

# 6

---

## TAXING BUSINESS-TO-CONSUMER INTERSTATE REMOTE RETAIL SALES: ECONOMICS V. JURISPRUDENCE IN THE BATTLE OVER TAX JURISDICTION

*Jeptha Nafziger*

Retail sales and use taxes constitute a major component of state and local tax bases, providing critical funds for many public programs. The continued and increasing significance of non-taxed remote retail sales—interstate sales of goods by firms without sufficient presence in the destination jurisdiction—has put the long-term solvency of these tax bases and the public programs they fund in jeopardy. To a considerable extent, this problem is attributable to the oft-criticized “nexus” standard, a legal concept that limits a jurisdiction’s ability to tax remote transactions based on constitutional and *stare decisis* grounds. This paper offers a summary of the jurisprudence that has yielded the current nexus interpretation, an economic critique of its underlying principles, and several recommendations that could serve as policy alternatives to the status quo.

### INTRODUCTION

Remote interstate business-to-consumer (B2C hereafter) sales are an increasingly important component of the U.S. retail market (see Table 1 in appendix). Catalog, mail order, and telephone sales account for the major-

---

*Jeptha Nafziger is a Master of Public Policy candidate at the Gerald R. Ford School of Public Policy, University of Michigan (nafziger@umich.edu).*

ity of such transactions, but “e-commerce” transactions are a critical and growing retail medium profoundly impacting the retail landscape. Recent estimates put total B2C remote sales in 2002 at about \$150 billion (Direct Marketing Association and Lenard 2004), which is roughly 5 percent of total retail sales (Table 1). Given the magnitude of B2C remote sales, *how* and *where* such sales are taxed impacts many economic outcomes, perhaps most critically the fiscal stability of state and local governments.

Why do remote interstate transactions cause problems for state and local taxing authorities? At its most basic, the current retail sales tax system is primarily dependent on *situs*; where a transaction takes place determines who is taxed, how they are taxed, and where the tax revenues go. The very nature of remote transactions compromises this feature by permitting economic interactions without geographic location. Constitutional provisions and clarifying case law rely on geographically based “nexus” rules to determine taxability, where nexus is defined as the sufficient presence of an entity within a state, so as to apportion the entity’s taxable income to that state (although the *Quill* decision, to be discussed later, reversed this to some extent) (Black 1990).

While it may be possible to determine the location of a good’s origin and/or destination and tax the transaction based on some rule, the fact that tax jurisdictions do not coordinate—as well as the existence of no-tax jurisdictions—allows tax competition, avoidance, and other distorting behaviors. Theoretically, firms have full license to route all remote transactions through no-tax jurisdictions, causing state and local revenues to erode accordingly. Similarly, a buyer may claim a tax-free purchasing location in a state that imposes no sales tax (e.g., Oregon) to avoid taxation. The danger here is clear: without reform, states and localities run the risk of an accelerating decrease in tax revenues as consumers increasingly substitute remotely purchased goods for locally sold equivalents.

The rise of internet sales has heaped new fuel on the proverbial “fire” that for decades has surrounded the interstate commerce tax debate. Considering what state and local tax authorities stand to lose in terms of tax base and levying authority (and sales and use taxes constitute a major component of both), it is not difficult to see why this fire has raged so intensely during the internet’s dramatic proliferation. A recent study conducted by the National Governor’s Association predicted a total loss in state and local revenues of \$440 billion between 2001 and 2011 “as a result of remote sellers failing to collect sales and use taxes” (National Governor’s Association). Notwithstanding debate over the extent of such revenue losses (Lenard 2004), states and localities face serious threats to

their fiscal stability.

This analysis focuses specifically on the sales and use taxation of B2C goods transactions across U.S. state borders in which the transacting firm lacks “sufficient nexus” in the destination state, as defined in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753, 87 S.Ct. 1389 (1967) (*Bellas Hess* hereafter). A firm may lack these requirements if it does business through mail order, via internet, etc. without any sort of physical infrastructure, employee base, “purposefully directed” sales, or business establishment in the destination state, as functionally established by *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 105 S.Ct. 2174 (1985). Generally speaking, such a transaction may involve a good sold over the internet by a firm in State A, the origin state, to a final consumer in State B, the destination state, without the firm holding a “substantial physical presence”—or nexus—in State B (Hellerstein and Hellerstein 1997). Other tax jurisdiction considerations, such as corporate income tax, are omitted here for the sake of brevity and focus.

The paper begins with a very brief and generalized description of current interstate retail sales and use tax conventions. It then explores the legal history of the nexus standard considering constitutional provisions and three salient case law decisions. An economic analysis follows, exposing the nexus standard’s weakness as a public policy instrument in light of economic criteria and optimal tax theory. The author offers alternatives to the nexus standard in pursuit of an improved remote sales and use tax logic, and then concludes with a short discussion on political implications and feasibility.

## THE TAX TREATMENT OF INTERSTATE BUSINESS-TO-CONSUMER TRANSACTIONS

Under current law, sales and use taxes are not collected on most remote interstate commerce for two reasons. Either the transaction is exempt from sales and use tax because it originates from an untaxed jurisdiction such as an Indian reservation or, more commonly, because a firm located in one state is not legally obligated to collect sales and use taxes on behalf of another state as per constitutional considerations. Many states give individual taxpayers the opportunity to declare interstate purchases and pay tax on them using state income tax forms, but individuals seldom make such admissions. Even the requirement of such declarations does not produce much revenue because tax administrations simply cannot audit the vast number and nuanced complexity of these transactions. Notably, forty-five states and the District of Columbia impose sales and

use taxes, implying that tax avoidance opportunities exist in other states. General sales tax rates range from 0 percent (e.g., New Hampshire and Montana) to over 7 percent (e.g., California and Nevada). About 7,600 tax jurisdictions exist in the United States, each with its own unique tax code that combines sales and use taxes on top of general state taxes to meet local revenue goals.

Retail sales taxes are typically applied to purchases of tangible personal property within a state, while use taxes are generally imposed by a state on its residents for purchases of tangible property outside the state (Hellerstein and Hellerstein 1997). In *McLoed v. Dilworth Co.*, 322 U.S. 327, 300 (1944), the court referred to the sales tax as a “tax on the freedom of purchase,” while the use tax could be considered a “tax on the enjoyment of that which is purchased.” Sales and use taxes do not explicitly account for sales of intangible property, such as online music or downloadable software, which is a growing concern among state and local tax authorities. Also, major purchases of goods bearing serial numbers or other specific means of identification (e.g., computers, boats, automobiles, etc.) are taxed regardless of remote sale. The application of these sales and use taxes varies by jurisdiction, but many localities credit the tax paid in the origin jurisdiction and apply use tax on the remainder of the tax due, based on the difference between rates in the origin and destination jurisdictions.

Thus, sales and use taxes in the United States vary across jurisdictions with respect to rates, structures, and applications. In nearly all cases, the geographic location of a transaction determines jurisdictional levying authority, and inter-jurisdictional transactions raise difficult questions when geographic establishment is unclear (for example, when a transaction is “borderless,” as is the case with e-commerce). This last point suggests that nexus establishment—the relevant test for determining jurisdiction in inter-jurisdictional transactions—is in need of revision as physicality and other nexus determinants are becoming less meaningful in modern transactions.

## THE LEGAL EVOLUTION OF THE NEXUS STANDARD

The U.S. Constitution is widely recognized as the starting point when resolving tax jurisdiction and levying authority controversies. As one author notes, the Constitution “provides the foundation for resolving tax disputes involving interstate taxation,” particularly when considering questions related to tax jurisdiction (Tidd 1999). The two most important constitutional passages related to interstate commerce taxation are found in the Commerce and Due Process Clauses. These rules have been

further defined and clarified by a multitude of judicial cases, particularly over the past century. This section critically assesses the evolution of the nexus rule in light of constitutional standards and three particularly notable case law decisions.

### **The Commerce and Due Process Clauses**

The Commerce and Due Process Clauses offer two different yet often complementary types of guidance in establishing tax-levying authority. The purpose of the Commerce Clause, as explicitly stated in the U.S. Constitution, is: "...[t]o insure [a] national economy free from unjustifiable local entanglements, and, under Constitution, such is domain where Congress alone has power of regulation and control." The Due Process Clause, with respect to state tax authority, complements this statement, asserting that, "in determining the power of state to impose burden of collecting use taxes upon interstate sales, [the] Constitution requires some definite link, some minimum connection, between state and person, property, or transaction it seeks to tax." Thus, the Commerce Clause deals with a state's legal right to levy sales and use taxes on interstate transactions without placing an undue burden on the transacting parties, while the Due Process Clause is primarily concerned with the fairness of a state tax on minimum contacts grounds. The nexus concept governing tax jurisdiction has grown out of a combination of these rules.

From these constitutional standards, two primary rules govern the establishment of a taxable business enterprise in a state: the economic entity must have a "substantial physical presence" within the taxing jurisdiction and there must exist some "minimal connection" between the entity and the tax jurisdiction to legitimize taxation. Interstate commerce is legally constrained by the Commerce and Due Process Clauses using three factors "in determining whether sales tax liability exists for a retail transaction" (Owen 1997). These nexus-establishing factors include: first, the content or substance of the transaction (i.e. whether a taxable transaction was made); second, the situs, or legal location of the transaction; and third, the prevailing tax jurisdiction (i.e. where nexus exists and who can tax based on this fact). The economically defined "factors of production" are useful guiding principles here, as the combination of land, labor, capital, and ideas involved in a transaction help guide standards governing tax jurisdiction and fairness, however conflictingly these may be applied.

The wording contained in both constitutional provisions has (probably purposefully) left substantial room for judicial interpretation. While courts remain the primary vehicle for constitutional interpretation and

clarification, Congress is designated as the supreme arbiter with respect to interstate tax reform legislation. Congress has yet to act definitively in this respect, so any further foray into the Commerce and Due Process Clauses requires the wisdom of the courts. The paper turns to this next.

### ***National Bellas Hess v. Department of Revenue of Illinois***

The *Bellas Hess* case represents the Supreme Court's first major attempt to decide how state and local tax authorities would treat new retail mediums, such as the mail-order catalog. In this 1967 case, "the U.S. Supreme Court established a physical presence requirement under the Commerce Clause for the application of sales/use taxes to mail order businesses in *National Bellas Hess vs. Illinois*" (Tidd 1999). The case involved "a State's attempt to require an out-of-state mail-order house that has neither outlets nor sales representatives in the State to collect and pay a use tax on goods purchased for use within the State" (Hellerstein and Hellerstein 1997). The Court subsequently ruled that a "seller whose only connection with customers in the State is by common carrier or the United States mail" did not satisfy the minimum contact, or nexus, rule established by the Commerce and Due Process Clauses (*Bellas Hess*). The decision wrought by the court in *Bellas Hess* was the beginning of a decades-long, often-embittered controversy over defining what, exactly, constitutes nexus. In this first blow against state and local tax authorities, the Supreme Court decided that sales made through mail or common carrier did not constitute a "definite link" or "minimum connection" insofar as a tax may be fairly levied consistent with constitutional concerns.

Jurisdictional standards, as a result, became explicitly linked to identifiable physical presence within a taxing jurisdiction. A retailer that lacked employees, infrastructure, or any other physical business-related presence could neither be compelled nor expected to collect sales and use tax on behalf of the destination state. This ruling created a unilateral test for determining whether or not nexus is established for tax purposes; subsequent cases would refine and broaden this rule.

### ***Complete Auto Transit, Inc. v. Brady***

Ten years after *Bellas Hess*, the Supreme Court, in *Complete Auto Transit, Inc. v. Brady* 430 U.S. 274, 97 S.Ct. 1076 (1977) (hereafter *Complete Auto*), provided new clarification and guidance concerning a state's ability to tax remote sales. In particular, "the Court added three more requirements in upholding a sales tax under the [Commerce] clause. In addition to substantial nexus, a tax must be fairly apportioned, not discriminate against interstate commerce, and be fairly related to the services provided by the

state” (Tidd 1999). These three requirements augmented the prior standard set in *Bellas Hess*, which dealt almost exclusively with physicality. The resulting four-prong test for determining Commerce Clause requirements relevant to a state’s tax jurisdiction clarified and extended nexus standards while not explicitly dealing with Due Process considerations. The Court’s language in the later *Quill* case reflected this distinction:

Although *Complete Auto* renounced an analytical approach that looked to a statute’s formal language rather than its practical effect in determining a state tax statute’s validity, the *Bellas Hess* decision did not rely on such formalism. Nor is *Bellas Hess* inconsistent with *Complete Auto*. It concerns the first part of the *Complete Auto* test and stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the “substantial nexus” required by the Commerce Clause (*Quill Corporation v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992)).

The “*Complete Auto* test” that grew out of the court’s ruling provided a more systematic analytical approach than before. As a result, the ways in which the Commerce Clause could be applied to nexus determination were broadened and began to move away from rote allegiance to physical considerations. Future cases would continue this shift away from physical presence as courts increasingly realized the new, borderless direction in which the economy was heading.

### ***Quill Corporation v. North Dakota***

Similar to *Bellas Hess*, the *Quill* case dealt with a state attempting to levy a use tax, collectible by the firm, on an office products business holding no stores, employees, or other components of physical presence within the destination state (Hellerstein and Hellerstein 1997). However, the Supreme Court discounted *Bellas Hess* because of the increasing significance of technological and social innovation in retailing and, specifically, in the area of remote interstate sales. Instead of considering the Commerce and Due Process Clauses together, as it had in *Bellas Hess*, the Court separated these considerations and concluded that the two clauses had distinct applications vis-à-vis nexus establishment.

The Court’s ruling had two major components. First, “a mail-order house may have the ‘minimum contacts’ with a taxing State as required by the Due Process Clause and yet lack the ‘substantial nexus’ with the State required by the Commerce Clause. These requirements are not identical and are animated by different constitutional concerns and policies” (*Quill*). Second, the courts stated that “to the extent that this Court’s decisions

have indicated that the Clause requires a physical presence in a State, they are overruled. In this case, Quill has purposefully directed its activities at North Dakota residents, the magnitude of those contacts are more than sufficient for due process purposes, and the tax is related to the benefits Quill receives from access to the State” (*Quill*). This stance essentially reversed the physical presence requirement established by *Bellas Hess*, relying instead on targeted solicitations. Together, these rulings rendered North Dakota’s tax on Quill unconstitutional because it impeded interstate commerce by unduly burdening Quill—not because it violated Due Process, but because of a lack of minimum contacts. “The requirements of due process are met irrespective of a corporation’s lack of physical presence in a State,” noted the court (*Quill*).

The wording of the decision invited, and indeed, nearly directed Congress to use its power over interstate commerce to render new legislation dealing with mail-order sales. *Quill* showed how troublesome interstate commerce nexus rules can be, and how poorly the rules are able to deal with burgeoning remote interstate sales. The court stopped short of undermining constitutional considerations, citing instead the role of Congress in policy change.

## THE ECONOMIC AND LEGAL ASPECTS OF NEXUS

As the application of constitutional rules toward interstate commerce taxation has evolved over the years, so has the way retailers do business. Retailing no longer relies on geographically specific transactions, rendering nexus requirements based on identifiable physical and solicitation-based rules obsolete. Several important questions follow: What is the economic concept of “sufficient nexus” as it is defined legally? How has this definition allowed for tax avoidance under current rules? Furthermore, what do economics and optimal tax theory have to say about what can be done to improve outcomes? Finally, what practical solutions can state and local tax authorities seek?

At first blush, the nexus standard is still fundamentally based on geographic (meaning time and place) considerations. Along these lines, the *Bellas Hess* case accorded nexus establishment when a retail transaction involved the “protection and services of the taxing State.” How, though, is this conceptual notion defined? This statement is a good starting point for considering nexus establishment, but any attempt to define which transactions unequivocally enjoy the protection and services of a state and which do not is an imprecise way to go about allocating taxability.

Despite the court’s willingness to adopt a more flexible approach to nexus

establishment in the *Quill* case, the legal interpretation of nexus remains problematic. For example, “a state can only impose a tax on corporations that have sufficient nexus under the Commerce Clause and Due Process Clause of the U.S. Constitution,” which can create avoidance opportunities (Fox and Luna 2002). In addition, firms engaging in interstate remote sales commonly do so because there is cost savings associated with locating business operations in one tax jurisdiction while making sales in others. Such savings may be based on myriad factors, including local corporate tax rates, proximity to supply and retail markets, etc. Analogously, consumers choose to purchase from remote retailers because an economic incentive is present, be it in the form of a lower price, lower transaction costs (defined as the time, effort, and other opportunity costs a consumer implicitly incurs when purchasing a good traditionally), tax benefits, or simply because a good is not locally available. If firms and consumers are both willing and able to wholly incorporate these cost savings into the price and consumer valuation (as they would under perfectly competitive assumptions), then every consumer will purchase from the remote retailer when the sum of benefits from transacting remotely are greater than the costs (taking into account what a consumer may pay explicitly and implicitly to transact with the firm). Herein lies a major problem.

### **Efficiency**

Efficiency costs associated with a tax are often evaluated in terms of the deadweight loss or excess burden the tax incurs across economic agents (Rosen 2004). A more efficient tax scheme yields many social benefits; perhaps most importantly, improved efficiency curtails resource expenditures related to avoiding or reducing tax liability. In countries with highly inefficient tax schemes or poor administrative oversight, these costs are nontrivial. The [non]taxation of remote interstate sales may unfavorably change the incentives and behavior of both firms and consumers, resulting in deadweight loss. The usual excess burden analysis takes firms’ and individuals’ responses to tax changes in the form of demand and supply elasticities, calculates changes in producer and consumer surpluses, and sums them to aggregate effects (these would be positive if, for example, a tax change leads to a less distortionary tax scheme) (Rosen 2004). A tax elicits minimal excess burden when the behavior of firms and individuals is identical before and after a tax is enacted. Unfortunately, very few taxes achieve this ideal, with the exceptions of lump-sum and some pure profit taxes.

When the opportunity for tax avoidance becomes available, economic

inefficiency is virtually inevitable. The current nexus standard operates in the context of a federalist political system where multiple tax jurisdictions are present, each with a somewhat unique retail sales and use tax logic. This can, and does, lead to inefficient economic behaviors. For example, Fox and Luna find fault with the current standard's inability to prevent what the authors call "nowhere income" (2002). Specifically, "nowhere income arises because the state where the sales factor should be situated cannot assert nexus and collect taxes related to the transactions. The importance of nowhere income will grow...as corporations become more sophisticated in tax planning" (Fox and Luna 2002). Thus, remote retail sales can be shielded from taxation when businesses use certain schemes known as entity isolation—one example being the use of passive investment companies (PICs)—where sales can be attributed to wholly-owned subsidiaries without established nexus in the taxing state (Swain 2003). Somewhat analogously, internet retailers can attribute sales to virtually any location by simply routing the relevant activities through servers or other untraceable means. This allows the transaction to avoid sales and use tax despite a business' minimal connection to the destination state. The resources used to achieve this result fall under the distinction of deadweight loss.

Efficient taxation of remote interstate sales removes opportunities for nontaxation and tax competition, and broadens the base (where base-broadening is the process of eliminating exemptions, exceptions, and any other tax avoidance opportunity vis-à-vis a given tax). Nexus standards should minimize tax avoidance opportunities by improving efficiency, promoting fairness, and ensuring simple application. This means moving away from strictly physical and benefits-received considerations to a more inclusive, broad-based tax treatment of remote transactions based on aligning remote sales with traditional retail transactions. Such an alignment would be efficiency enhancing. While the most efficient result would be achieved by non-taxation of all retail sales, remote or otherwise, the reality of state and local revenue needs renders this consideration largely moot. Without the revenues generated by sales and use taxes, the capacity of state and local governments to provide public goods that are vital and nonexcludable to the voting population, such as physical infrastructure and education, would be diminished.

### **Fairness and Uniformity**

Considerations of fairness and uniformity demand a system that taxes similar transactions alike. Fair and consistent "rates are desirable from a tax policy perspective because they do not skew consumer choices among

consumption alternatives” (Swain 2003). Perhaps the greatest oddity associated with sales and use taxation of remote interstate sales is that the mechanisms fail to do just this. Instead of streamlining tax collection, current nexus rules treat similar transactions differently, and thereby create inefficient and distortionary economic behaviors. Optimal commodity tax theory directs the taxation of a given good to be inversely related to that good’s demand elasticity and consistent across similar, or substitute, goods. Current nexus rules violate this maxim as well, as two identical items with the same demand elasticity are taxed differently when sold by local as opposed to remote retailers.

Horizontal equity, the relevant fairness concept for this discussion, is defined as “the principle that tax liability ought to be the same for any two families [or buyers, or sellers] with the *same* level of well-being,” or equivalently stated as “the *equal* taxation of *equals*,” a definition that extends to the like-taxation of two equivalent goods (Slemrod and Bakija 2004). Nexus rules clearly violate horizontal equity because any company that does not establish nexus in a given state and then proceeds to sell a product (or a perfect substitute) that is also sold and taxed locally is at an advantage because of the non-uniformity in the tax treatments. If the goods are priced equivalently, the local seller will be at a price disadvantage equal to the local and state sales tax rate, assuming transaction costs facing each purchaser are also equivalent. If it can also be assumed that sellers are rational, correctly perceive relative transaction costs (which, again, can be assumed as equivalent in this simple model), have perfect price information, and the goods in question are exact substitutes, the asymptotic behavior of consumers is likely to tend toward full substitution of remote for local goods over time. Consequently, the asymptotic behavior of the local retail sales tax base will tend toward zero. To remedy this potential pitfall, “commerce over the internet should strive to replicate traditional commercial experiences” (Cockfield 2001).

### **Simplicity and Enforceability**

Simplicity and enforceability are critical evaluative criteria when considering the costs and benefits of a proposed tax change. With respect to the topic at hand, simplicity relates to how much individuals and firms must spend in terms of transaction costs to calculate, collect, and remit a given tax (often in relation to the amount collected). Enforceability, however, pertains to two considerations: how easily sellers or consumers are able to avoid a given tax through tax planning, and how effectively a tax administration can audit and enforce a given tax. Any tax change must take into account

the administrative burden it imposes on the economic agents it affects (the tax's *simplicity*), as well as how effectively the tax can be imposed and how readily collections can be monitored (the tax's *enforceability*).

The sales and use tax treatment of remote interstate retail sales is administratively simple because in actuality, no tax exists. The de facto exemption remote sales receive from constitutional limitations and voluntary reporting conventions places virtually no burden on sellers or buyers (save voluntary reporters). Remote sales constitute an entirely new set of challenges for tax jurisdictions hoping to maintain a retail sales tax base because any attempt to tax a seller or buyer inside or outside of the jurisdiction creates an incentive for the agent to misreport location and thus avoid taxes.

To achieve both a simple and enforceable tax requires the elimination of tax competition potentialities, attention to uniformity, removal of non-taxation opportunities, and broadening of the tax base. Given the fact that interstate remote retail sales are essentially non-taxed, simplicity and enforceability considerations come into play when designing an alternative tax scheme that includes such sales in the tax base. The next section, which includes possible alternatives, will include such analysis.

## LEGISLATIVE ALTERNATIVES

Unified legislative bodies have the opportunity to overcome current nexus standards through innovative law-making. Indeed, this approach offers a potentially swift and cost-effective way of alleviating inefficiencies associated with current remote sales tax treatment. As one observer commented, “efforts to resolve [problems raised by state taxation of electronic commerce] through our existing state tax structures, as confined by federal constitutional restraints, are unlikely to meet with much success. If there is to be a sound resolution of these problems, it will have to come from a uniform legislative approach” (Hellerstein 1997). Such an approach may be undertaken either by Congress or state and local government coalitions, as this section will highlight.

The Constitution provides Congress with the power to regulate commerce between all states and the “Supreme Court has interpreted that power in sweeping terms,” including giving Congress the power “to regulate local [tax] rates because they affected interstate rates” (Hellerstein 2000b). Whether Congress uses this power to propel more uniform interstate tax coordination, redefine nexus standards, or legislate broad tax reform is a matter of both political feasibility and economic efficiency. This section posits that state-driven interstate coordination is probably the most feasible long-term solution, but congressionally legislated nexus redefinition and/or

tax reform could provide more immediate and sweeping remedies.

### **State Coordination**

If states coordinated their sales and use tax rates and structures, many problems associated with remote sales and nexus establishment could be eliminated. Such changes could lower compliance costs as complexity and avoidance opportunities are removed. For states to accomplish this goal independently poses a difficult negotiating problem, and Congressional intervention would probably raise vehement state tax sovereignty concerns. Each state uses a mix of taxes including property, sales, use, income, etc. to meet its revenue goals; allowing Congress to impinge on a state's tax formula could be seen as a threat to autonomy and self-determination. There is a real possibility that a potentially serious reduction in state and local tax collections stemming from remote sales will not be addressed until a crisis emerges.

There is, however, a growing concerted effort to coordinate among states, known as the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA holds much promise for cross-jurisdictional sales and use tax rate alignment and the attendant efficiency improvements such alignment offers (Streamlined Sales Tax Project (SSTP)). As of late 2003, thirty-seven states and the District of Columbia were voting parties to this agreement (along with five non-voting participants), which will ostensibly become a binding instrument once ten of these states ratify it (Swain 2003). The SSUTA is not designed to make sales and use taxes strictly uniform across states, but rather it compels adherents to abide by certain rules governing administrative procedure, jurisdiction, critical definitions, and tax base. In addition, the SSUTA provides a *de facto* broadening of nexus standards via tax base alignment and increased information sharing which could lead to an abandonment of current nexus rules, either quietly, through the courts, or via Congress. One ranking SSTP official stated the objectives of the agreement thus: "The simplified system will eliminate much of the guesswork for retailers and states in ... determining the taxability of items and which jurisdiction imposes the tax" (Streamlined Sales Tax Project). One observer, who commented, "good tax policy and the legal rules [defining nexus] are at odds," noted that state-driven coordination "currently holds the most hope" for substantive reform (Swain 2003).

The SSUTA's attractiveness extends beyond economic considerations of efficiency, uniformity, and simplicity. Parties ranging from state and local tax authorities to business leaders have been involved in the creation of the agreement, giving it the potential to be a consensus-based reform

in which virtually all states will benefit in the long-term. The next few years will be a critical period for assessing this statement, as the SSUTA is currently moving through no less than twenty state legislatures.

### Redefining Nexus

State decisions following *Quill* and the inability of the courts to determine more definitive nexus rules in lieu of reformatory congressional legislation have put the onus of nexus redefinition squarely on Congress. Two considerations should guide the formation of new nexus rules: where situs is established and what formally constitutes nexus. Taking on both considerations simultaneously, Hellerstein (2000a) states, “remote sales... should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has a physical presence in the state ... [and] where it is impossible to determine the destination of sales [e.g., digital content] ... it may be necessary to substitute a surrogate system.” Destination-based taxation is preferable because, among other features, it prevents race-to-the-bottom tax competition as well as inefficient business relocations to no-tax or low-tax areas. Intangible goods, such as e-commerce software sales that feature borderless transactions, require a proxy tax scheme to maintain horizontal equity and efficiency standards. With these principles in mind, a new nexus standard should emerge from the currently inefficient, distortionary model. The solvency of many state and local government programs depends on a new standard’s realization.

All retail B2C transactions would be more efficiently taxed under new nexus rules for reasons previously mentioned. For tangible goods with definite destinations, the retailer should be required to collect sales tax at the destination jurisdiction’s rate. In the past, businesses were exempted from this requirement because it would place an undue burden on the transaction. However, new tax-calculating software and other technological developments are reducing compliance costs to the point where the burden would fall far below the tax collected, satisfying the *Complete Auto Test* considerations. For example, governments are driving tax-related technological advances through independent and coalition projects, such as the SSTP’s North Carolina software pilot program, which offer significant economic benefits through positive spillover effects. Put simply, the new rule could state that nexus is established whenever a destination state provides the means for which a market may be established for the successful transacting of retail sales. Such a broad-based rule would ostensibly capture all retail sales in the tax base.

How a proxy tax scheme for intangible goods may be effectively de-

signed is less clear. One method may be to require purchasers of intangible property to declare a destination jurisdiction in the form of a zip code upon completing a transaction. While this would still allow tax avoidance for sophisticated purchasers—who, for example, may claim a non-taxing state as their destination and then reroute the delivery—there is likely to be a substantial increase in tax collections relative to revenues under current rules. Moreover, all public computers could have internet protocol (IP) addresses situated in a given jurisdiction to eliminate their use for tax avoidance. Another way to eliminate avoidance could involve requiring credit card intermediaries, such as PayPal, to keep track of a purchaser's jurisdiction using zip code information and attaching the information to the transaction. The fact that most purchases of intangible goods are paid for with credit cards may make this an attractive alternative. It is worth noting that all of these situsing options offer privacy-protecting solutions by not requiring identifying information transfers. Outside of superficial information such as IP addresses and zip codes, cross-jurisdictional data sharing would include no information that could be misused under virtually any circumstance. In combination, these three situsing measures would significantly capture intangible good sales as never before, improving efficiency and uniformity in the process.

A new broad-based nexus standard coupled with advanced situsing methods would greatly reduce tax avoidance, stop the erosion of state and local tax bases, and provide greater levels of efficiency, uniformity, and simplicity to a broken retail tax system. Furthermore, these goals can be attained without compromising consumers' privacy.

### **Remote Retailer Value Added Tax: A Consumption Tax Alternative?**

Perhaps the most radical approach to taxing remote retail sales would be the creation of an entirely new tax designed solely to service such transactions. The inspiration for this alternative comes from Schenk and Oldman's (2001) discussion of Varsano's VAT and McClure's CVAT, as well as their subsequent focus on subnational retail taxes, but is otherwise the author's own (2001). This tax logic would capture sales of both intangible and tangible goods in the tax base, as well as build-in a quasi sales tax that would place remote vendors on roughly the same footing as brick-and-mortar businesses. Main Street and Silicon Valley, now at competitive odds, could conduct business on more traditional cost-driven considerations rather than non-uniform tax treatments.

The tax, referred to as a remote retailer value added tax (RRVAT), would

work in the following way. A retailer that receives a substantial portion of business income from B2C remote retail sales would calculate this amount of business income and attribute it to destination state jurisdictions based on broad-based nexus rules discussed in the previous section. What defines “substantial portion” is certainly not arbitrary, but can be thought of as 10 percent or more of business income from B2C retail sales. Also, for simplicity’s sake, it can be assumed that states are the only autonomous jurisdictions that may receive these remittances; subsequent adjustments to local jurisdiction remittances may be made at the state level at the state’s discretion. Once retailers calculate which proportion of the B2C remote retail business income is attributable to each state jurisdiction, they would calculate tax liability to each destination state based on each state’s contribution to B2C remote retail business income, at that state’s prevailing retail sales tax rate. Like other tax information, these records would be available for public audit and scrutiny.

More formally, the RRVAT would work as follows: If  $Y$  is total business income for a firm,  $p$  is the proportion of income generated by remote B2C retail sales,  $r$  is the prevailing sales tax rate in a given destination state, and  $q$  is the proportion of  $pY$  attributable to that state, then the tax liability,  $T$ , would simply be:  $rqpY = T$ . The idea is that affected businesses would recognize that they owe tax liability to destination states at year’s end, and would build-in an additional amount, much like a VAT (although not statutorily required like a European-style VAT), to cover the cost. This cost would be roughly equivalent to the expected average sales tax rate proportional to the destination states to which they sell. Accordingly, the RRVAT would act much like an implicit sales tax set at a rate roughly equivalent to the average of U.S. sales tax rates weighted by consumer populations, which under current rates would probably fall between 5.5 and 6.5 percent.

An example may help clarify the RRVAT logic. Assume ABC is a business that sells movie DVDs (and only movie DVDs) over the internet and makes more than 10 percent of its business income on such remote sales. ABC is located in Oregon and only sells and ships DVDs to California and Washington. In 2005, ABC remotely sells 1,000 DVDs (500 to California and 500 to Washington) at a price of \$20 each for total remote business income of  $\$20 \times 1,000 = \$20,000$  (of which each state is attributed a 50 percent portion, or \$10,000). California’s sales tax rate is 7 percent while Washington’s is 5 percent (for an average tax rate of 6 percent), prompting a tax remittance liability on ABC of \$700 to California and \$500 to Washington. Along with the remittance, ABC furnishes a sales record to

each state that can be used by the state to redistribute the tax remittance to local jurisdictions based on purchases, should it choose to do so. All calculations, remittances, and sales information could be processed with relatively simple software. Businesses would have the freedom to build in the RRVAT as they see fit; it could be price-implicit or could be piggy-backed onto the good's price by adding it on at the end of the sale, much like a traditional sales tax. Transition to this system could be facilitated by using sales information from past years to determine first period RRVAT rates, from which later adjustments would be made.

ABC could adjust sales prices to reflect the imposition of the RRVAT. Purchasers in states with high sales tax rates (i.e. California in the example) would enjoy a greater tax benefit from the purchase because the built-in RRVAT would be an effective 6 percent. This might lead critics to point out that some form of tax competition could ensue, creating greater inefficiency. However, with reasonable assumptions about increasing inter-jurisdictional tax rate uniformity (i.e. success of the SSUTA), increasing cost advantages from remote retailing (in terms of lower overhead costs, transaction costs, etc.), and decreasing barriers to consumers transacting remotely (e.g., cheaper, more widely-available internet access), these potential inefficiencies would be largely offset through price equalization. Also, mechanisms could be put in place to curtail upward movements in effective RRVAT rates such as narrow year-to-year target bands based on RRVAT rates calculated from previous (non-RRVAT) years. Others may argue that this new tax would be biased against small businesses and start-ups that depend on remote retailing, even though they may lack sufficient economies of scale to enjoy the cost benefits associated with remote retailing. However, like those present in current business tax rules, certain concessions could be given to small firms (i.e. with total business income under some threshold) and start-ups such as incremental phase-in or qualified exemption. The "substantial portion" of income from remote sales that is offered here—namely 10 percent—is also alterable to achieve a desirable mix of taxation and small business protection.

The purpose of proposing this tax alternative is to illustrate that methods of taxing remote retail sales transactions efficiently, uniformly, and simply are available. Assumptions such as reliable business reporting, clear income definitions, and other non-trivial considerations are taken for granted here, but this does not preclude the functional viability of the logic. A developing country with poor tax administration and insufficient auditing standards may find these assumptions unrealistic, but U.S. businesses and governments have proven to be amongst the world's most uniform in

terms of reliable reporting, transparency, and legal definitions. In sum, a combination of inter-jurisdictional coordination, legislative nexus redefinition, and realistic tax reform could create a better way to tax.

## CONCLUSION

Taxing remote retail sales is an issue that has plagued state and local tax administrators since the advent of the mail-order catalog. As brick-and-mortar businesses face increasing competition from non-taxed remote retailers, tax administrators face increasing pressure to raise sufficient revenues with a declining retail and use tax base. These two pressures are clearly at odds. While remote retail transactions currently make up 5 percent of total retail sales, the dramatic growth of e-commerce will contribute to this figure's increasing significance in the coming years (see Table 1, which forecasts that e-commerce alone will constitute more than 3 percent of total retail sales by 2010). Unless measures are taken to expand the tax base through remote sales inclusion, the pressure on state and local treasuries will accelerate as consumers continue to substitute remotely purchased goods for local equivalents.

Hope, however, is not lost. Congress has the power to reverse this trend, as do states through concerted cooperation. The evolution of the nexus standard illustrates that courts are not able to establish economically efficient ways to tax remote interstate sales because of their inability to establish bright-line rules over and above congressional and state sovereignty. Fortunately, federal and state legislators are slowly realizing their mandate. McClure succinctly expresses the problem at hand:

America should seize the opportunity to replace the archaic and anarchic sales tax "system" inherited from the industrial age with a streamlined system that is appropriate for the 21<sup>st</sup> century ... There will be some loss of state sovereignty, but not over anything that matters. The benefits—simplification, economic neutrality, fairness, and preservation of state (and perhaps local) sovereignty over sales tax rates—are far more important (McClure 2000).

While it is true that coordinating state taxes, redefining nexus, and legislating radical tax reform would compromise some aspects of jurisdictional tax sovereignty, far-sighted tax administrators will realize that the long-term benefits from doing so will outweigh prevailing sovereignty costs.

So what is the best course of action in the coming years? For state and local tax authorities, continued support of the SSUTA is absolutely necessary. Intense lobbying at the state level should inform state legislatures of

the problem at hand. In addition, educating localities through micro-level campaigns should bring greater political will to the problem, especially if voters realize that maintaining revenue neutrality threatens public programs and increases the likelihood of higher taxes in other areas. Once state legislators grasp the problem's immediacy—hopefully before a full-on revenue crisis—they would do well to push SSUTA passage, especially in those states where it has already reached the legislature. The SSUTA promises to do much more than simply increase interstate coordination; its passage would probably result in *de facto* lowering of current nexus rules, as well as information sharing and tax base streamlining that would greatly improve sales and use tax efficiency.

If the SSUTA loses momentum or stalls in any way, the burden of remote retail tax reform will shift to Congress. With proper information from state and local tax jurisdictions, Congress will realize that reform is a necessity if revenue crises are to be avoided. Congress will then have to explore ways to explicitly change the way nexus is defined for the purposes of interstate sales. New legislation should include language that expands the tax base to include all transactions, by redefining the current benefits received standard to one more concerned with whether the destination state has provided a market for such transactions to occur.

Finally, if both the SSUTA and, subsequently, nexus reform fail to materialize, Congress will be left with the option of levying a new tax or redesigning the current system such that interstate sales are captured. This probably would be the most difficult strategy, as resistance could come from both business and consumer interests. Such legislation implicitly would undermine state sovereignty by binding states to new tax rules, while also subjecting new groups of consumers and remote retailers to tax liabilities and collection demands. In addition, formulation of such a tax would have unclear implications with respect to constitutionality; whether or not such a tax impeded interstate commerce would be a question open to considerable legal challenge. Notwithstanding these difficulties, a well-designed tax could increase economic efficiency, uniformity, and simplicity. The RRVAT is one example of such a tax, but other possibilities are conceivable.

Although the political implications of remote retail sales tax reform are not extensively discussed heretofore, the politics of each reform proposal are complex and impact each alternative's viability. This paper's central theme is that there are better methodologies than the current remote retail sales tax treatment, and that these alternatives offer improved efficiency, fairness, and simplicity features. Consequently, the paper places greater emphasis on the possible reforms themselves than the short-term political

viability of each. Indeed, the mere fact that thousands of tax jurisdictions exist within the U.S. federal system violates fundamental economic concerns such as efficiency and simplicity, but this does not presume that the short-term political infeasibility of full jurisdictional alignment should censor the discussion of fundamental reform.

Given political imperatives, tax reform is often an incremental process. For example, at the beginning of the 20<sup>th</sup> century, the United States introduced personal income taxes as a means to raise necessary revenue to support a growing federal government. To make these changes politically palatable, personal income taxes were first levied at very low rates and only on exceptionally high-income individuals. At that time, introducing a personal income tax similar to the current system in one sweeping reform would have been politically inexpedient at best.

The three proposals provided here are likely to be seen as politically radical in the short-term because each implicitly constrains jurisdictional sovereignty. Indeed, this paper presents the proposals in an ascending order, reflecting the author's own perception of political radicalism. Thus tax reform alternatives advanced here are likely to be approached incrementally to retain their political feasibility. The SSUTA fundamentally follows an incremental approach much like this; by remaining relatively politically benign and pursuing a state-by-state adoption process, it is likely to achieve greater short-term success relative to federally legislated alternatives. Nevertheless, political constraints should not preclude the discussion of what, asymptotically, remote retail sales and use tax reform should strive to achieve.

Whichever path is ultimately chosen, the fact is that America's tax system will be better off in the long-run under an alternative remote sales and use tax regime. Let us hope that those who make and interpret laws find favor with the simple economics of a better tax system.

## APPENDIX

**Table 1: United States Retail and E-Commerce Sales,  
Seasonally Adjusted 1999-2010\***

Year	Qtr	Retail Sales (\$millions)		E-Commerce as Percentage of Total	Percent Change from Prior Quarter		Percent Change from Same Quarter One Year Ago	
		Total	E- Commerce		Total	E-Commerce	Total	E-Commerce
2010	4	1507269	47243.8	3.1	2.2	3.2	9.0	13.9
2010	3	1475038	45761.4	3.1	2.2	3.3	9.0	14.2
2010	2	1443514	44303.8	3.1	2.2	3.3	9.0	14.4
2010	1	1412697	42871	3.0	2.2	3.4	9.0	14.7
2009	4	1382586	41463	3.0	2.2	3.5	8.9	14.9
2009	3	1353181	40079.8	3.0	2.2	3.5	8.9	15.2
2009	2	1324483	38721.4	2.9	2.2	3.6	8.9	15.5
2009	1	1296491	37387.8	2.9	2.1	3.6	8.8	15.7
2008	4	1269205	36079	2.8	2.1	3.7	8.7	16.0
2008	3	1242626	34795	2.8	2.1	3.8	8.7	16.3
2008	2	1216754	33535.8	2.8	2.1	3.8	8.6	16.7
2008	1	1191587	32301.4	2.7	2.1	3.9	8.5	17.0
2007	4	1167127	31091.8	2.7	2.1	4.0	8.4	17.3
2007	3	1143374	29907	2.6	2.1	4.0	8.3	17.7
2007	2	1120327	28747	2.6	2.0	4.1	8.2	18.0
2007	1	1097986	27611.8	2.5	2.0	4.2	8.1	18.4
2006	4	1076352	26501.4	2.5	2.0	4.3	8.0	18.8
2006	3	1055424	25415.8	2.4	2.0	4.4	7.8	19.2
2006	2	1035202	24355	2.4	1.9	4.4	7.7	19.6
2006	1	1015687	23319	2.3	1.9	4.5	7.5	20.1
2005	4	996878.5	22307.8	2.2	1.8	4.6	7.3	20.5
2005	3	978776.2	21321.4	2.2	1.8	4.7	6.8	21.0
2005	2	961380.3	20359.8	2.1	1.8	4.8	6.3	21.0
2005	1	944690.8	19423	2.1	1.7	4.9	6.3	20.8
2004	4	928707.7	18511	2.0	1.3	5.1	6.9	22.6
2004	3	916510	17614	1.9	1.4	4.7	6.2	21.5 (proj.)
2004	2	904135	16823	1.9	1.7	4.6	7.7	23.8 (revised)
2004	1	889062	16084	1.8	2.3	6.6	7.4	27.9
2003	4	869133	15095	1.7	0.7	4.1	6.4	25.1
2003	3	862695	14502	1.7	2.7	6.7	6.1	27.2
2003	2	839630	13592	1.6	1.5	8.1	4.3	27.0
2003	1	827446	12579	1.5	1.3	4.2	4.0	26.7

2002	4	817221	12067	1.5	0.5	5.8	1.1	30.0
2002	3	813375	11401	1.4	1.1	6.6	4.1	37.5
2002	2	804864	10700	1.3	1.2	7.7	2.1	28.4
2002	1	795288	9932	1.2	-1.6	7.0	2.1	20.7
2001	4	808072	9280	1.1	3.4	11.9	4.5	17.8
2001	3	781138	8292	1.1	-1.0	-0.5	1.6	12.0
2001	2	788670	8335	1.1	1.3	1.3	3.5	26.2
2001	1	778560	8227	1.1	0.7	4.5	2.1	38.9
2000	4	773144	7875	1.0	0.5	6.3	4.1	69.7
2000	3	769040	7405	1.0	0.9	12.1	5.8	NA
2000	2	762191	6603	0.9	0.0	11.5	7.2	NA
2000	1	762358	5922	0.8	2.6	27.6	9.6	NA
1999	4	743019	4640	0.6	2.2	NA	9.3	NA

Source: U.S. Department of Commerce. <http://www.census.gov/mrts/www/current.html> (accessed December 22, 2004).

\*Shaded figures—from 4<sup>th</sup> quarter 2004 to 4<sup>th</sup> quarter 2010—are the author's own forecasts based on a quadratic regression methodology using the following model:  $Y = \text{Beta}(0) + \text{Beta}(1)t + \text{Beta}(2)t^2$  where  $t$  is the time period (4<sup>th</sup> quarter 1999 is defined as  $t = 1$ ) and  $Y$  is either total retail sales or e-commerce sales.

## REFERENCES

- Black, H.C. 1990. *Black's Law Dictionary, 6<sup>th</sup> Edition*. St. Paul: West Publishing Co.
- Burger King Corp. v. Rudzewicz, 471 U.S. 462, 105 S.Ct. 2174 (1985).
- Cockfield, Arthur J. 2001. Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation. *Minnesota Law Review* 85: 1171-1266.
- Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 97 S.Ct. 1076 (1977).
- Fox, William F. and LeAnn Luna. 2002. State Corporate Tax Revenue Trends: Causes and Possible Solutions. *National Tax Journal* 55, 3: 491-508.
- Hellerstein, Jerome R. and Walter Hellerstein. 1997. *State and Local Taxation: Cases and Materials, 6<sup>th</sup> Ed.* St. Paul: West Publishing Co.
- Hellerstein, Walter. 1997. Transaction Taxes and Electronic Commerce: Designing State Taxes that Work in an Interstate Environment. *National Tax Journal* 50, 3: 593-606.
- \_\_\_\_\_. 2000a. Deconstructing the Debate Over State Taxation of Electronic Commerce. Symposium: Debating the Prospect of E-Commerce Taxation: Article and Policy Commentary. *Harvard Journal of Law and Technology* 13: 549-565.
- \_\_\_\_\_. 2000b. Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce. *National Tax Journal* 53, 4: 1307-1325.

- Lenard, Thomas M. 2004. *Taxation of Online Sales: Competing With the Streamlined Sales Tax Project*. The Progress and Freedom Foundation: Presentation to the Virginia General Assembly's Joint Subcommittee to Study the Impact of Collecting Sales Taxes on the Economy, October 4, 2004. <http://www.pff.org/issues-ubs/testimony/041004sstp.pdf> (accessed December 27, 2004).
- McLoed v. Dilworth Co., 322 U.S. 327, 300 (1944).
- McClure Jr., Charles E. 2000. Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness. Symposium: Debating the Prospect of E-Commerce Taxation: Article and Policy Commentary. *Harvard Journal of Law and Technology* 13: 567-596.
- National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753, 87 S.Ct. 1389 (1967).
- National Governor's Association. 2001. *New Report Shows States to Lose Nearly \$440 Billion in Sales Tax Revenue from Remote Sales: National Governor's Association to Act and Defend Main Street America*. National Governor's Association Press Release, October 2. <http://www.nga.org/nga/newsRoom/> (accessed December 22, 2004).
- Owen, Sandi. 1998. State Sales and Use Tax on Internet Transactions. *Federal Communications Law Journal* 51, 1: 245-262.
- Quill Corporation v. North Dakota, 504 U.S. 298, 112 S.Ct. 1904 (1992).
- Rosen, Harvey S. 2004. *Public Finance, 7<sup>th</sup> Ed.* New York: McGraw-Hill/Irwin Publishing.
- Schenk, Alan and Oliver Oldman. 2001. *Value Added Tax: A Comparative Approach, With Cases and Materials, 1<sup>st</sup> Ed.* Ardsley, New York: Transnational Publishers, Inc.
- Slemrod, Joel and Jon Bakija. 2004. *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes, 3<sup>rd</sup> Ed.* Cambridge, MA: The MIT Press.
- Streamlined Sales Tax Project. <http://www.streamlinedsalestax.org> (accessed January 6, 2005).
- Swain, John A. 2003. State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century. *Georgia Law Review* 38: 343-393.
- Tidd, Ronald R. 1999. Electronic Commerce: Interjurisdictional Issues. *Taxes* 77, No. 4 (1999): 6-7.
- United States Constitution. 1789. <http://www.house.gov/Constitution/Constitution.html> (accessed December 27, 2004).
- United States Department of Commerce. 2004. *Quarterly Retail E-Commerce Sales, 3<sup>rd</sup> Quarter 2004*. <http://www.census.gov/mrts/www/current.html> (accessed Decemb