that is due to the Claremont reform has not been fully financed with new revenues, forecasters are predicting that New Hampshire will end the FY00-01 biennium with a budget deficit of $40 million to $100 million.

Given this predicted budget shortfall, New Hampshire did not enact a mid-term budget adjustment in the past legislative session. Instead, policymakers chose to leave in place the budget for FY01 that was enacted in June 1999. This budget provides for own-source revenue spending of $2.1 billion, up 2.7 percent over FY00 appropriations. However, informally, Governor Jeanne Shaheen asked many state agencies to trim their FY01 expenses by about $20 million, and she formally instituted a hiring freeze that will last through FY01. Because the amount that the state will spend on an adequate education will increase next year, the budget shortfall is expected to balloon to $200 million or more during the next biennium, FY02-03, leaving policymakers plenty of work to accomplish in the legislative session that starts in January 2001.

Rhode Island

Rhode Island collected $1.82 billion in tax revenues during FY00, up 8.5 percent from FY99 and well ahead of the 3.5 percent growth that had been predicted when the FY00 budget was enacted. FY00 tax collections were led by sales and personal income tax revenues, which grew by 11.1 percent and 7.9 percent, respectively. The stronger than expected revenue growth generated a tax revenue surplus of $50.8 million. Unspent surplus tax revenues were reduced to $7.6 million when the legislature enacted a supplemental appropriations bill totaling $43.2 million.

At the end of June, the legislature enacted an own-source revenue budget of $3.2 billion for FY01, up 8.6 percent over FY00 appropriations. The FY01 budget contains three major spending priorities: increased local aid for municipalities, continued relief for taxpayers, and increased spending for human services. Budget highlights include the following:

Tax relief:

- Local aid to communities is increased by $27.7 million in order to continue to fund the phase-out of local property taxes on business inventories and on motor vehicles.
- Funding is provided for the fourth in a series of five planned income tax rate reductions of 0.5 percentage points. This particular reduction will lower the income tax rate from 26 percent to 25.5 percent of federal tax liability.

Local aid:

- General revenue sharing to local communities is increased by $5.9 million.

- Aid to local public education is increased by $45.9 million. Providence will get the lion's share of this increase, about $22 million, which represents an increase of 16 percent. The remaining $23.9 million will be spread across the rest of the state's communities, representing an average increase of 5 percent for these cities and towns.

Human services:

- Spending for the state's managed health care program, Rite Care, is increased by $29.3 million.
- Medical care assistance to lower-income families is increased by $42.5 million.

Vermont

Vermont finished FY00 with tax collections totaling $888.1 million, up 6.2 percent from FY99. Revenue growth was stronger than anticipated, surpassing the predicted growth rate of 2 percent. Personal income tax revenues grew by 12.7 percent, sales and use taxes increased by 5.2 percent, and meals and room tax collections were up by 5.9 percent, with all three tax collections exceeding expectations. On the downside, corporate tax receipts declined 11.3 percent – a significant fall, but better than the forecasted 16.8 percent decrease. The stronger than anticipated growth in overall tax collections helped the state to realize an estimated operating budget surplus in the General Fund of $21.3 million.

The legislature enacted and Governor Howard Dean signed into law a $1.47 billion own-source revenue budget for FY01, up 3.2 percent from FY00 appropriations. Budget highlights include the following:

Spending increases:

- The state's anti-tobacco initiative, funded with tobacco settlement funds, is increased by $6.1 million.
- Health care spending, also funded with tobacco settlement funds, is increased by $17.2 million.
- $29.2 million is appropriated for a variety of one-time spending projects.
- An appropriation of $3.0 million is made for affordable housing.

Tax cuts:

- An earned-income tax credit of up to $3,000 is established for taxpayers earning less than $12,000. This tax credit is estimated to cost $3.5 million.

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