



# Quick Study

A Policy Report Summary by the Institute for Policy Innovation

## New.Economy@Old.Constitution: Internet Taxes and the Constitution

A Summary of IPI Policy Report #153

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### I. The Battle Lines

No sooner was the Internet a reality than efforts to tax it began. However, Sen. Ron Wyden (D-OR) and Rep. Christopher Cox (R-CA) persuaded Congress to enact The Internet Tax Freedom Act of 1998 (ITFA), which contained a moratorium on new Internet taxation. The moratorium did not bestow any advantages on cyberspace businesses, but allowed for the imposition of state and local taxes on electronic business at a rate equal to that applied to phone and mail order companies.

More fundamentally, the Internet has revived the age-old struggle between those who support political diversity, decentralization and tax competition among the states and those who advocate political centralization and tax uniformity among the states.

#### **No Unconstitutional Taxes On The Internet**

Some of the most prominent proposals to tax the Internet are constitutionally suspect. Others treat the Internet *per se* as the tax base or target activities unique to the Internet. The largest category con-

sists of activities that may be conducted on the Internet but are not necessarily unique to the Internet.

Unconstitutional taxes could only be levied if the Constitution were amended, the Court reversed an earlier relevant opinion or Congress overturned the Court. All of the taxes in this category are state taxes. The National Governors' Association (NGA) plan that encourages the states to adopt a uniform sales tax system on all forms of retail commerce should be considered unconstitutional.

#### **No New Taxes On The Internet, Constitutional Or Not**

Productivity, and along with it tax revenues, has surged since the introduction of the Internet. The federal government expects budget surpluses of \$3.152 trillion over the next 10 years. Combined state and local revenues as a share of GDP hit an all-time high of 11 percent in 1995 and remain near that point today at more than 10.7 percent. A recent CATO Institute study showed that state sales tax revenues grew at nearly twice the rate of inflation between 1992 and 1998, and they grew at an even

faster pace last year: 7.3 percent in the last quarter of 1999, over the same period in 1998.

Ernst & Young estimates that the amount of sales and use taxes not collected in 1998 due to remote Internet sales is \$170 million — one-tenth of 1 percent of total state and local sales and use tax collections. Eighty percent of transactions conducted online are business-to-business sales, which are either non-taxable or paid directly by in-state business purchasers, and most of the business-to-consumer transactions are non-taxable securities and information services, or airline tickets for which applicable taxes are in fact collected. As economist Austan Goolsbee has found, more aggressive tax collection efforts will most likely offset any additional sales tax revenue.

Utah Governor Michael Leavitt, speaking on behalf of the NGA, acknowledged that uncollected taxes from Internet sales currently pose no fiscal problem. The governors' concern is that as e-commerce expands, uncollected taxes will increase. Governor Leavitt himself admits that, "The success-

The Internet Taxation Debate				
TAX LEVIED ON	FEDERAL GOVERNMENT TAXES		STATE GOVERNMENT TAXES	
	Constitutional	Unconstitutional	Constitutional	Unconstitutional
Internet Per Se	<ul style="list-style-type: none"> <li>● Web Site Excise Tax<sup>1</sup></li> <li>● Byte Tax<sup>1</sup></li> <li>● Bandwidth Tax<sup>1</sup></li> <li>● Internet License Fees<sup>1</sup></li> </ul>		<ul style="list-style-type: none"> <li>● Web Site Excise Tax<sup>1, 2</sup></li> <li>● Byte Tax<sup>1, 2</sup></li> <li>● Bandwidth Tax<sup>1, 2</sup></li> </ul>	<ul style="list-style-type: none"> <li>● Tax Levied By: Unauthorized Interstate Compact; or ii. State Confederacy</li> </ul>
Activities Unique to Internet	<ul style="list-style-type: none"> <li>● Internet Access Fees<sup>1</sup></li> <li>● E-mail Excise Tax<sup>1</sup></li> <li>● E-commerce Transactions Tax<sup>1</sup></li> </ul>		<ul style="list-style-type: none"> <li>● Internet Access Fees<sup>1, 2</sup></li> <li>● E-mail Excise Tax<sup>1, 2</sup></li> <li>● E-commerce Transactions Tax<sup>1, 2</sup></li> </ul>	<ul style="list-style-type: none"> <li>● Tax Levied By: Unauthorized Interstate Compact or ii. State Confederacy</li> </ul>
Retail Sales & Use	<ul style="list-style-type: none"> <li>● Sales, Use and Excise Taxes Collected Directly From Consumer</li> <li>● Mandated Collection of Sales and use Taxes by Internet Companies</li> </ul>		<ul style="list-style-type: none"> <li>● Sales, Use and Excise Taxes on Internet Sales Collected Directly From Consumer</li> <li>● Mandated Collection of Sales and Use Taxes by Internet Companies w. Nexus</li> </ul>	<ul style="list-style-type: none"> <li>● Mandated Collection of Sales and Use Taxes by Internet Companies w/o Nexus</li> </ul>
Income, Payroll, Real Property & Universal Business Activities	<ul style="list-style-type: none"> <li>● Corporate Income and Payroll Taxes Levied On Internet Companies</li> <li>● Income and Payroll Taxes On Wages &amp; Salaries Earned from Internet Companies</li> <li>● Property Taxes Levied on Internet Companies</li> <li>● Business and License Fees</li> <li>● Unemployment and Workers Compensation</li> <li>● Taxes Collected From Internet Companies</li> </ul>		<ul style="list-style-type: none"> <li>● Corporate Income and Payroll Taxes Levied on Internet Companies w. Nexus</li> <li>● Income and Payroll Taxes on Wages &amp; Salaries Earned from Internet Companies w. Nexus</li> <li>● Property Taxes Levied on Internet Companies w.Nexus</li> <li>● Business and License Fees Levied On Internet Companies w. Nexus</li> <li>● Unemployment and Workers Compensation</li> <li>● Taxes Collected From Internet Companies w. Nexus</li> </ul>	<ul style="list-style-type: none"> <li>● Corporate Income and Payroll Taxes Levied on Internet Companies w/o Nexus</li> <li>● Income and Payroll Taxes On Wages &amp; Salaries Earned from Internet Companies w/o Nexus</li> <li>● Property Taxes Levied on Internet Companies w/o Nexus</li> <li>● Business and License Fees Levied on Internet Companies w/o Nexus</li> <li>● Unemployment and Workers Compensation</li> <li>● Taxes Collected From Internet Companies w/o Nexus</li> </ul>

☐ Constitutional and economically defensible

■ May be constitutional but raise serious issues of both law and economic prudence.

■ Unconstitutional

1 Tax currently prohibited by the Internet Tax Moratorium

2 Tax may be constitutionally suspect

ful retailer of the future will have a retail presence, a catalogue presence and an Internet presence.” For instance, Amazon.com recently established six distribution centers throughout the country giving it nexus in seven states. The very retail-presence/store-front-locations that Governor Leavitt foresees will create nexus and solve the problem about which the NGA is concerned.

Governor Leavitt also overstates a problem he depicts as a “campaign to prohibit state and local governments from creating tax systems in their own communi-

ties.” The only effort that approaches this description is a single, isolated bill introduced by Sen. McCain and Rep. Kasich which would preempt states from collecting sales or use taxes on Internet sales *within* the state.

## II. The Constitutional Underpinnings

### Due Process

Due process for state taxation means the taxpayer must have some sort of physical presence in a state to be subject to its taxing authority. In *Quill Corp. v. North Dakota ex rel. Heitkamp* (1992), the Court ruled that while due

process required nothing more than certain minimum contacts with a state, the Commerce Clause imposes a more stringent standard for purposes of taxation.

Key due process considerations have been raised by laws in North Carolina and Michigan that require residents to report their “use tax liability” on state income tax forms. Residents could end up paying tax on “use” of items purchased from concerns that have no constitutional nexus with the state.

### Commerce Clause

There is substantial reason to believe that Governor Leavitt and

his allies are using the e-commerce issue to attempt to change or clarify the Supreme Court's Commerce Clause rulings on what constitutes "nexus." If commerce evolves in such a way that it is difficult to prove a "nexus" or physical presence in most states, states will need federal backing for any substantive redefinition (not to mention the ability to withstand a court challenge).

### **The Interstices of Federalism**

States can coordinate policy 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...."

The Supreme Court has allowed states to collaborate in the exchange of crime records, regional transportation agreements, coordination of health warnings or quarantines, etc. The NGA proposal contemplates the surrender of the states' sovereign right to decide when and how to change their own laws concerning sales and use taxes. No one can say for certain that the scheme would violate the Compact Clause, but it directly enhances state power at the expense of the national government. The message of ITFA is that the federal government is occupying the field of e-commerce and Internet taxation for now.

While a Confederation Clause objection may seem novel, it raises some interesting questions. 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, and much more, all geared to "residents" of cyberspace who only incidentally are also geographical residents of the states that form the Confederation. If a group of states crafted a "virtual secession" via the Internet, how would Washington stop them?

### **Electronic Space: Where Is It?**

The only real concern that is properly the province of the states is the possibility of electronic transactions being conducted between companies with proper nexus to a state and residents of the same state. It is hard to see why this particular problem justifies constitutionally questionable compacts among states.

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## **III. Practical Federalism For The 21st Century**

The original NGA plan was sold on the basis that it protected fundamental principles of federalism. In fact it is rational planning *par excellence*, and, as former Tax Reform Commission Chairman Jack Kemp said, "the very antithesis of American federalism."

### **The Problem of Collusion**

All governments want to collect taxes as painlessly as possible. But the NGA scheme is not federalism: it is a new creature, whereby states, facing obstacles to collection actions for practical reasons or due to implicit constraints on their power, join together (with or without assistance from Washington) in order to siphon revenue from legitimate tax-paying enterprises. The irony is that this "collusive federalism" has arisen during the same period that there has been a revival of political rhetoric (frequently from the same colluding politicians) aimed at alleged collusive, preda-

tory, anti-competitive, or fraudulent behavior on the part of the *private* sector.

### **A World of Choice**

The emergence of electronic retailing gives savvy states a unique opportunity to rethink not just their tax systems, but their mission in a 21st Century economy. In the state of Virginia alone, Republicans and Democrats alike have introduced bills repealing the state's 4.5percent sales tax, on the grounds that it works against traditional vendors who are competing against cyber-merchants. Lawmakers in Virginia (over half of all cybertraffic crosses the state's borders) have concluded that the sales tax may not deserve to survive the Internet Age. Virginia's coffers are overflowing with income tax revenues, producing a large surplus (estimated at \$2.4 billion this year) largely driven by growing payrolls at America Online and other Virginia-based Internet companies.

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## **A Few Pointers**

**No Rush to Judgment.** If radical remedies are ever needed, state and local tax enforcers should rethink the way they tax from the bottom up, rather than tamper with legal rights and institutional relationships that have served the nation well for over two centuries.

**No Taxation without Representation.** The original NGA plan clearly goes beyond the bounds in this regard. The same objection can legitimately be made to various hybrid proposals supported by the business community and by ACEC members otherwise sympathetic to low taxation.

**No New (Net) Taxes.** The ITFA moratorium on "new" Internet taxes should be made permanent.

This does nothing to undermine state enforcement of sales and use taxes where there is a constitutional nexus. A congressional commitment is needed to ensure that *any* new revenue sources or enforcement actions geared to the Internet impose *no net increase in the tax burden*.

**Balance of Power.** The interests of the taxpayer are best served by continuing tension between the states and the federal government. Taxpayer vigilance will be vitally important in e-commerce as in any other tax issue.

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### Epilogue: A New Tax Paradigm

For years, supply-siders and others have complained about static concepts of revenue generation in which tax policy and tax rates are assumed to have little or no impact on actual economic activities. Consider why public officials complain about the Internet destroying their revenue base at a time when they have more revenue than they need.

If the Internet expands as many predict, state sales taxes may indeed become obsolete unless either 1) levied and collected at the point of origin, i.e. in the “seller state”; or 2) made nationally uni-

form to facilitate collection at the point of purchase. One reason the “rational administrators” have been reluctant to embrace lower tax rates is because they believe that they, as experts, are responsible for protecting a seamless revenue system, with themselves as the arbiters of fairness.

We don’t know yet where the output-maximizing point for Internet commerce may lie, but for once we have a chance to let the market determine that without political interference. That the Internet’s economic dynamism is cranking out income, payroll, and even sales tax revenues for all levels of government — even if (or because?) there may be some inherent slippage in collections — is undisputed. Let’s let the Internet work its magic in creating jobs, revenues, and new markets before we try to throttle it with obsolete 20th Century theories of taxation.



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