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Internet Taxation

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Abstract

Taxation of Internet transactions is essential for funding government provided services; however, a new methodology for collecting these taxes is required to assure fair and equitable enforcement. This process should be designed to be easily understood by the consumer and to assure speedy transactions. This methodology must be standardized to guarantee equitable enforcement and to ensure government accountability. Additionally, this policy should require the Internet vendor to collect appropriate state taxes on goods within the state where the web page originates, as opposed to where the purchase was initiated.

Internet Taxation

The Internet has introduced many changes in the way business is conducted. Amongst these transformations are differences in the business process, billing and tax accounting practices. However, despite these conversions, taxes on goods and services must be collected. The government will not be able to provide the services necessary for social programs, and other essential assistance, without a strong tax base. Taxes have a very negative connotation; however, they do serve a useful purpose to society.

Debates have arisen concerning the proper methodology to utilize to collect and account for taxes on Internet purchased goods and services. The Internet has made its mark in the retail business and is fast becoming a popular alternative to in store purchases. Many states have attempted to enact various different methodologies to try and collect owed taxes on products and services. This is a futile effort wrought with complexities because there is no standardized method to completely assure taxes are fairly collected and accounted for. Any attempt to standardize a single process for tax collection will, undoubtedly, stir up controversy in both the commercial and political arenas. However, the standardize strategy is a definite requisite for the assurance of equitable tax collection and enforcement of payment. There are a plethora of programs involved both on the state and federal level; therefore, the process created must be simple, fair and adaptable to the different programs that will utilize it. Internet transactions that take place in another state are comparable to a consumer from a different state making an out of state purchase at a retail store. The consumer would pay the local state tax on the item despite the fact that they reside in a different state than the store location.

Internet customer's payment of their fair share of taxes, on purchased products and services, will assure ample tax bases to guarantee that citizens are provided essential government provided assistance. To ensure the fair and equitable collection of these taxes, the new process would need to identify the taxes, and the site would need to charge the current sales tax for the location where the web page is situated. For example, if the business' web page is located in Michigan, then the standard Michigan tax should apply, and be added. Employing this relatively simple process will allow for taxes to be collected in each state that houses the utilized web page. This practice will allow for tax collection in the state that provides services to the web page location. Additionally, it must be clearly indicated that the sales tax for the web page state will be collected.

If it is not technologically possible to identify the nexus for the web site, or if it is located in an area outside of the country, the home location of the main business office should be utilized as the default to determine the tax rate. Each country has different rules that apply to both the statement of taxes at the time of purchase, and the collection of taxes at checkout (Chan & Suwanda, 1999). The home location of the main business office should be used in determining the tax rate. This would be no different than if a person were to travel outside the US and purchase an item from a local vendor. In this case, the purchase would fall under the same rules and import restrictions as determined by the current federal statutes. As an example, United States citizens are not allowed to purchase cigars from Cuba, and bring the items into this country. This restriction is extended to Internet purchases, and no different from any other overseas purchase. If the US citizen gets discovered to be ordering and shipping the product into the country, the U.S. Government would prosecute just as any other illegal operation. This process shifts the burden of proper accounting methods from the government to the business

itself. The Internal Revenue Service would provide the oversight for proper collection of taxes thru Internet transactions, as they do now.

Literature review

Discussing taxation of Internet transactions is analogous to a debate concerning religion or politics. This subject matter has sparked much controversy and is a contemporary topic of debate in many articles. Research think tanks have tackled this issue, as well as special interests groups who lobby for their needs to be addressed in any new policy that might be adopted. Considering the fact that taxation on Internet sales still has no set, definitive process, it is no wonder the matter is so prone to these debates and controversy. In lieu of this ambiguity, many parties have turned to the courts for interpretation of the various conflicting laws from the United States Congress. After reviewing many articles related to taxation of Internet transactions, one Supreme Court case concerning *Quill v. South Dakota* (U.S Supreme Court, 1992) serves as a great example of this dispute. The subject of the case concerns the process of collecting taxes from an e-commerce company, specifically where no local sales representation was in place. The case was based on the Fourteenth Amendment of the United States Constitution where Congress is tasked to set policy guidelines around e-commerce taxation. Congress did just that along with the statement they made in the Internet Taxation Act of 1998 (Ward, Sipior, McGinty, 2006). Essentially, Congress created a moratorium on taxation when items are purchased on the Internet. The interpretation of this act is the subject of many lawsuits, along with several opinions from the United States Supreme Court. Many of the cases are reversed by the Supreme Court based solely on the interpretation of the fourteenth amendment.

The problem of Internet taxation is not a dilemma isolated to just one country. Many countries struggle to create policy in order to collect their fair share of sales and use taxes (Ward et al., 2006). Countries such as Mongolia have put policies in place to react to the sudden increase of Internet commerce. In the book by Thomas Friedman, "*The World is Flat A Brief History of the Twenty-First Century*", he discusses the new process of one world wide economy, based on the e-commerce revolving around the Internet (Friedman, 2005). The premise is that since the internet is available twenty four hours a day, the physical time zones have essentially melted away, leaving pure business transactions. The author recommends that since there is a population somewhere available to work, harness that activity to process business transactions. For example, if a movie producer needs to process or render images, the server can be located anywhere on the planet. Programmers and designers can be hired throughout the world, and at any given moment that team can be working the images electronically, thus reducing the time involved in the completion of partial and crucial points in the movie, such as digital imaging and animation.

Since the implementation of the web, it is often impossible to know where the sale point is located, or the shipping place and hence the taxing location. Implementation of dynamic taxation structures, without the rigors of overbearing governmental influence may seem daunting. In fact, many countries have attempted to address the concerns of Internet sales by increasing the taxing bodies capabilities to collect and audit sales. The European Union relies heavily on the collection of Internet sales. The Union has created the Value Added Taxing (VAT) body that initiated a reverse charge mechanism to track and assure taxes are fairly assessed to members within the European Union (IBLS, 2007). In the United States, the e-commerce clause of the United States

Constitution, grants congress the power to regulate commerce amongst the states (United States Constitution, Amendment 16, 1913).

Many organizations want to impress their opinion into the realm of taxation. One such example is the Mackinac Foundation, which outlines a policy mainly for the guidance of Michigan residents. The report critiques the state's taxation policy by critiquing the governor's policy on taxation, in relationship to fairness and uniformity (Reed, 2000, p. 3). The report further provides an outline of what should be taxed and spells out how the taxes should be collected. The Center of Budget and Policy Priorities, located in Washington D.C., creates a document every year outlining their recommendations and guidance on the subject, to influence Congress in support of low and middle income households (Mazerof, 2003, p.xi).

The most vocal in their opinions of e-commerce taxation is the business' themselves. This is not very surprising since they would have much to lose if a new policy is adopted and they are faced with the daunting task of sorting out tax issues. The business owners, therefore, would have much to say about the costs involved in collection and reporting taxes (LaFaive, 2008).

However, they also have much to lose if the business goes bust due to ignorance, or non-compliance of changes in tax policies. With the recent update to the Internet Tax Freedom Act, Suits will be harder to win in respects to the state taxation issues. For example, In *City of Rome v. Hotels.com*, 654 S.E.2d 166, 2007 case, The Georgia Court of Appeals upheld the dismissal from a lower court, that travel services are not required to charge sales tax under the new clarification of services in the tax act. The City of Rome was attempting to collect state sales tax from local hotels, but since the reservations were made over the internet thru Hotels.com, the local hotel was not obligated to collect the sales tax (Samson, 2006). This case against the large on line reservation business are becoming more frequent, but unsuccessful, as seen in the City of

Atlanta V. Hotels.com, City of Los Angeles V. Hotels.com, and other suits against expedia.com, Orbitz.com, and Priceline.com (Samson, 2006).

The business', however, are not the only ones who are verbalizing their opinions on Internet taxation. In fact, the afore mentioned Mackinac Center put out a lengthy report titled, "Internet Purchases: To Tax or Not to Tax, Here Are The Questions- Analysis of Arguments for and against Taxation of Internet Consumers and Recommendations to Keep the "Cyber-Economy" Growing" (Reed, 2000). This group is a self proclaimed nonpartisan research and educational organization whose major aim is to improve Michigan's citizen's quality of life. However, they also state that their research and commentaries help to provide an alternate decision to the standard belief that a government intervention is the only solution (Reed, 2000). That statement would lead one to suspect that their findings would not be the promotion of government intercession no matter their findings.

The Mackinac report discusses several interest groups, the National Governors' Association, the National Association of Counties, and the U.S. Conference of Mayors, all three of these groups are in favor of implementing some sort of taxation of Internet transactions that would involve a "third-party" entity whose job would be to collect and distribute sale taxes (Reed, p.3). One very outspoken Governor, William Janklow of South Dakota, threatened to take matters in to his own hands if taxes were not soon collected from online purchases. As Janklow stated, he will be: "sending out the highway patrol to start pulling over little brown trucks,".(Foster, p.1). The trucks he inferred were carrying out of state purchases whose packages would be followed to force his constituents to pay the South Dakota's use tax (Foster, 1999). The utilization of this extreme quote leads the reader to infer that this whole plan is radical in nature. Additionally, the report includes analyst, Adam Thierer's ,explanation that the "trusted third party tax collection

system could seriously compromise both individuals and corporate confidentiality”. (Thierer, 2000).

The report, additionally, presents groups that oppose the implementation of Internet taxation. Among these groups are Americans for Tax Reform, the National Taxpayers Union, and several other governors (Reed, p.2) These groups oppose Internet taxation because they believe there are many benefits to leaving the Internet tax-free. They firmly believe that e-commerce’s growth is largely due to the fact that there is little direct taxation. The Mackinaw Center adamantly supports this position, as Reed (2000) states: “In our view, the best policy is one that leaves the modern technology of the Internet alone to develop its potential unhindered by ancient ways of extracting revenues for government”. (p. 4). Given their self proclaimed lack of confidence in government taxation, it is not surprising that they support this position.

One argument in favor of Internet taxation deals with the inequity caused by taxing consumers in local retail establishments, and not taxing those same consumers when purchasing over the Internet. This unfairness and lack of tax uniformity deals a blow to the local businesses. The Mackinaw report addresses this concern by stating that many forms of taxation favor select groups and individuals (p. 5). They specifically single out the Michigan Economic Development Corporation which has granted, as Reed (2000) points out: “special breaks, favors and sometimes even direct subsidies to select businesses” (p.5) to promote Michigan’s so called “economic development” (p. 5). This is indeed unfair and non-uniform taxation. However, one must then question whether past unfairness should be cited as the basis for creating further tax inequities. This argument seems to be poorly lacking in the principles of justice.

Another illustration the report utilizes to portray the unfairness of Internet taxing is the example of an out-of-state vendor who pays taxes but will not receive the benefits of tax provided

services. In view of the fact that collected taxes are for police, fire protection, road maintenance within the state; out-of-state vendors being charged the same taxes as in state businesses is a form of taxation without representation (p. 9). It could be argued that this point speaks to the importance of the missing tax revenues that are necessary to provide these vital services which often are cut back due to limited funding.

An additional valid point made in the Mackinac Report is the problem of Internet merchants moving to an off-shore location if forced into paying Internet taxes. The report suggests that freedom on Internet-based transactions will allow all businesses to compete equally on the Internet (p. 14). Moving to a remote location to avoid the payment of taxes is not a novel idea. However, do you exempt all United States citizens from paying income taxes because you are afraid they will move to a foreign country? This argument seems ludicrous, and could be utilized to eliminate all taxes that are collected.

The Mackinac Report tackles the root of the problem with Internet taxation; the need to clarify the definition of the originating business with regards to what Reed (2000) states as a “substantial physical presence”. Reed (2000) states: “This actual physical presence must mean what most rational individuals take it to mean; the actual, tangible presence of a company’s buildings, employees, and related property within the boundaries of a state or locality”. (p. 20). Armed with this information, Commissioner Lebrun, former president of the National Conference of Commissioners on Uniform State Laws states as the implementation of an “origin-based, or seller-state, system of sales tax would be possible” (Reed, p. 21). The Report supports Commissioner Lebrun’s, origin based taxation plan because this would permit sales taxes to be collected at the point of the sale, instead of at the destination. This would require the collection of sales taxes owed to governments within the state where the company has a

substantial physical presence. Therefore, there would be no further tax requirements outside their home territory.

According to Governor James Gilmore, chairman of the Advisory Commission on Electronic Commerce (ACEC), and Dean Andal, ACEC member and vice chairman of the California State Board of Equalization, in order for this origin based system to work, Reed (2000) states:

It will be necessary to clarify and codify constitutional and Supreme Court precedents regarding the taxation and regulation of interstate commerce. Congress could do this by adopting an unambiguous nexus standard that conforms to existing Supreme Court jurisprudence and constitutional objectives. (p. 26).

Andal has made a presentation to the commission, “Uniform Jurisdictional Standard,” asking them to lend their formal support behind the Supreme Court’s physical presence test, indicating when state and local governments have the right to impose sale taxes (p.20). This would modify federal law, Public Law 86-272, dealing with state income e taxation of companies engaged in interstate commerce. Andal seeks to broaden the existing law to include all forms of state and local taxation of interstate commerce. Also, the law would clearly define what constitutes a “substantial physical presence” (Reed, p. 20).

The major concern is that state and local officials and tax officials not replace the traditional nexus standards. There are many new suggested theories concerning the nexus such as “attributorial”, “representational” and “agent”(p. 20). These new essentially, nonphysical presence nexus’ would invalidate the constitutional requirement of physical presence. A clearly defined nexus must be standardized and must conform to existing Supreme Court jurisprudence and constitutional objectives (p. 20).

Additional supporters of an origin based tax collection system include, Terry Ryan, director of state and local taxes for Apple Computer, and Eric Miethke, partner with Sacramento law firm of Nielsen, Merksamer, Parrinello, Mueller, & Naylor. They are so in favor of this system that they have listed all the benefits afforded by such a system, as quoted by Reed (2000), they state:

Minimize the burden on sellers, maximize the amount of tax collected for states, remove nexus uncertainty and constitutional concerns, eliminate the threat of double taxation, preserve local jurisdictional tax rights, respect privacy rights, respect federalism principles and preserve jurisdiction tax competition, be more politically feasible (p.21,p. 22).

To ensure the long term viability of sales tax, as a key source of revenue for states depends largely on the adoption and implementation of an origin based tax collection system for Internet purchases. The severe fiscal problems that states are facing call for a new source of revenue which can be answered by Internet taxation revenues. The origin based taxation system addresses the need for the fair and equitable enforcement of tax collection on the Internet. The clear definition of the point of sale, as the source for sales tax collection, will make it easy for the consumer to understand and assure speedy transactions. Additionally, with the adoption of the Supreme Court's legal definition for "substantial physical presence" it will eliminate the ambiguity surrounding nexus uncertainty by taxing only companies within a state's border. Unfortunately, Congress feels that internet taxation can continue being a low priority item, as a recent update in November, 2007 to the Internet Tax Freedom Act outlines. The update includes a continuation to the moratorium until 2014, with several states such as South Dakota and Ohio considered "grandfathered" into the act, thus immune. The updated Act was also meant to

expand and clarify the definition of non-taxable services to include such items as Internet Access accounts, e-mail accounts and other electronic storage facilities (Cummings 2008).

Internet taxation should be hailed as the savior for states who are experiencing harsh fiscal times. The revenue stream will allow for the continuation, and even the expansion, of badly needed services to the community.

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