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# Taxation of Internet Sales and Access: Legal Issues

**Erika K. Lunder**  
Legislative Attorney

April 10, 2015

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

R43800

## Summary

In recent years, there has been significant congressional interest in the states' ability to impose sales and use taxes on sales made over the Internet. While these taxes are imposed on the consumer, states generally prefer that retailers collect and remit them, rather than relying on the consumer to pay the tax. State laws requiring retailers to collect sales and use taxes are subject to federal law. First, such laws must comply with the U.S. Constitution, of which two provisions are particularly relevant—the dormant Commerce Clause and the Fourteenth Amendment's Due Process Clause. Second, such laws must comply with the Internet Tax Freedom Act.

Both the dormant Commerce Clause and the Due Process Clause require that a retailer have a certain connection or “nexus” to the state before the state can require the collection of tax. The Supreme Court has held that the required nexus under the dormant Commerce Clause is the seller's “physical presence” in the state, while due process requires only that the seller have directed purposeful contact at state residents. Notably, Congress may change the “physical presence” standard under its power to regulate interstate commerce, so long as it is consistent with other constitutional provisions including due process. In the 114<sup>th</sup> Congress, legislation has been introduced (S. 698, Marketplace Fairness Act) that would allow a state to impose sales and use tax collection duties on remote sellers, regardless of physical presence, if the state (1) is a member of the multistate Streamlined Sales and Use Tax Agreement (SSUTA) or (2) sufficiently simplifies its sales and use tax laws and administration.

In addition to the Constitution, state sales and use tax collection laws must also comply with the federal Internet Tax Freedom Act (ITFA). It imposes a temporary moratorium on states imposing discriminatory or multiple taxes on electronic commerce. The moratorium also generally prohibits state taxes on Internet access. The act is scheduled to expire on October 1, 2015.

Meanwhile, some states have recently enacted laws, often called “Amazon laws” after the Internet retailer, in an attempt to capture uncollected taxes on Internet sales while still complying with the “physical presence” standard. States enacting these laws have used two basic approaches: (1) “click-through” nexus, which imposes the responsibility for collecting taxes on retailers who compensate state residents for placing links on their websites to the retailer's website and (2) requirements that remote sellers provide information about sales to the state and the customers.

State Amazon tax laws have raised issues under both the U.S. Constitution and the ITFA and have had a mixed reception in the courts. While the highest court in New York upheld that state's click-through nexus law against facial challenges on Commerce Clause and due process grounds, a federal district judge struck Colorado's notification law as violating the dormant Commerce Clause. However, the appeals court subsequently determined that federal courts do not have jurisdiction to hear the Colorado challenge due to the federal Tax Injunction Act. In March 2015, the U.S. Supreme Court held in *Direct Marketing Association v. Brohl* that the act did not apply to this suit, but left open the possibility that the suit might be barred by the comity doctrine. Notably, Justice Kennedy wrote a concurrence in which he suggested that *Quill* should be reconsidered in light of technological advances and the development of the Internet. With respect to the ITFA, the Illinois Supreme Court held in 2013 that the state's click-through nexus law violated the statute's moratorium on discriminatory taxes because it treated retailers engaged in online performance-based marketing differently than those with similar print and broadcast marketing arrangements.

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In recent years, there has been significant congressional interest in the states' ability to impose sales and use taxes on sales made over the Internet. A use tax is the companion to a sales tax—in general, the sales tax is imposed on the sale of goods and services within the state's borders, while the use tax is imposed on purchases made by the state's residents from out-of-state (remote) sellers.<sup>1</sup> The purpose of the use tax is to dissuade residents from purchasing goods and services from out-of-state merchants in order to avoid the sales tax.<sup>2</sup>

Sales and use taxes are imposed on the consumer. However, states generally prefer that retailers collect and remit them, rather than relying on the consumer to pay the tax since consumer compliance is low. State laws requiring retailers to collect and remit these taxes are subject to federal law. First, the laws must comply with the U.S. Constitution, of which two provisions are particularly relevant—the dormant Commerce Clause and the Fourteenth Amendment's Due Process Clause. Second, such laws must comply with the Internet Tax Freedom Act (ITFA), which prohibits multiple or discriminatory taxes on electronic commerce. ITFA also prohibits state and local taxes on Internet access.

This report first looks at the Constitution's requirement of nexus, including an examination of whether recent state laws comply with the nexus standard and federal legislation that would affect the standard. It then looks at the scope of the ITFA moratorium on multiple or discriminatory taxes on electronic commerce and taxes on Internet access.

## Constitution's Nexus Requirement

There is a common misperception that the U.S. Constitution prohibits states from taxing Internet sales. This is not true. States have the power to tax their residents on online purchases, even when the seller is located outside the state and has no real connection with it—in this situation, the state can impose the use tax on the purchaser. The Constitution does, however, limit the state's power to require an out-of-state seller to collect use tax from the purchaser on behalf of the state. Specifically, the Due Process Clause of the Fourteenth Amendment and the Commerce Clause both require that a sufficient connection or “nexus” exist between a state and an out-of-state business before the state may impose tax obligations on it.<sup>3</sup>

Due process requires there be a sufficient nexus between the state and the seller so that (1) the state has provided some benefit for which it may ask something in return and (2) the seller has fair warning that its activities may be subject to the state's jurisdiction.<sup>4</sup> The dormant Commerce Clause requires a nexus in order to ensure that the state's imposition of the liability does not

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<sup>1</sup> For information on state sales and use taxes, see CRS Report R41853, *State Taxation of Internet Transactions*, by Steven Maguire.

<sup>2</sup> See *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 343 (1954) (uses taxes, while not significant revenue raisers, have two purposes: “One is protection of the state's revenues by taking away from inhabitants the advantages of resort to untaxed out-of-state purchases. The other is protection of local merchants against out-of-state competition from those who may be enabled by lower tax burdens to offer lower prices.”).

<sup>3</sup> U.S. CONST. Amend. 14, §1 (“nor shall any State deprive any person of life, liberty, or property, without due process of law ...”); Art. 1 §8, cl.3 (“The Congress shall have Power ... To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes”). The Supreme Court has long held that because the Constitution grants Congress the authority to regulate interstate commerce, the states may not unduly burden such commerce—this is known as the dormant Commerce Clause. See *Okla. Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 180 (1995).

<sup>4</sup> See *Quill v. North Dakota*, 504 U.S. 298, 308 (1992).

impermissibly burden interstate commerce.<sup>5</sup> Importantly, Congress has the authority under its commerce power to permit state taxation that would otherwise violate the dormant Commerce Clause, but cannot change the standard required for due process.<sup>6</sup>

The nexus standard for use tax collection liability is not the same under both clauses. The Supreme Court has ruled that, absent congressional action, the standard required under the dormant Commerce Clause is the seller's physical presence in the state, while due process requires only that the seller have directed purposeful contact at the state's residents.<sup>7</sup>

This was not always the case. The Court first articulated the physical presence requirement in the 1967 case *National Bellas Hess v. Dept. of Revenue of Illinois*,<sup>8</sup> where it grounded the requirement in both clauses. The Court noted

#### **Tax-Free Internet Sales?**

While states cannot require remote sellers to collect use taxes unless the seller has a sufficient nexus with the state, this does not mean the sale is free from tax. The purchaser still has the duty to pay the tax to the state.

that each required a similar connection between the state and the seller: due process required that “the state has given anything for which it can ask return,” while state taxes on interstate commerce were permissible when they represented “a fair share of the cost of the local government whose protection [the seller] enjoys.”<sup>9</sup> The Court concluded that these principles, along with the fact that the use tax collection obligations would burden interstate commerce due to the significant number of U.S. taxing jurisdictions and complexity of their requirements, meant that a state's authority to impose the obligations was limited to when the seller had a physical presence in the state.<sup>10</sup>

By the late 1980s, it seemed possible that physical presence was no longer required for use tax obligations because the Court had modified its analysis of both the Due Process and the Commerce Clauses. The Due Process Clause in other contexts was no longer interpreted to require an individual or entity's physical presence in a state before that state could exercise authority over the individual or entity; instead, liability could be imposed when the individual or entity intentionally made a sufficient level of contact with the state.<sup>11</sup> Additionally, moving away from bright-line prohibitions against certain types of taxation on interstate commerce, the Court developed a flexible test to determine whether a tax placed an unacceptable burden on interstate commerce.<sup>12</sup> It seemed possible that technological advances might have sufficiently reduced the

<sup>5</sup> See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>6</sup> See *Quill*, 504 U.S. at 318.

<sup>7</sup> See *Quill*, 504 U.S. at 308, 317-18.

<sup>8</sup> 386 U.S. 753 (1967).

<sup>9</sup> *Id.* at 756.

<sup>10</sup> *Id.* at 758-60; see also *Miller Bros.*, 347 U.S. at 347 (finding insufficient nexus, based solely on due process grounds, when the seller's activities did not involve the “invasion or exploitation of the consumer market in” the taxing state, with the Court contrasting “active and aggressive operation within a taxing state” with the seller's “occasional delivery of goods sold at an out-of-state store with no solicitation other than the incidental effects of general advertising”).

<sup>11</sup> Many of these cases addressed whether an individual or entity could be subject to suit in state court. For example, in *Burger King v. Rudzewicz*, 471 U.S. 462 (1985), the Court held that a Michigan franchisee without any contacts with Florida could be subject to suit in state court after entering into a contract with a Florida corporation. The Court wrote, “So long as a commercial actor's efforts are ‘purposefully directed’ towards residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there [citations omitted].” *Id.* at 476.

<sup>12</sup> See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

complexity of collecting use taxes so that the burden on interstate commerce would not be unacceptable under the new test.

However, in the 1992 case *Quill v. North Dakota*,<sup>13</sup> the Supreme Court rejected the idea that physical presence was no longer required. It held that, absent congressional action, the dormant Commerce Clause still prevented a state from imposing use tax collection liability on a mail-order seller with no physical presence in the state. As in *Bellas Hess*, the Court found that collecting the tax would be an impermissible burden on interstate commerce, noting again the magnitude of the potential burden in light of the numerous taxing jurisdictions across the country.<sup>14</sup> The Court, however, altered its reasoning from *Bellas Hess* by expressly rejecting the idea that due process also requires physical presence. The Court, noting that the two clauses served different purposes, found that its due process analysis had evolved so that physical presence was not necessary so long as the seller had directed sufficient action toward the state's residents.<sup>15</sup> The Court found such purposeful contact existed in *Quill* since the seller had "continuous and widespread solicitation of business" within the state.<sup>16</sup>

## When Is There Sufficient Nexus?

The Supreme Court has not revisited the issue of when a state may impose use tax obligations on a seller since *Quill*. Nonetheless, several pre-*Quill* cases provide guidance on determining when a state may impose use tax collection obligations on out-of-state retailers. Clearly, a state can impose such responsibilities on a company with a "brick and mortar" retail store or offices in the state.<sup>17</sup> This can be the case even if the in-state offices and the sales giving rise to the tax liability are unrelated to one another. For example, the Court held that a state could require a company to collect use taxes on mail-order sales to in-state customers when the company maintained two offices in the state that generated significant revenue, even though the offices were used to sell advertising space in the company's magazine and had nothing to do with the company's mail-order business.<sup>18</sup> The Court firmly rejected the argument that there needed to be a nexus not only between the company and the state, but also between the state and the sales activity. It reasoned that there was a sufficient connection between the state and company as the two in-state offices had enjoyed the "advantage of the same municipal services" whether or not they were connected to the mail-order business.<sup>19</sup>

Absent some type of physical office or retail space in the state, it also seems that having in-state salespeople or agents is sufficient contact. In several cases predating *Bellas Hess* and *Quill*, the Court upheld the power of the state to impose use tax collection liabilities on remote sellers when

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<sup>13</sup> 504 U.S. 298 (1992). While *Quill* is the current standard for nexus, Justice Kennedy wrote a concurrence in a March 2015 decision, *Brohl v. Direct Marketing Association*, in which he suggested that *Quill* should be overruled. *Brohl* is discussed below in "State "Amazon Laws" and Their Constitutionality."

<sup>14</sup> *Id.* at 313.

<sup>15</sup> *See id.* at 308.

<sup>16</sup> *Id.*

<sup>17</sup> *See* *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941) (upholding imposition of use tax collection liability on mail order sales when company had retail stores in the state); *Nelson v. Montgomery Ward*, 312 U.S. 373 (1941) (same); *see also* *D.H. Holmes Co., Ltd. v. McNamara*, 486 U.S. 24, 32-33 (1988) (upholding imposition of use tax on company with 13 stores in the state).

<sup>18</sup> *Nat'l Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551 (1977).

<sup>19</sup> *Id.* at 561.

the sales were arranged by local agents or salespeople.<sup>20</sup> In *Scripto, Inc. v. Carson*,<sup>21</sup> the Court held that a state could impose use tax collection liability on an out-of-state company that had no presence in the state other than 10 “independent contractors” who solicited business for the company. These individuals had limited power and had no authority to make collections or incur debts on behalf of the company. They merely forwarded the orders they solicited to the company’s out-of-state headquarters, where the decision to fill the order was made. Finding their status as independent contractors rather than employees to be constitutionally insignificant,<sup>22</sup> the Court held that there was a constitutionally sufficient nexus between the company and the state because the individuals had conducted “continuous local solicitation” in the state on behalf of the company.<sup>23</sup> The Court later described the case as “represent[ing] the furthest constitutional reach to date” of a state’s ability to impose use tax collection duties on a remote seller.<sup>24</sup>

### Discriminatory Taxes

In addition to requiring nexus, the Commerce Clause prohibits state laws that discriminate against interstate commerce.<sup>25</sup> A state law that “regulates even-handedly to effectuate a legitimate local public interest” and has “only incidental” effect on interstate commerce is constitutionally permissible “unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.”<sup>26</sup> On the other hand, a state law that facially discriminates against out-of-state sellers is “virtually *per se* invalid.”<sup>27</sup> Traditionally, such laws are permissible only if they meet the high standard of “advanc[ing] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.”<sup>28</sup> Thus, a state law that subjects remote sellers to tax-related burdens not imposed on in-state sellers would appear to be facially discriminatory and subject to a strict judicial scrutiny.

## State “Amazon Laws” and Their Constitutionality

The most significant legal development in recent years regarding state taxation of Internet sales has been states enacting laws to try to capture more of the uncollected use taxes.<sup>29</sup> These are generally called “Amazon laws” in reference to the Internet retailer.

Two primary approaches have developed. One is “click-through nexus.” It refers to the click-throughs or online referrals that some Internet retailers solicit through programs where an individual or business (called an associate or affiliate) places a link on its website directing Internet users to the online retailer’s website. The associate or affiliate receives compensation for the referral when a consumer clicks through a link and purchases goods and services. State click-

<sup>20</sup> See *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960) (discussed *infra*); *Felt & Tarrant Co. v. Gallagher*, 306 U.S. 62 (1939) (upholding imposition of use tax collection liability on company with two agents in the state); *General Trading Co. v. Tax Comm’n*, 322 U.S. 335 (1944) (upholding imposition of use tax collection liability on company with salespeople in the state).

<sup>21</sup> 362 U.S. 207 (1960).

<sup>22</sup> *Id.* at 211.

<sup>23</sup> *Id.*

<sup>24</sup> *Bellas Hess*, 386 U.S. at 757.

<sup>25</sup> See *Complete Auto Transit, Inc.*, at 279; *Oregon Waste Systems, Inc. v. Dep’t of Environmental Quality*, 511 U.S. 93, 98 (1994).

<sup>26</sup> *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

<sup>27</sup> *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 575 (1997) (internal citations omitted); see also *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979).

<sup>28</sup> *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988); *Hughes*, 441 U.S. at 336-37.

<sup>29</sup> For a more complete discussion of these laws, see CRS Report R42629, “Amazon Laws” and Taxation of Internet Sales: *Constitutional Analysis*, by Erika K. Lunder and Carol A. Pettit.

through nexus statutes require an online retailer to collect use taxes based on the physical presence of its associates or affiliates. The second approach requires remote retailers to provide information on taxable sales to the state and customer, rather than requiring retailers to collect the use taxes themselves.

Since their enactment, questions have been raised about whether these laws are consistent with due process and the dormant Commerce Clause. Courts have considered the constitutionality of two statutes: New York's click-through nexus law and Colorado's notification law.

In a 2012 case brought by Overstock and Amazon, New York's highest court rejected facial constitutional challenges to the state's law.<sup>30</sup> New York's law provides a rebuttable presumption that a retailer must collect use taxes if it enters into an agreement with a New York resident providing compensation in exchange for referring potential customers to the retailer via a website link or other means.<sup>31</sup> In rejecting the argument that the law was facially unconstitutional under the Commerce Clause because it applied to sellers without a physical presence in the state, the court noted it had previously held that the physical presence required by *Quill* did not have to be "substantial," but rather "demonstrably more than a slightest presence" and could be met if economic activities are performed in the state on the seller's behalf.<sup>32</sup> The court found this standard to be met since the law was based on "[a]ctive, in-state solicitation that produces a significant amount of revenue."<sup>33</sup> With respect to due process, the court found that "a brigade of affiliated websites compensated by commission" was clearly sufficient to meet *Quill*'s standard of "continuous and widespread solicitation of business within a State."<sup>34</sup> The court also rejected the argument that the law violated due process because the presumption was unreasonable and irrebuttable, finding the presumption was (1) reasonable because it presumed that affiliates would solicit in-state acquaintances in order to increase their compensation and (2) rebuttable, as evidenced by the state tax agency's guidance discussing the methods to rebut it.<sup>35</sup>

The Colorado law met a different result. In 2012, a federal district court struck down the state's notification law on Commerce Clause grounds.<sup>36</sup> The law requires that retailers who do not collect Colorado sales tax must (1) inform Colorado customers that tax may be owed on purchases and it is the customer's responsibility to file a tax return; (2) send Colorado customers a year-end notice about any purchases; and (3) provide an annual statement to the Colorado tax agency showing the amount paid for purchases by in-state customers.<sup>37</sup>

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<sup>30</sup> *Overstock.com, Inc. v New York State Dept. of Taxation & Fin.*, 987 N.E.2d 621 (N.Y. 2013), *cert. denied*, 134 S. Ct. 682 (2013).

<sup>31</sup> N.Y. TAX LAW §1101(b)(8)(vi).

<sup>32</sup> *Overstock.com*, 987 N.E.2d at 625 (internal quotations omitted).

<sup>33</sup> *Id.* at 626. The court also noted that while not dispositive, sellers do not pay these taxes themselves, but rather "are collecting taxes that are unquestionably due, which are exceedingly difficult to collect from the individual purchasers themselves, and as to which there is no risk of multiple taxation." *Id.*

<sup>34</sup> *Id.* at 627.

<sup>35</sup> *See id.* The court left open the possibility that the presumption might not be reasonable in all circumstances, specifically as applied to those receiving compensation unrelated to actual sales, since "[i]t is difficult to distinguish that arrangement from traditional advertising." *Id.* However, the court found this was not sufficient to strike the statute as facially unconstitutional. *See id.*

<sup>36</sup> *Direct Mktg. Ass'n v. Huber*, Civil Case No. 10-cv-01546-REB-CBS, 2012 U.S. Dist. LEXIS 44468 (D. Colo. March 30, 2012).

<sup>37</sup> COLO. REV. STAT. ANN. §39-21-112(3.5); *see also* COLO. REV. STAT. ANN. §39-26-102(4) (defining retailer).

The problem with this law is that it applies only to companies that do not collect Colorado sales taxes, which would appear to be primarily those retailers without a physical presence in the state. The federal district court determined this was fatal to the law for two reasons under the dormant Commerce Clause: there was insufficient nexus, and the law was impermissibly discriminatory. First, the court found that the notification requirements were “inextricably related in kind and purpose” to the tax collection responsibilities at issue in *Quill* and therefore subject to the physical presence nexus standard, which the law plainly did not meet.<sup>38</sup> Second, the court found the law only applied to, and thus discriminated against, out-of-state vendors and failed to survive strict scrutiny.<sup>39</sup> While there were legitimate governmental interests involved (e.g., improving tax collection and compliance), the court found the state had not provided evidence to show that these interests could not be served by reasonable nondiscriminatory alternatives, such as collecting use taxes on the resident income tax return and improving consumer education.<sup>40</sup>

However, in August 2013, the Tenth Circuit Court of Appeals dismissed the case after finding that the federal Tax Injunction Act (TIA) prohibits federal courts from hearing it.<sup>41</sup> The act provides that federal district courts “shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.”<sup>42</sup> In March 2015, the Supreme Court held that the TIA does not apply to this suit,<sup>43</sup> but left open the possibility that the suit might be barred by the comity doctrine, under which federal courts refrain from interfering with state fiscal operations “in all cases where the Federal rights of the persons could otherwise be preserved unimpaired.”<sup>44</sup> The Court instructed the Tenth Circuit to determine if the doctrine applies here.

The Court’s opinion was unanimous. Notably, Justice Kennedy wrote a concurrence in which he raised the possibility that *Quill* was wrongly decided and should be reconsidered in light of technological advances and the development of the Internet.<sup>45</sup> Characterizing the *Quill* holding as “tenuous” and “inflicting extreme harm and unfairness on the States,” he stated that “[i]t should be left in place only if a powerful showing can be made that its rationale is still correct.”<sup>46</sup>

## Congressional Authority to Act

Under its authority to regulate commerce, Congress has the power to authorize state action that would otherwise be an unconstitutional burden on interstate commerce, so long as it is consistent

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<sup>38</sup> *Id.* at \*27.

<sup>39</sup> *See id.* at \*13-\*17.

<sup>40</sup> *See id.* at \*18-\*20.

<sup>41</sup> *Direct Mktg. Ass’n v. Brohl*, 735 F.3d 904 (10<sup>th</sup> Cir. 2013), *cert. granted*, 134 S. Ct. 2901 (2014).

<sup>42</sup> 28 U.S.C. §1341.

<sup>43</sup> *Direct Mktg. Ass’n v. Brohl*, 135 S. Ct. 1124 (2015) (concluding that the notice and reporting requirements were not an act of “assessment, levy, or collection” within the specific meaning of those terms as used in tax law, and that the suit could not be said to “restrain” the assessment, levy, or collection of a tax if it “merely inhibits,” rather than stops, those activities).

<sup>44</sup> *Id.* (quoting *Levin v. Commerce Energy, Inc.*, 560 U. S. 413, 422 (2010)).

<sup>45</sup> *See id.* at 1134-35 (J. Kennedy, concurring).

<sup>46</sup> *Id.* at 1134, 1135 (J. Kennedy, concurring).

with other provisions in the Constitution.<sup>47</sup> As such, Congress may permit state taxation without physical presence, but cannot change the standard required to satisfy due process.<sup>48</sup>

## Marketplace Fairness Act and Other Legislation

Thus far, Congress has not defined a standard for nexus under the Commerce Clause, although legislation has been introduced in the 114<sup>th</sup> Congress (S. 698, Marketplace Fairness Act).<sup>49</sup> S. 698 would authorize states to require that remote vendors collect sales or use taxes for sales sourced to that state, regardless of whether the remote vendors have a physical presence in the state. In order to do so, the state would either (1) have to be a member of the multistate Streamlined Sales and Use Tax Agreement (SSUTA)<sup>50</sup> or (2) adopt the act's minimum simplification requirements for their sales and use tax laws. In either case, states could only impose the collection obligation on remote sellers with more than \$1,000,000 in gross annual receipts in total U.S. remote sales during the preceding calendar year.

The minimum simplification requirements include such things as providing a single entity within the state responsible for all state and local sales and use tax administration, return processing, and audits. Additionally, any changes to SSUTA after the act's enactment would have to be consistent with these requirements.

Sales would be sourced to SSUTA member states according to the agreement. For non-SSUTA states, sales would generally be sourced to the location where the item sold is received by the purchaser based on the delivery instructions (the act includes other rules for cases in which no delivery location is specified).

If S. 698 were enacted into law, SSUTA members could require the collection of sales and use taxes on remote sales beginning 180 days after the state publishes notice of its intent to do so, but no earlier than the first day of the calendar quarter that is at least 180 days after the act's enactment. Non-SSUTA members could require the collection no earlier than the first day of the calendar quarter that is at least six months after the state complies with the act's simplification requirements and other provisions.

Another bill, the Wireless Telecommunications Tax and Fee Collection Fairness Act of 2015 (H.R. 1087), has been introduced that would use Congress's commerce authority to restrict state sales and use taxation related to wireless telecommunication services. The legislation would prohibit states from requiring a person to collect from or remit on behalf of another person any state or local fee, tax, or surcharge imposed on a purchaser or user for wireless telecommunication services within the state unless there is a "financial transaction" between the

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<sup>47</sup> See *Northeast Bancorp v. Board of Governors of Fed. Reserve Sys.*, 472 U.S. 159, 174 (1985) ("[S]tate actions [that burden interstate commerce] which [Congress] plainly authorizes are invulnerable to constitutional attack under the Commerce Clause. [citations omitted]"); see also *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408, 434 (1946) (describing Congress's Commerce Clause power as plenary and limited only by other constitutional provisions).

<sup>48</sup> See *Quill*, 504 U.S. at 318.

<sup>49</sup> In the 113<sup>th</sup> Congress, the Senate passed a similar version of the act (Marketplace Fairness Act of 2013, S. 743) by a vote of 69 to 27. The House took no action on the bill.

<sup>50</sup> SSUTA was created by a group of state tax administrators who formed in 2000 in order to simplify and make uniform the administration of sales and use taxes. See STREAMLINED SALES TAX GOVERNING BOARD INC., <http://www.streamlinedsalestax.org>. Member states adopted the agreement in 2002, and efforts are now aimed at state compliance. Forty-four states and the District of Columbia participate, and 24 have enacted conforming legislation.

person and the purchaser or user. A “financial transaction” would be “a transaction involving cash, credit or any other exchange of monetary value or consideration given by the purchaser or user upon whom the fee, tax or surcharge is imposed to the person required to collect or remit the fee, tax or surcharge.”

## Internet Tax Freedom Act

The Internet Tax Freedom Act (ITFA), enacted in 1998, imposes a moratorium on (1) state and local governments imposing multiple or discriminatory taxes on electronic commerce and (2) taxes on Internet access.<sup>51</sup> Originally set to expire in 2001, the moratorium has been extended several times, with the current continuing resolution extending it until October 1, 2015.<sup>52</sup>

The moratorium only applies to “taxes” (i.e., charges imposed for the purpose of generating revenue for governmental purposes) and not to any charge properly characterized as a user fee.<sup>53</sup> Importantly, the definition of “taxes” includes not only the tax itself, but the imposition on a seller of an obligation to collect and remit any sales or use tax imposed on the buyer. Certain government-imposed charges are excluded from the definition of “tax,” including (1) franchise and similar fees imposed by state and local franchising authorities under Sections 622 and 653 of the Communications Act of 1934 and (2) any other fee related to obligations of telecommunications carriers under the Communications Act of 1934.<sup>54</sup>

## Moratorium on Multiple and Discriminatory Taxes on E-Commerce

For purposes of the moratorium on multiple or discriminatory taxes on electronic commerce, a “multiple tax” is generally any tax on the same electronic commerce that is subject to tax by another state without a credit for taxes paid in other jurisdictions.<sup>55</sup> It does not include a sales or use tax on tangible personal property or services imposed by a state and a political subdivision, with the definition of tangible personal property, and thus the exemption’s scope, determined by state law.<sup>56</sup> There is sparse case law interpreting “multiple,” none of which seems noteworthy.

A “discriminatory tax” includes any tax where electronic commerce is treated differently than other types of commerce (e.g., mail-order or brick-and-mortar stores) because the tax is only imposed on e-commerce, is applied at a different rate, or imposes different obligations to collect

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<sup>51</sup> P.L. 105-277, Div. C, Title XI, §1101(a), found at 47 U.S.C. §151 note. Some taxpayers are not allowed to benefit from the moratorium: (1) persons or entities who make online communications for commercial purposes that include materials harmful to minors unless steps have been taken to restrict access by minors, and (2) Internet access providers that do not provide screening software. *ITFA*, §1101(d), (e).

<sup>52</sup> P.L. 107-75, §2 (extended moratorium through Nov. 1, 2003); P.L. 108-435, §§2, 8 (extended it retroactively from Nov. 1, 2003, to Nov. 1, 2007); P.L. 110-108, §2 (extended it to Nov. 1, 2014); P.L. 113-164, §126 (extended it to Dec. 11, 2014); P.L. 113-235, §624 (extends it to October 1, 2015).

<sup>53</sup> *ITFA*, §1105(8)(A). See *City of Eugene v. Comcast of Or. II, Inc.*, 333 P.3d 1051, 1066 (Or. Ct. App. 2014) (city license fee imposed “as compensation for use of right-of-way” is not a tax for ITFA purposes).

<sup>54</sup> *ITFA*, §1105(8)(B).

<sup>55</sup> *ITFA*, §1105(6).

<sup>56</sup> See *id.*; see also *City of Chicago v. StubHub!, Inc.*, 624 F.3d 363 (7<sup>th</sup> Cir. 2010) (noting that the applicability of the exemption for a city ticket tax would turn on whether tickets are tangible personal property under state law).

or pay it.<sup>57</sup> It also includes a tax that establishes a classification of Internet access service providers or online service providers in order to tax them at a higher rate than the one generally applied to providers of similar information services delivered through other means. Further, discriminatory taxes include those defined with reference to certain nexus requirements for remote sellers:

- if the sole ability to access a site on a remote seller’s out-of-state computer server is a factor in determining the seller’s tax collection obligation, or
- if a provider of Internet access or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of the display of a remote seller’s information or content on the provider’s out-of-state computer server or the processing of orders through that server.

An example of a tax that was found to be discriminatory is a state retail telecommunication excise tax that was imposed on the sale of items by telecommunication service providers (e.g., games sold by a mobile phone company), but did not apply when similar products were sold by someone other than a telecommunication service provider (e.g., Walmart).<sup>58</sup> On the other hand, a court found that a local privilege tax on any business “where persons utilize electronic machines ... to conduct games of chance” was not discriminatory.<sup>59</sup> Rejecting the argument that the ordinance was discriminatory because it only taxed Internet-based games of chance, the court reasoned that the law “never mentions ‘internet-based’ sweepstakes or makes a distinction regarding electronic commerce; it only imposes the tax for cyber-gambling establishments that use a computer or gaming terminal in provision of games of chance.”<sup>60</sup>

Courts have rejected arguments that taxes are discriminatory when they are generally applicable and any disparate tax treatment is business related. For example, a court held that the ITFA was not violated when an Internet service provider who did not own lines for transmitting data traffic had to purchase them and pay tax on the purchase, while cable-based and facilities-based Internet service providers did not have to pay any tax because they already owned the infrastructure.<sup>61</sup> The court explained that the different treatment was due solely to the company’s business decisions and that nothing in the tax laws prevented the company from installing its own lines, in which case it would not owe tax.<sup>62</sup> Similarly, several courts rejected the argument that local hotel occupancy taxes are discriminatory because the tax is effectively higher for purchases made through online travel companies (OTCs) than traditional travel agents.<sup>63</sup> In general, these taxes are based on the amount the renter pays for the room: when a renter purchases through an OTC, the company’s fee is included in the price and thus taxed, but when someone purchases through a traditional travel agent, the hotel charges the customer for the room and separately pays the agent’s fee, so the agent’s fee is not included in the amount taxed. In finding this treatment was

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<sup>57</sup> *ITFA*, §1105(a)(2).

<sup>58</sup> *Alltel Comms., LLC v. Montana Dep’t of Revenue*, 2012 Mont. Dist. LEXIS 28 (Mont. Dist. Ct. Feb. 22, 2012).

<sup>59</sup> *IMT, Inc. v. City of Lumberton*, 724 S.E.2d 588 (N.C. Ct. App. 2012), *rev’d on other grounds*, 738 S.E.2d 156 (N.C. 2013).

<sup>60</sup> *Id.* at 48.

<sup>61</sup> *Concentric Network Corp. v. Commonwealth*, 897 A.2d 6 (Pa. Commw. Ct. 2006).

<sup>62</sup> *Id.* at 15.

<sup>63</sup> *Village of Rosemont v. Priceline.Com Inc.*, 2011 U.S. Dist. LEXIS 119231 (N.D. Ill. Oct. 14, 2011); *District of Columbia v. Expedia, Inc.*, 2012 D.C. Super. LEXIS 14 (D.C. Super. Ct. Sept. 24, 2012); *Travelocity.com, LP v. Wyo. Dep’t of Revenue*, 329 P.3d 131 (Wyo. 2014).

not discriminatory, courts have noted that the laws are universally applied to the amount the renter pays and imposed at the same rate, regardless of whether the transaction is online or through other means.<sup>64</sup>

## Moratorium on Taxes on Internet Access

The moratorium also prohibits states from taxing Internet access, regardless of whether imposed on a provider or buyer of Internet access and the terminology used to describe the tax.<sup>65</sup> This does not apply to taxes levied upon or measured by net income, income, capital stock, net worth, or property value, nor to grandfathered taxes (discussed below) and some other exceptions.<sup>66</sup> Also, Internet access can be taxed if the service provider does not separate charges for Internet access from taxable telecommunications charges and other charges, unless the provider can reasonably identify the Internet access charges from its books and records.<sup>67</sup>

For purposes of the moratorium, “Internet access” is any service that enables users to connect to the Internet to access content, information, or other services offered over the Internet, as well as the purchase, use, or sale of telecommunications by a service provider if done to provide these services or to otherwise enable users to access the Internet.<sup>68</sup> It also includes services such as email and instant messaging, regardless of whether these are provided incidentally to the Internet access or independently. However, “Internet access” does not include voice, audio, and video programming or other products and services (other than those already mentioned) that utilize Internet protocol (or any successor protocol) and for which there is a charge.

Importantly, the moratorium does not apply to taxes on Internet access that were “generally imposed and actually enforced” prior to October 1, 1998.<sup>69</sup> Additionally, in order for this grandfathering provision to apply, two things must have occurred prior to October 1, 1998:

- the tax was authorized by statute, and
- either of the following is true: (1) a provider of Internet access services had a “reasonable opportunity to know” that the relevant tax authority had interpreted and applied the tax to Internet access services because the authority had issued a rule or other public proclamation saying so; or (2) a state or local government “generally collected” the tax on charges for Internet access.

One court examining the “reasonable opportunity to know” criteria found it was not sufficient for a city to merely point to the plain language of the ordinance and a regulation that repeated that

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<sup>64</sup> See, e.g., *Village of Rosemont*, 2011 U.S. Dist. LEXIS 119231 at \*26-\*28.

<sup>65</sup> *ITFA*, §§1101(a), 1105(10)(A).

<sup>66</sup> *ITFA*, §1105(10)(B), (C) (additional exception for certain taxes).

<sup>67</sup> *ITFA*, §1106.

<sup>68</sup> *ITFA*, §1105(5). See, e.g., *j2 Global Communications, Inc. v. City of Los Angeles*, 218 Cal. App. 4th 328 (Cal. App. 2d Dist. 2013) (online faxing services did not qualify as “Internet access” services); *IMT, Inc.*, 724 S.E.2d at 596 (privilege license tax on businesses providing electronic machines for games of chance was not a tax on Internet access).

<sup>69</sup> *ITFA*, §1104(a). See, e.g., *City of Chicago v. AT&T Broadband, Inc.*, 2003 U.S. Dist. LEXIS 15453 (N.D. Ill. Sept. 4, 2003) (city franchise fee was not “generally imposed” when imposed only on cable operators providing cable modem services and not on all providers of Internet access services).

language.<sup>70</sup> As the court explained, “It is not enough that the language of its ordinance, or even its rules, might be broad enough to encompass Internet access services,” but rather the city must specifically and publicly provide that it interprets the language to apply to Internet access.<sup>71</sup>

The grandfathering provision does not apply if the state or local government repealed or stopped applying the tax to Internet access. Thus, while the grandfathering provision originally captured 13 states, it now appears to apply only to Hawaii, New Mexico, North Dakota, Ohio, South Dakota, Texas, and Wisconsin.<sup>72</sup> Like the moratorium, the grandfathering provision is scheduled to expire on October 1, 2015. For a policy discussion of the grandfathering provision and related issues, see CRS Report R43772, *The Internet Tax Freedom Act: In Brief*, by Jeffrey M. Stupak.

## ITFA and Federal Taxes

While the ITFA defines “tax” as a tax imposed by “any governmental entity,” the moratorium only restricts the taxing power of state and local governments, not that of the federal government.<sup>73</sup> However, the law enacting the ITFA also provides the following:

It is the sense of Congress that no new Federal taxes similar to the taxes described in section 1101(a) should be enacted with respect to the Internet and Internet access during the moratorium provided in such section.<sup>74</sup>

Questions are sometimes asked about the legal effect of this language. In general, “sense of Congress” language is appropriate if Congress wishes to make a statement without making enforceable law.<sup>75</sup> Ordinarily, a statement that it is the “sense of Congress” that something “should” or “should not” be done is “merely precatory,” creating no legal rights.<sup>76</sup> However, in the appropriate context, a “sense of Congress” provision can have the same effect as statements of congressional purpose, resolving ambiguities in more specific language of operative sections of a law.<sup>77</sup> In other words, “courts rely on the sense of Congress provisions to buttress interpretations of other mandatory provisions and do not interpret them as creating any rights or duties by themselves.”<sup>78</sup> Here, there is no apparent ambiguity in the act’s moratorium, which supports the conclusion that the “sense of Congress” provision is simply precatory.<sup>79</sup>

<sup>70</sup> See *City of Eugene*, 333 P.3d at 1067.

<sup>71</sup> *Id.*

<sup>72</sup> CRS Report R43772, *The Internet Tax Freedom Act: In Brief*, by Jeffrey M. Stupak.

<sup>73</sup> ITFA, §1101(a) (“No State or political subdivision thereof may impose any of the following taxes during the period beginning November 1, 2003 and ending November 1, 2014....” (emphasis added)); §1105(7) (defining “state”).

<sup>74</sup> P.L. 105-277, Div. C, Title XII, §1201.

<sup>75</sup> CRS Report 97-589, *Statutory Interpretation: General Principles and Recent Trends*, by Larry M. Eig, at 35.

<sup>76</sup> *Monahan v. Dorchester Counseling Ctr., Inc.*, 961 F.2d 987, 994-95 (1<sup>st</sup> Cir. 1992); see also *Yang v. California Dep’t of Social Services*, 183 F.3d 953, 955, 958-61 (9<sup>th</sup> Cir. 1999).

<sup>77</sup> See *Accardi v. Pennsylvania R.R.*, 383 U.S. 225, 229 (1966); *State Highway Comm’n v. Volpe*, 479 F.2d 1099, 1116 (8<sup>th</sup> Cir. 1973).

<sup>78</sup> *Yang*, 183 F.3d at 959.

<sup>79</sup> The legislative history of the “sense of Congress” provision is sparse. See, e.g., S.Rept. 105-276 (committee amendment states simply “it is the sense of the Congress that no new Federal taxes like the State and local government taxes to which the two-year moratorium applies should be enacted on Internet activity during the moratorium”).

## Internet Tax Freedom Act and State “Amazon Laws”

As discussed above (“State “Amazon Laws” and Their Constitutionality”), some states have recently enacted “click-through nexus statutes” that require a retailer to collect use taxes if its associates or affiliates have a physical presence in the state, even if the retailer does not. Since the ITFA defines “tax” to include not only charges for raising revenue, but also laws that impose an obligation on a seller to collect and remit sales or use taxes,<sup>80</sup> these laws are “taxes” for purposes of the ITFA and subject to the moratorium on multiple and discriminatory taxes.

In the only case challenging such a law under the ITFA, the Illinois Supreme Court struck down its state’s click-through nexus law in 2013 as being discriminatory.<sup>81</sup> The 2011 Illinois law applied to any retailer who entered into a contract with a person in the state under which that person receives a commission based on the retailer’s sales in exchange for referring potential customers to the retailer “by a link of the person’s Internet website.”<sup>82</sup> According to the court, the problem was that this provision is limited to online performance-based marketing arrangements even though similar arrangements occurred in print and broadcast media. The state argued these other arrangements were covered by a separate provision that applied to retailers who are “pursuant to a contract with a broadcaster or publisher located in this State, soliciting orders for tangible personal property by means of advertising which is disseminated primarily to consumers located in this State and only secondarily to bordering jurisdictions.”<sup>83</sup> However, this did not solve the problem in the court’s eyes since this provision only applied to advertising “disseminated primarily to consumers located in this State” and not that disseminated nationally or internationally, while online advertising was inherently national and international. Thus, the court found that the law was preempted by the ITFA moratorium on discriminatory taxes because it applied to retailers engaged in performance-based marketing over the Internet, but not retailers engaged in national or international performance-based marketing in print or broadcasting.<sup>84</sup>

Two points should be made about state Amazon laws and the ITFA. First, this case does not suggest that click-through nexus laws inherently violate the ITFA. For example, New York’s statute would appear to not be discriminatory under the court’s reasoning because it applies to retailers who enter into affiliate agreements where the referral occurs “via a website link *or otherwise*” (emphasis added). Second, it is not clear that all Amazon laws are subject to the ITFA. For example, Colorado’s notification law does not impose an obligation to collect and remit tax on remote sellers, and thus it might be argued the law could fall outside the ITFA’s scope.

## Legislation Related to ITFA and Similar Concepts

As mentioned above, the ITFA moratorium is scheduled to expire on October 1, 2015. Two bills have been introduced in the 114<sup>th</sup> Congress to make the moratorium permanent, while allowing the grandfathering provision for states that tax Internet access to expire—the Internet Tax Freedom Forever Act (S. 431) and the Permanent Internet Tax Freedom Act (H.R. 235). For a

<sup>80</sup> *ITFA*, §1105(a)(8).

<sup>81</sup> *Performance Mktg. Ass’n v. Hamer*, 998 N.E.2d 54 (Ill. 2013).

<sup>82</sup> *Id.* at 56.

<sup>83</sup> *Id.* at 58.

<sup>84</sup> *See id.* at 59-60 (also rejecting the state’s argument that Internet affiliates engaged in activities beyond advertising, which would subject them to another statute that did not distinguish between Internet and other types of retailers).

policy discussion related to the ITFA legislation, see CRS Report R43772, *The Internet Tax Freedom Act: In Brief*, by Jeffrey M. Stupak.

Other legislation introduced in the 114<sup>th</sup> Congress would create a moratorium similar to the ITFA. The Digital Goods and Services Tax Fairness Act of 2015 (H.R. 1643 and S. 851) would prohibit state and local governments from imposing “multiple or discriminatory taxes” on the sale or use of digital goods and services, as well as provide that taxes on the sale of digital goods and services could only be imposed by the state or local jurisdiction whose territorial limits encompass the customer’s address.

## **Author Contact Information**

Erika K. Lunder  
Legislative Attorney  
elunder@crs.loc.gov, 7-4538