Subj: Constitutionality: Perspectives of Americans For Tax Reform
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To: Internet Caucus Advisory Committee

A Clear, Constitutional Approach to e-Commerce Taxation

Submitted to the Advisory Commission on Electronic Commerce by the e-Freedom Coalition on November 15, 1999.

The E-Freedom Coalition recommends that the temporary tax-free zone arrangement created by the Internet Tax Freedom Act (ITFA) be made permanent for both access taxes and sales or use taxes on electronic commerce. Moreover, the Advisory Commission should recommend that any existing state or local taxes that were grandfathered under the ITFA be phased out or repealed outright.

The economic arguments against taxing electronic commerce are strong. First, such taxation is inefficient. Imposing multiple, overlapping or discriminatory access or sales taxes on the Internet or electronic commerce in general would be extremely difficult and inefficient in practice. Having 30,000 or even just 50 tax jurisdictions and policies would create a confusing and counter-productive domestic tax regime. Imposing such a tax regime on the Internet or electronic commerce would also have an extremely deleterious effect on the Internet sector just as it is beginning to grow and expand. Industry output and entrepreneurship would likely be greatly curtailed as a result.

The negative effects of a new Internet tax regime would reverberate throughout the national economy. Almost every American industry is now engaged in some form of electronic commerce or has initiated Internet-based services. Imposing burdensome taxes on Internet access or sales would discourage further efforts in this regard and likely retard innovation, job creation, and economic growth in general.

The creation of such a tax regime or regimes would likely require a significant increase in government tax oversight and enforcement efforts. Tax collection agencies and/or their surrogates at all levels of government would grow larger and more intrusive as efforts to tax electronic commerce proliferated. The resulting expansion in the overall size of government would likely lead to more government meddling in the private sector in general and the high-tech sector in particular.

Just as the economic arguments against Internet taxation are strong, so are the legal and constitutional arguments. The Supreme Court has long held that attempts by a state or local government to tax or regulate out-of-state activity or "remote commerce" are unconstitutional. State and local governments can only tax those parties that have a "nexus" or "substantial physical presence" within their jurisdictions. Establishing a tax system that grants state and local governments the right to impose multiple and over-lapping taxes would reverse two centuries worth of sound Supreme Court case law and create a disturbing precedent for the taxation of other forms of interstate commerce.

Beyond upsetting legal precedent, taxing electronic commerce represents a direct affront to constitutional first principles and a threat to America's federalist structure of government in general. The Founding Fathers included language in Article 1, Section 8 of the Constitution to allow Congress to "regulate interstate commerce" in an attempt to remedy the problems the colonies experienced when they operated under the Articles of Confederation. Excessive parochialism and perpetual interference with the free flow interstate commerce forced the Founders to abandon the Articles and instead adopt our modern Constitution to alleviate these ills. The federal republic they created allowed for extensive state and local experimentation and autonomy, but also placed firm limits on the ability of state and local governments when interstate commerce was at stake. An important part of America's federalist system of government, therefore, is an understanding and appreciation of the limits of state sovereignty. In order for each state to preserve an autonomous sphere for itself, there must necessarily be limits on its jurisdictional authority. Simply put, a state's jurisdictional authority ends at its own borders. Allowing state or local taxation of the Internet would betray this constitutional first principle by allowing governments to impose their will on consumers and companies outside their jurisdictional boundaries.

For these economic and legal reasons, it is vital that the Advisory Commission propose a permanent ban on access taxes or any form of discriminatory sales or use taxes on electronic commerce.

Addressing and Debunking the "Fairness" Arguments

Despite these arguments, some may still resist the adoption of a permanent ban on Internet access and sales taxes because of certain "fairness" arguments they have heard repeatedly voiced by critics of the Internet Tax Freedom Act. These fairness arguments typically come in two varieties:

- ✕ Fairness Argument #1 : It is not fair to exempt remote Internet vendors from access or sales taxes when "bricks and mortar" or "Main Street" businesses within a state are required to collect them.

- ✕ Fairness Argument #2 : It is not fair to deprive state and local governments of the revenues that could be collected by taxing Internet access or electronic sales.

These arguments represent legitimate concerns that are being raised by a host of state and local government officials and some businesses. Therefore, it is important that the members of the Advisory Commission address and debunk these fairness arguments to ensure that new tax schemes are not imposed on electronic commerce.

The first argument regarding the fairness of exempting remote vendors from access or sales taxes misses an important point: remote vendors do not use or deplete state or local resources which state or local taxes support. In fact, it would be patently unfair to force out-of-state companies to pay taxes for government services or programs they do not use or benefit from. State and local businesses pay or collect such taxes because they can take advantage of the programs or services provided with those funds. Remote vendors engaging in interstate electronic transactions do not benefit in a similar way from these taxes, and shipping companies already pay taxes to cover their use of public goods and services.

Moreover, Internet vendors are tangible "bricks and mortar" businesses that will continue to pay routine income taxes where they reside. A permanent Internet tax moratorium would only exclude states and localities from taxing remote vendors of electronic commerce.

The second fairness argument regarding the threat a Net tax moratorium poses for future state and local tax revenues is equally flawed. The remarkable and explosive rise of the Internet and electronic commerce is creating a virtually unprecedented level of entrepreneurship and innovation in America. Moreover, this remarkable technological renaissance has been the driving engine behind America's recent strong and sustained economic growth.

This has presented policymakers with a paradoxical situation. The rise of this new unregulated and, for the most part, low tax sector, has helped fuel the sustained growth of not only economic activity, but government tax revenues as well. For the first time in decades, Americans now live in an "Age of Surplus," where federal, state, and local governments are taking in record tax revenues. How can this be if critics are correct in their contention that a tax-free Internet represents a serious drain on governmental tax collections?

Simple economics explains the apparent paradox. First, the rise of the Internet and the Information Economy has created new jobs and new business opportunities that did not exist previously. In turn, this increased economic activity and output increased individual income and business profits, which, consequently, provided new tax sources and higher revenues overall for all governments. And, again, it is important to reiterate that simply because interstate Internet transactions have been exempted from taxes, that does not mean companies engaging in electronic commerce are completely tax-free. Electronic vendors are still responsible for paying routine corporate income taxes and are treated like any other business within their home states. A permanent moratorium on Net taxes would not upset this balance in any way.

Setting a Uniform Jurisdictional Standard for Sales Tax Collection

Next, the expansion of economic activity and opportunity through electronic commerce does not require abandoning state and local taxing authority, only better defining it. By placing clear parameters on state and local authority to tax interstate commerce, Congress can reduce the threat of taxation in jurisdictions in which vendors do not have a substantial physical presence. The U.S. Supreme Court has long recognized that the Commerce Clause requires a physical connection between the taxing jurisdiction and the taxpayer.

See ***Complete Auto Transit, Inc. v. Brady***, 430 U.S. 274 (1977). A substantial physical presence provides an identifiable standard that ensures a state's power to tax is limited to taxpayers within its borders. Nothing will do more harm to the growth of electronic commerce, and to taxpayers and consumers directly, than expanding state and local taxing authority beyond their borders.

The threat of taxation is as much an issue as the obligation of taxation itself. The Supreme Court's decisions in ***National Bellas Hess, Inc. v. Department of Revenue of Illinois***, 386 U.S. 753 (1967), and ***Quill Corp. v. North Dakota***, 504 U.S. 298 (1992), have not been uniformly adhered to or interpreted. States continually litigate new theories in the hope of expanding their jurisdiction beyond their borders, not just for use taxes but other excise and business activity taxes. The cost to taxpayers and consumers in money and time is substantial. All the while, predictable jurisdictional standards are being eroded. This lack of certainty is the biggest threat to business on the Internet. One of the biggest hurdles facing businesses engaged in interstate commerce is simply knowing which tax agencies are involved. For the on-line business, the uncertainty is positively mind-boggling because the technology itself poses new questions in jurisdictional standards. Can an ISP that facilitates the processing of data cause its customers to have tax obligations in the state, county and city of the ISP? Does the mere fact that a customer can order via your web page subject your company to taxation in the state of the consumer? What about the in-state use of a license or copyrighted material?

With the exception of PL 86-272, which relates strictly to state income taxes and to sellers of tangible personal property, Congress has left the question of the limits of state taxing authority to the courts. The courts, however, have failed to solve the problem. Each decision is the subject of subsequent dispute and argument over its proper application. New theories are developed and more time and energy spent litigating for certainty and predictability.

The definition of "substantial nexus" is most often the subject of dispute. Some decisions suggest that it applies differently depending on the type of tax. While the Supreme Court in ***Quill*** reiterated the standard of a "substantial physical presence" articulated in the 1967 decision of ***National Bellas Hess***, 386 U.S. 753, some states argue their standard only applies to the collection obligation under the use tax, and not, for example, to income taxes. See ***Geoffrey, Inc. v. South Carolina Tax Commission***, 437 S.E.2d 13 (S.C. 1993), ***cert. den***, 510 U.S. 992 (1993) (foreign corporation's licensing of its Toys 'R Us trademark in the taxing state and the royalties generated from it established nexus even without a physical presence).

The indirect establishment of a substantial presence on the part of the out-of-state person is another fruitful ground of controversy. Over the last decade, the states have attempted to expand the theory of "attributional nexus," which attributes the substantial physical presence of one person to that of another either by way of agency or corporate affiliation. Does advertising by an out-of-state company on a web page that happens to be on a server located in the taxing state suffice? What about a logo on a web page "hot-linked" to an out-of-state vendor? What about the in-state presence of a telecommunications service provider's equipment used by an in-state resident to order from an out-of-state vendor with whom the telecommunications company contracts for services? For example, Texas has asserted that a web site on a Texas server creates nexus for an ISP's out-of-state customer.

Even if one assumes that jurisdiction to tax exists, the next layer of uncertainty is what is subject to tax (tax base) and the appropriate rate to apply. Computing the proper tax liability is the most intrusive aspect of taxation and in many cases the most burdensome aspect of taxation. The more tax agencies involved, the more burdensome compliance becomes.

Unlike the bricks and mortar business that state and local governments so often argue are being discriminated against, the out-of-state retailer is asked to do that which the in-state retailer is not: determine the place of use for each of its customers. For example, the brick and mortar retailer doesn't ask if I'm taking my purchase and going back to my home which is in a different taxing jurisdiction. They don't care. The sales tax treats the place of purchase as the place of consumption. However, if the same transaction occurred online via the company's web page, different standards would apply. If the store is in my home state, most likely the sales tax would once again apply but the seller would first have to determine the destination of the sale. If the seller was in a different state, the use tax applies and the seller would have to identify the destination of the sale and collect and remit based on the rules and rates for that local jurisdiction assuming the company has nexus (reliance on zip codes is not legally sufficient as many zip codes cross taxing jurisdictions). In the purely digital world, where both the consummation of the agreement and the exchange of the product or service occur on-

line, location is not just irrelevant; it can be impossible to determine. The use tax is not a surrogate consumption tax, as some would suggest. It was a device conceived to protect in-state merchants.

The physical presence standard properly respects state borders. The basic purpose of taxation is to raise money for government services and programs. Why should a business, having no physical presence in a state, be obligated to contribute to the programs and services in that state? The argument of a "maintenance of a market" for the out-of-state business mistakes the nature of that market. The market exists because of the people, not the government (while such might be true in a centrally planned economy, it is not the case in America). And clearly, out of their own self-interest, the people who live in the jurisdiction properly pay the taxes necessary to support the roads, education and other infrastructure to meet the needs of that market.

Subjecting taxpayers to the intricacies of the tax codes of the jurisdiction in which they are physically present is not an insignificant burden, but subjecting taxpayers to all the tax codes in all the jurisdictions of their customers would create an insurmountable burden to all but the largest businesses, or alternatively require the vast expansion of government tax collection agencies and/or their surrogates. Neither suggestion is friendly to taxpayers and consumers.

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II. The Constitutional Underpinnings
The taxation of electronic commerce brings together an unusual confluence of constitutional considerations, ranging from basic issues of federalism (state vs. federal power) to minute yet telling issues of factual interpretation (does a web server constitute a physical presence in a state?). But at the heart of the controversy over how to apply existing rules of taxation to commerce over the Internet is the oldest dispute in America politics: whether we are a unified nation and market as Hamilton envisioned, or are we an assemblage of states that retain sovereign authority over commerce within their physical boundaries, yielding only cross-state and foreign commerce to the national government (the Madisonian view).

Historically this dispute has been marked by wide swings of the pendulum in sorting out the respective powers of the states and the federal government, whether through constitutional interpretation in the courts or in the legislative process. But in the 20th century at least, the overwhelming trend was to build up federal power and reinforce the idea of a national marketplace, at the expense of state power. This result was perhaps a natural outgrowth of technologies that broke down transportation and communications barriers to the exchange of goods and services across the nation; but it also got a big boost in the political process, beginning with the Progressive Era and accelerating with the New Deal assumption of sweeping new federal powers over economic activity of all kinds.

Whether the 21st century will see a different approach remains to be seen, but already the emergence of electronic commerce has scrambled the traditional 'correlation of forces' that up to now has shaped federal-state relations in taxing and regulating economic activity. While states normally trumpet their autonomy and independence to legislate as they choose, where e-commerce is concerned, they demand the right to impose uniform rules across state lines and complain that the federal government is impeding them. While the federal government normally seeks to tap any new revenue source, where the Internet is concerned it has moved to restrain state taxation without stepping in to assert its own taxing power. And substantial elements of the business community, both high-tech and 'traditional' in nature, lean more towards the states' desire for uniformity than to the current federal preference for no (or minimal) taxation of the Internet.
How this will sort itself out no one can predict, but clearly a shift in economic power relations (and their constitutional parameters) between the states and the Feds is in the works. Before we speculate on what may happen, let us look at the most critical constitutional issues surrounding e-commerce today.

Due Process
For purposes of federal-state relations in the area of taxation, 'due process' means the requirement of the 14th Amendment to the Constitution barring states from depriving "any person of life, liberty, or property, without due process of law." While due process requirements are most familiar from areas such as criminal procedure and the property rights movement, their application to the subject of taxation is limited but important. In essence, they boil down to the idea of "no taxation without representation," not in the sense that they require the taxpayer to have voting rights in the taxing jurisdiction, but in requiring that the taxing authority have sufficient grounds for taxing a person or corporation not resident (incorporated) in the state, and that the taxpayer have a reasonable expectation or understanding that he or she is subject to the state's taxes.

In practice, due process for state taxation has been boiled down to the notion that the taxpayer must have some sort of physical presence in a state in order to be subject to its taxing authority. While the constitutional standards for such a presence (as decided by the Supreme Court) have evolved over the years, they loosened substantially in ***Quill Corp. v. North Dakota ex rel. Heitkamp***, case decided by the Court in 1992.[23] In that case the Court drew a clear distinction between Due Process jurisprudence and Commerce Clause jurisprudence, ruling that while due process required nothing more than certain minimum contacts with a state (not necessarily a physical presence) for purposes of taxation, the Commerce Clause imposed a more stringent standard against states (see discussion, below).

Why does this matter for electronic commerce? First, while the Due Process constraint on state taxation has been substantially narrowed by the courts, it hasn't been erased. The Internet, and the commercial transactions conducted over it, raises entirely new questions: Does a web server in the state constitute even a 'minimum

contact' for Due Process purposes? Do freely-posted commercial web offerings, passively available to anyone with Internet access but not 'aimed' at any particular jurisdiction, constitute such contact?
The question may seem moot since, as we will see in discussing the Commerce Clause, it is hard to imagine a form of presence in a state that would pass the Commerce Clause test yet fail a Due Process test. However, since Congress has freedom to reinterpret the Commerce Clause via legislation (so long as it doesn't breach clear constitutional limits), it is not inconceivable that federal legislation, or some less formal type of federal-state accord, might ratify certain forms of Internet taxation that would nonetheless fail a ' minimum presence' test for Due Process purposes. That seems unlikely for now, but the law is constantly evolving, as legal commentators are always eager to remind us. In any event, given the (literally) ethereal and non-tangible nature of commercial activity conducted over the Internet, it is not inconceivable that Due Process jurisprudence in the field of state taxing jurisdiction could be revived: another reason to be wary of ' comprehensive' proposals for Internet taxation like the original NGA proposal.

In fact, a possible Due Process case is not difficult to find even now. As we have seen in Section I, the most critical area of dispute concerns the imposition of state sales and use taxes on electronic commerce. In that Section we also point out (see Table 1) that states could constitutionally collect sales and use tax directly from the consumer at point of sale. In response to frustration over their inability to collect taxes on remote sales (mail order as well as electronic) to their residents, however, some states (North Carolina, Michigan) have resorted to requiring taxpayers to report their " use tax liability" on state income tax forms. This is an important and novel development, because (1) the whole concept of use tax is to require vendors to collect and remit tax on items purchased for 'use' by residents of their states—switching the tax-collection burden to the residents themselves alters the very nature of the taxing relationship; and (2) the requirement that a state's residents know exactly which of their out-of-state transactions are subject to use tax assumes that those residents (for purposes of constitutional jurisprudence) know which companies they deal with out-of-state have an adequate 'nexus' to the state under the Commerce Clause rulings.
Placing the incidence of tax ***and*** the burden of collecting it on consumers puts them in the middle of a constitutional conundrum, and creates a sort of hybrid direct (on the consumer) and indirect (on the transaction) tax. Every taxpaying resident of these states could end up having to be a constitutional law expert, and have to conduct an in-depth survey of the corporate structure of his or her out-of-state vendors as well.

Not only is that a somewhat bizarre notion, it could stir up a new class of due process claims. If states try to assess use taxes on their residents using this self-reporting device, those residents could well end up paying tax on 'use' of items purchased from concerns that have no constitutional nexus with the state. That raises questions of fundamental fairness, notice and certainty, and...yes...taxation without representation, all of them key due process considerations. It may be that the states experimenting with this device for collecting use tax really intend to (1) put pressure on their residents to hold out-of-state vendors accountable, and (2) create popular support for making those vendors directly liable for collecting use tax. Regardless of state intent, this new approach to the use tax collection issue could easily revive some aspects of due process jurisprudence regarding state taxation of cross-border transactions.[24]

Commerce Clause
The Commerce Clause of the U.S. Constitution, especially after the ***Quill*** decision, is the primary source of federal power over state and local taxation that involves cross-border issues. The enactment of ITFA itself is premised on Congress' power over interstate commerce, and over the years that power has been asserted (by private parties as well as the federal government) to limit the states' taxing power not just with regard to sales and use taxes, but income and excise taxes as well. For the current Internet tax debate, the Commerce Clause is where it's at.

As we have noted earlier, the relevance of Commerce Clause jurisprudence to the Internet is obvious. Electronic commerce brings a new level of complexity to the issue of taxing purchases by residents of a state from vendors whose retail facilities are located elsewhere: when orders are placed in cyberspace, who has jurisdiction? Obviously every business has a physical presence somewhere (offices, warehouses, shipping facilities), but that presence will seem increasingly insignificant as e-commerce grows and just-in-time order fulfillment using drop shipping becomes the norm.

In another sense, though, e-tailing of goods and services is no different (for constitutional purposes) than mail-order and phone sales, which have been going on for some time. Mail-order sales were the issue in ***Quill***, after all, and the Court's action striking down North Dakota's attempt to impose use tax on such sales did not provoke a wave of concern that state and local revenues would be gutted, the way e-commerce has. E-

commerce seems to be such an unknown quantity to state and local tax collectors, with tremendous but hard-to-predict potential, that it leads to extravagant claims about how different the commercial world of the future will be. Before considering the differences, let's look at some of the similarities between e-commerce and other forms of cross-state transactions.[25]

Both forms of commerce involve a resident of a state contacting (or being contacted by) a vendor who is not 'located' in the same state in order to purchase goods or services, which then are shipped to the resident from a location determined by the vendor. If the vendor ships from a warehouse in the resident's state, or also does business from a physical location in the resident's state, there is little question that sales and use tax is owed to that state. As the ***Quill*** Court said in reaffirming existing criteria for determining taxable ' presence' in a state for Commerce Clause purposes, "we affirmed the continuing vitality of Bellas Hess' 'sharp distinction' … between mail-order sellers with [a physical presence in the taxing] State and those … who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[26]

The problem for states and localities arises, of course, where they cannot demonstrate a 'substantial nexus' between an out-of-state vendor (e-tailer or mail-order) and their jurisdiction. 'Nexus' means a physical presence of some kind in the state (or locality), but exactly what that constitutes remains open to judicial refinement as new fact situations present themselves. Importantly, nexus is necessary but not sufficient for states to impose sales and use tax: under existing jurisprudence they also must not discriminate against interstate commerce, must apportion tax fairly, and tax in a manner related to services the State provides to firms selling into their jurisdiction.[27]

Obviously states, who have had limited practical success in collecting use tax from out-of-state mail order firms, are concerned that electronic transactions will be even more difficult to collect tax on. That is why Gov. Leavitt and his colleagues in the National Governors Association have proposed a systematic new scheme for coordinating sales and use tax policy (including collections) among the various states and with the private sector (at least, that is the ***stated*** reason). But the main difference between mail order and electronic sales is the means of placing the order. Tracking down transactions that may be subject to sales and use tax is not necessarily any more difficult in cyberspace, and software innovations might actually make it easier in the future. The real problems states face, with regard to both mail orders and Internet sales, are privacy concerns (government prying into people's buying habits is unpopular, to say the least) and wariness of treading on federal power over interstate commerce.

There is substantial reason to believe, then, that Gov. Leavitt and his allies seek to use the flurry of interest in e-commerce as an occasion to muster support for the more 'rational' approach to sales and use taxation they prefer: similar rules among the states, an agreed-upon technical means for all states to collect and share taxes 'due' on cross-state transactions. While Leavitt and his like-minded colleagues will continue to refine and modify their proposals to build political support, one thing is clear: to accomplish what these states want would require a substantial change, or at least clarification, of what constitutes 'nexus' in the meaning of the Supreme Court's Commerce Clause rulings. That change could be accomplished two ways: Through congressional action (which the ***Quill*** court invited Congress to undertake if it chose to), or through a series of adjudications more favorable to the Leavitt position.[28]

No doubt, it is for this reason that the Number One concern of the Leavitt group seems to be to head off congressional action redefining 'nexus' in a way that would restrict their efforts to subject more interstate economic activity. Several proposals to do that have been made, including some from the business community (which does, after all, want common standards if it can get them) and one submitted to the Advisory Commission on Electronic Commerce by Commissioner Dean Andal. In fact, the Governors would probably prefer to live with ITFA for the foreseeable future (since ITFA does not interfere with existing constitutional jurisprudence on 'nexus' but only restricts Internet access fees and 'multiple or discriminatory' taxation) than have it replaced by a tightly-drawn federal definition of what does and does not constitute 'nexus'.

Is there a bottom line here? Probably so. First, since there is no state/local revenue crisis on the horizon (see our discussion in Section I), there is no urgent need to 'clarify' the Commerce Clause to facilitate state collections of sales and use tax. It may indeed be useful to legislate some clearer standards of 'nexus' consistent with the existing physical presence test, which is what Commissioner Andal, among others, proposes to do. But that is a policy determination, not a legal one: it would certainly be desirable in the interest of facilitating the growth of electronic commerce, which is a major factor in generating the revenue boom that both states and the federal

government are enjoying. But as the Supreme Court has said, Congress is free to legislate pursuant to the Commerce Clause or leave a substantial gray area to be clarified by future adjudications.

Second, while there is no immediate threat that state sales and use taxes will be seriously undermined by e-commerce, it is certainly possible that as commercial habits and relations evolve, the concept of taxation at point of sale, coupled with a 'use' tax on purchases by residents from out-of-state vendors, may become obsolete and ineffective. For that reason alone, it is certainly prudent for states and localities to be thinking about alternative revenue sources and restructuring their tax bases for the future. In the long run, any adjustment in state taxing authority as it affects Internet (or mail-order) commerce will require a hard-fought political accommodation with the federal government. That, after all, is what the federal power over interstate commerce is all about. If commerce evolves in such a way that it is difficult or impossible to prove a 'nexus' or physical presence in most states, then states will need federal backing (if only legislative acquiescence) for any substantive redefinition of those terms (not to mention the ability to withstand a court challenge). If commerce does evolve as dramatically as Gov. Leavitt and some of his colleagues seem to think it will, it would be much more prudent of them to reexamine their internal tax structures from top-to-bottom rather than continuing to chase after the marginal tax dollar from cross-border transactions. Thanks to the Commerce Clause, they are not dealing from a position of strength in this area, relative to the federal government.

Third, it does not follow from the supremacy of federal power over interstate commerce, and the increasingly nationalization of market activity driven by telecommunications, growing wealth, and mobile populations, that federalism as we know it is dead, or that states will (or should) become dependent on the federal government for revenue to perform their functions. There is a tendency to view the natural evolution of markets as a reason to suddenly alter the governmental structure, usually in favor of greater centralization and more power over the economy. In the 1970's, the mantra was that with the growth of multinational companies and business conglomerates, economic activity had become too 'complex' for a limited-government, low-tax approach to work. The Reagan Revolution should have proved how wrong that was, but memories are short.

The new mantra is that nationalization and globalization of markets requires 'harmonization' of tax and regulatory structures across state (and national) boundaries. That, for instance, is what the European Union is all about. But neither complexity nor globalization should drive changes in the constitutional structure, which has served America quite well indeed for over two centuries. The Constitution and its Commerce Clause envision a sort of matrix system in which states are free to innovate within their boundaries, subject to mediation by the federal government and federal preemption when necessary to keep goods and services flowing smoothly across state borders. That paradigm is as valid today as ever, and adapting tax systems to the world of cyberspace need not disrupt the federal system. But that adaptation will require great imagination and innovation on the part of policymakers, something that many of our Governors seem unwilling or unable to supply. But when they have to, they will.

The Interstices of Federalism

While the federal system encourages states to innovate (and indeed compete) within their borders, the Constitution gives less-clear guidance as to what states can do acting together, rather than individually. After all, the federal government is supposed to express the collective will of the states (as well as the people) in legislative and policy matters: the U.S. Senate itself was created to represent "the states" in the national government. In very extreme circumstances, collective action by a group of states split the nation in two (the Confederacy), resulting in a bloody war to settle the issue of national power and unity.

But short of that extreme case, there are many areas in which states cooperate or coordinate policy, ranging from law enforcement to land-use planning, without disturbing federal-state relations. They are free to do so insofar as they do not run afoul of Article I, Section 10 of the Constitution, which says in pertinent part that "No State shall enter into any Treaty, Alliance, or Confederation;" and that "No State shall, without the Consent of Congress, … enter into any Agreement or Compact with another State … ". Over the years the Supreme Court has interpreted these provisions to allow states to collaborate in most normal 'housekeeping' or police power matters without express Congressional approval: examples include exchange of crime records, regional transportation agreements, coordination of health warnings or quarantines, and so forth.

For purposes of our analysis, however, the issue is possible joint-state efforts in the field of taxation to coordinate or 'harmonize' policies, practices, and procedures in the interest of maximizing their revenue take and clamping down on cross-border 'evasions' of what they see as taxes rightly due them. While there is no system or accord in place now in the field of Internet taxation that raises issues under the Confederation Clause

or the Compact Clause (as the above-reference provisions are commonly referred to), there most certainly are proposals on the table that, at a minimum, test the boundaries of what states can do collectively without requiring congressional approval. The original proposal by Gov. Leavitt and the National Governors' Association, for example, would have gone so far as to revive the ancient and despised use of "tax farmers" by channeling tax-collection information to private sector entities ("trusted third parties") for the purpose of analyzing tax liability and divvying up the proceeds of sales and use taxes among the states. It also would have imposed penalties on states that declined to "harmonize" their sales and use tax policies to minimize e-commerce leakage.

While the Governors' proposal is still evolving (the 'trusted third party' feature has been dropped, and a less coercive means of harmonization seems to be in the works), the issues it raises under the Constitution are very much alive. In interpreting the Compact Clause the Supreme Court has made it clear that 'substance over form' is the order of the day: the issue is not the degree of formality with which states enter into agreements, but "the essence and the substance of things … It would be but an evasion of the constitution to place the question upon the formality with which the agreement is made."[29] The Court has determined that the real issue under the Compact Clause is " ;the formation of any combination tending to the increase of political power in the States, which may encroach upon or interfere with the just supremacy of the United States."[30]
This 'political power' standard is a highly subjective one, and it may not be immediately obvious why this standard differs from federal control over interstate commerce under the Commerce Clause. The answer is that the Compact Clause pertains to much more than commercial relations across state lines; and that the very notion of agreements among the states raises issues of constitutional structure that the Commerce Clause ignores. In essence, the Compact Clause as interpreted by the courts goes to the fundamental question of states joining together to, ***de facto***, create a new political entity that is neither state nor federal in nature, but something in between. Such entities, when found, are prohibited when they intrude on the 'just supremacy' of the United States.

Applying the Compact Clause in the area of taxation is therefore a tricky matter, because the Constitution does not bar the states from any ***source*** of taxation except insofar as it interferes with interstate commerce (a tariff, for example), as we saw in our discussion of the Commerce Clause. In fact, the leading Supreme Court case on state taxation agreements, ***U.S. Steel Corp. v. Multistate Tax Commission***, 434 U.S. 452 (1978) found no Compact Clause bar to an agreement that helped determine and apportion state income tax liabilities for businesses with income-producing activity in multiple states, including (***inter alia***) apportionment formulas and auditing requirements enforced by the Commission. The Court concluded, in brief, that "Any State's ability to exact additional tax revenues from multistate businesses cannot be attributed to the Compact; it is the result of the State's freedom to select, within constitutional limits, the method it prefers."[31]

At face value the ***Multistate*** decision appears to validate the notion that states may join together to harmonize their tax policies, and even tax collection procedures such as audits, without congressional approval, notwithstanding the Compact Clause. That would be a hasty conclusion. First, the types of accords the Governors seem to be contemplating in the area of Internet taxation include such measures as common collection agents for the states; penalties on states that do not adopt certain types of harmonization legislation, such as definitions and audit rules that would apply uniformly to on-site, mail-order, or Internet sales; and surrendering their sovereign right to act unilaterally on such fundamental issues of tax administration as classifying products and deciding when and how to change their own laws concerning sales and use taxes (after all, you can't have 'harmony' and 'certainty' if states retain too much independence!).

No one can say for certain that some of the proposals for coordinating and regulating state tax policy concerning e-commerce would be found to violate the Compact Clause if adopted without congressional approval. We can and do say, however, that these proposals go directly to the issue of enhancing state power at the expense of the national government. This is exactly what the Compact Clause, according to the Supreme Court, was designed to address. Indeed, the issue of taxing the Internet has inspired states to argue that in order to protect their sovereignty, they have to surrender their sovereignty—but to some intermediate authority or coordinating system, not to the federal government. Knowing that Congress has historically resisted legislating solutions to state revenue collection problems, many of the Governors appear to be taking advantage of the emergence of e-commerce to effectively ' legislate' their own solutions, bypassing Congress altogether. If the Compact Clause has any bite at all, this is where it should come into play.

In addition, and in the realm of pure speculation, it can be argued that the ***Multistate*** case was wrongly decided and might come out differently today. In his dissent in that case Justice White made a strong argument that the

Court adopted the proper standard of looking to the impact of an agreement on federal-state power relations, but then failed to apply that standard accurately to the facts of the case. Justice White particularly cited the Multistate accord's audit enforcement powers and rules for apportioning income, concluding that "It is pure fantasy to suggest that 21 States could conceivably have arrived independently at identical regulations for apportioning income, reciprocal subpoena powers, and identical interstate audits of multinational corporations, in the absence of some agreement among them."[32] White dismissed the Court's finding that whatever the Multistate agreement provided, states could each have done on their own, pointing out that "it cannot be disputed that the action of over 20 States, speaking through a single, established authority, carries an influence far stronger than would 20 separate voices."[33]

Justice White's remains a minority view, but it is worth pointing out that the ***Multistate*** decision was handed down long before the advent of e-commerce, and without Congress having expressed its will as it has done in enacting ITFA. The message of ITFA clearly is that the federal government is occupying the field of e-commerce and Internet taxation for now, subject to the sovereign authority of states acting on matters within their borders. Any compact or agreement undertaken by the states (even if done without an express accord, since the Supreme Court is interested in substance, not form) would have to be more closely scrutinized under both the Commerce Clause ***and*** the Compact Clause in light of this unambiguous expression of congressional intent. As a matter of practical politics, the states will not be able to coordinate action effectively in this area without congressional acquiescence, unless they resort to the courts and succeed in breaking significant new ground in the field of constitutional jurisprudence.

Similar concerns apply under the Confederation Clause of Article I, Section 10, although here the issues are more cut-and-dried. While that Clause was invoked as an objection to the secession of the Confederate States, its linkage in Article I with the concept of "treaties" means that most constitutional jurisprudence under this section deals with limits on the power of states to delve independently into the realm of foreign relations. While a Confederation Clause objection against any state compact on Internet taxation may seem novel, it raises some very interesting questions. For example, in the emerging era of e-commerce, should we really be so concerned about alliances based on geography (which is what the Framers clearly were thinking of), or alliances and accords based on power and interest? The futurists among us predict not just an explosion of e-commerce, but an accelerating shift of social relations, interest group activities, political speech, entertainment, and even civic activity (cybervotes) to electronic 'space'. If that proves true, does a confederation barred by Article I Section 10 really have to be based on geography, as was the Confederate States of America?

Perhaps not. An Electronic Confederation can easily be envisioned, embracing the kinds of tax harmonization sought by many Governors, but also including common standards of privacy, censorship, residency, voting standards, welfare requirements, and much more, all geared to 'residents' of cyberspace who only incidentally are also geographical residents of the states who form the Confederation. This is no more an exercise in the imagination than the arguments of tax collectors and regulators who see cyberspace as a massive threat to their authority, a sort of Cayman Islands of the ether. After all, the same technological advantages available to private citizens are also available to all levels of government: if a group of states crafted a ' virtual secession' via the Internet, how would Washington stop them?

Whatever the future of the Confederation Clause as a regulator of state-to-state agreements, it is worth remembering that this Clause has one critical distinction from the Compact Clause: Congress cannot legislate out of it. Whereas compacts can always survive if approved by Congress, the Constitution gives Congress no power to 'approve' a Confederation, or an unauthorized treaty action by any state or states. Confederations are found by the courts only in extreme cases, but they are absolutely barred where found.

[Editor's Note: Footnotes unavailable. Please see http://www.ipi.org for more information]

Subj: Constitutionality - Nexus/Quill: Perspectives of IPI: Center for Technology Freedom

From: Bartlett Cleland <bcleland@ipi.org, (972) 874-5139> Institute for Policy Innovation

To: Internet Caucus Advisory Committee

The Nexus Debate

Issues surrounding taxing the Internet are not new; they are the same ones that have plagued catalogue sales for years. This year, about 15 billion catalogues will be delivered to people's homes. That works out to about 50 catalogues for every American. And consumers will spend an estimated $57 billion buying those products. Long before the Internet became the focus of discussion, interstate catalogue sales raised the same questions about sales taxes.

States and local communities see their inability to tax interstate sales as a loophole that costs them revenue, and they have gone to the courts in order to force companies to collect the tax for them.

In ***Quill Corp. v. North Dakota***, the U.S. Supreme Court ruled in 1992 that the Commerce Clause barred the states from requiring an out-of-state mail-order company to collect taxes on sales made to customers inside the state unless the company had a substantial presence (referred to as "nexus") within the state. Since Quill had no outlets or sales representatives or other significant presence within the state of North Dakota, it did not have to collect the tax.

Thus, while states have the right to collect taxes, that authority stops at their borders. However, the states are currently doing their best to change that fact. A number of groups including the National Governors' Association, National League of Cities, National Association of Counties, U.S. Conference of Mayors, National Conference of State Legislators, Council of State Governments and the International City/Council Management Association are backing a proposal that they claim would simplify state sales tax assessments and collections, making it easier to collect taxes on interstate mail-order or online purchases. If successful, the net effect of their proposal would be to bypass ***Quill***.

Subj: Constitutionality - Commerce Clause: Perspectives of IPI: Center for Technology Freedom
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To: Internet Caucus Advisory Committee

The Commerce Clause

Federal, state and local governments have the constitutional or statutory authority to collect taxes—such as sales and use taxes and taxes on business income—when people and businesses fall within the governmental body's jurisdiction. That includes traditional retail sales, catalogue sales and sales made over the Internet.

The rationale behind the current taxing system comes from the Commerce Clause. A customer living within the state's boundaries benefits from the highways, police and other public services funded by the sales tax. Therefore, the customer has an obligation to pay the tax. People living outside the state's boundaries are unlikely to benefit from that state's public services and so should not be obligated to pay the tax.

However, a number of caveats exist. If a customer buys a product subject to a sales tax in a retail store, the vendor collects the tax at the point of sale and passes it on to the state. If retail vendors take an order over the phone, they are supposed to charge that sales tax if the purchaser lives within the same state. If the customer lives in a different state, vendors do not collect a sales tax. However, unbeknown to most people, the customer may still be obligated to pay a "use" tax to his home state. But the fact is that almost no one does that; for that matter, almost no one knows they're supposed to.