

THE HONEYMOON'S OVER: STATES CRACK  
DOWN ON THE VIRTUAL WORLD'S TAX-FREE  
LOVE AFFAIR WITH E-COMMERCE

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## I. INTRODUCTION

“[T]he Internet . . . will make it more difficult for government to collect taxes.”<sup>1</sup>

- *Nobel Prize-winning economist Milton Friedman, 2000*

The advent of the Internet<sup>2</sup> in the past decade brought with it waves of economic and legal uncertainty, with some people likening Internet ramifications to the extensive changes experienced during the Industrial Revolution.<sup>3</sup> With the Internet revolution,<sup>4</sup> consumers connected to the World Wide Web<sup>5</sup> and states found themselves the victims of the cyberspace frontier,<sup>6</sup> that Wild West of the twenty-first century where legal rules of the offline world are often broken with impunity.<sup>7</sup> As millions of users signed on to do their shopping and business,

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(This Comment received the Chamberlain, Hrdlicka, White, Williams & Martin writing award for Distinguished Paper in Taxation).

1. *Commanding Heights: The Battle for the World Economy: Milton Friedman* (PBS television broadcast Oct. 1, 2000) (transcript at [http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int\\_miltonfriedman.html](http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int_miltonfriedman.html) (last visited Mar. 18, 2007)) (commenting on how he believes the Internet will affect economics and politics).

2. The Internet Tax Freedom Act defines “Internet” as “collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.” Pub. L. No. 105-277, § 1101(e)(3)(C), 112 Stat. 2681-719, -720 (1998).

3. Steven Levy, *Bill and Al Get It Right*, NEWSWEEK, July 7, 1997, at 80 (“[T]he world is poised on the cusp of an economic and cultural shift as dramatic as that of the Industrial Revolution. (OK, it doesn’t take a genius, or even a politician, to figure out that big changes are afoot when we have a medium that lets someone throw up a virtual storefront on the Web and instantly gain access to the global market.)”).

4. Brian Fagan, *Taxation of Electronic Commerce: Avoiding an Inroad upon Federalism*, 49 DRAKE L. REV. 465, 465 (2001) (describing the Internet revolution as an “explosion of electronic commerce [that] fundamentally changed our economy and behavior”).

5. See Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 430 (1997) [hereinafter *State Taxation of Electronic Commerce*] (describing the World Wide Web).

6. See DONALD BRUCE & WILLIAM F. FOX, UNIV. OF TENNESSEE CTR. FOR BUS. & ECON. RESEARCH, STATE AND LOCAL SALES TAX REVENUE LOSSES FROM E-COMMERCE: ESTIMATES AS OF JULY 2004 1-2 (2004) (noting that “revenue erosion from e-commerce continues to represent a significant loss to state and local governments”).

7. See generally Jeffrey P. Cunard & Jennifer B. Coplan, *Internet and E-Commerce: A Summary of Legal Developments*, in COMMUNICATIONS LAW 2002, at 168-209 (PLI Pats., Copyrights, Trademarks and Literary Prop. Course, Handbook Series No. G0-00UG, 2002), WL 727 PLI/Pat 159 (discussing a wide variety of legal topics including major copyright issues that have arisen with the growth of the Internet including the Digital Millennium Copyright Act as well as Napster’s peer to peer file sharing and similar cases). Cunard and Coplan’s article also includes a section discussing taxation of “Internet-based electronic commerce [which] raises a host of domestic and international tax issues.” *Id.* at 343-45.

states lost millions in tax revenues.<sup>8</sup>

In 2003, electronic commerce (“e-commerce”)<sup>9</sup> retail sales totaled more than \$56 billion in America alone.<sup>10</sup> In 2006, Internet sales increased to \$102.1 billion, continuing the steady rise in national spending on the Internet.<sup>11</sup> The National Conference of State Legislatures estimated states lose up to \$8.9 billion a year from uncollected sales and use taxes<sup>12</sup> on e-commerce transactions.<sup>13</sup> The volume of e-commerce sales and

8. See Deb Price, *States Fight Tax-Free Web; At Stake for Michigan: \$400 Million in Sales Tax; But E-Retailers Vow to Keep Their Advantage*, DETROIT NEWS, Mar. 21, 2000, at 1A. Two professors at the University of Tennessee estimated that by 2003, California would stand to lose the most in sales tax in cyberspace—anywhere from \$1.1-1.67 billion. BRUCE & FOX, *supra* note 6, at 7. Texas was estimated to be second, predicted to lose from \$748 to \$778 million in sales tax. *Id.*

9. The Internet Tax Freedom Act defines “e-commerce” as “any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access.” Pub. L. No. 105-277, § 1104(3), 112 Stat. 2681-719, -725 (1998). The United States Government Electronic Policy website provided a broader definition of “e-commerce”:

[A]ll forms of commercial transactions involving organizations and individuals that are based upon the processing and transmission of digitized data, including text, sound, and visual images. It also refers to the effects that the electronic exchange of commercial information may have on the institutions and processes that support and govern commercial activities. These include organizational management, commercial negotiations and contracts, legal and regulatory frameworks, financial settlement agreements, and taxation, among many others.

Fagan, *supra* note 4, at 467 (alteration in original); see also *State Taxation of Electronic Commerce*, *supra* note 5, at 430-31 (discussing examples of “electronic commerce”).

10. U.S. DEPT OF COMMERCE, U.S. CENSUS BUREAU, E-STATS 4 (2005), available at <http://www.census.gov/eos/www/papers/2003/2003finaltext.pdf>. The annual report from the U.S. Census Bureau shows a twenty-five percent increase in “retail e-sales” from 2002, which posted \$45 billion in “e-sales.” *Id.* The report estimated the “e-sales” for 2004 at \$69 billion. *Id.* The Census Bureau defines “e-commerce sales” as “sales of goods and services where an order is placed by the buyer or price and terms of sale are negotiated over the Internet, an extranet, Electronic Data Interchange (EDI) network, or other online system. Payment may or may not be made online.” U.S. CENSUS BUREAU, E-COMMERCE: FREQUENTLY ASKED QUESTIONS (FAQS), <http://www.census.gov/mrts/www/efaq.html> (last visited Mar. 18, 2007).

11. Keisha Lamothe, *Online Retail Spending Surges in 2006: ComScore Networks Says Holiday Season Helped Spending Increase Over the \$100 Billion Threshold*, CNNMoney.com, Jan. 4, 2007, [http://money.cnn.com/2007/01/04/news/economy/online\\_sales/?postversion=2007010410](http://money.cnn.com/2007/01/04/news/economy/online_sales/?postversion=2007010410).

12. Sales tax is composed of two different taxes, sales tax and use tax: “In general, ‘sales tax’ is paid on in-state purchases while ‘use tax’ is paid on out-of-state purchases.” John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 420 n.5 (2002). For a general overview of sales and use taxes, see *infra* Part II.

13. Mike Glover, *States Hope to Begin Taxing Online Sales*, USA TODAY, Oct. 4, 2005, available at [http://www.usatoday.com/tech/news/techpolicy/2005-10-04-online-taxes-states\\_x.htm](http://www.usatoday.com/tech/news/techpolicy/2005-10-04-online-taxes-states_x.htm); see, e.g., JONATHAN D. ROBBINS, ADVISING EBUSINESSES § 10-1.20 (2006) (estimating that populous states like New York and California lose nearly \$1-1.5 billion in revenue due to online sales); Bryan Johnson, *Sales Tax Bill Could Make Your Online*

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the amount states stand to lose in tax revenues will only continue to grow as the Internet sales market finds more patrons. The contention between state taxation powers and states' limited constitutional authority to tax Internet sales is "[o]ne of the greatest controversies in the field of state taxation today."<sup>14</sup>

However, the once ubiquitous belief that online transactions were untouchable by the taxing arms of the state is no longer true.<sup>15</sup> States are strengthening efforts to assert their tax rights on Internet sales, and the future of e-commerce may inevitably result in more taxation.<sup>16</sup> This article attempts to present an overview of state taxation of e-commerce and Internet retailers. A general understanding will allow businesses to develop and plan their e-commerce transactions in anticipation of the potential tax ramifications. While some large companies are being targeted in the states' battle for sales and use taxes,<sup>17</sup> smaller vendors may soon become the next victims. As states and local tax jurisdictions continue to fight for a piece of the tax pie, small vendors may face unprecedented pressure from multiple tax jurisdictions to collect sales and use taxes for Internet sales transactions.

This overview aims to give these companies a basic foundation for understanding the history and complex and uncertain future of e-commerce and Internet sales and use taxes.

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*Purchases Cost More*, KOMOTV.com, Jan. 2, 2007, <http://www.komotv.com/news/5066631.html> (noting that the state of Washington is estimated to lose "\$607 million in potential remote sales tax dollars" in 2007); Joe Morris, *Making the Internet Pay*, CHARLESTON GAZETTE, Dec. 31, 2006, at P1C, available at <http://wvgazette.com/section/Business/2006123013> (estimating that West Virginia loses approximately \$100 million in Internet sales tax revenue yearly).

14. Bradley W. Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 VA. TAX REV. 109, 109 (2004) (citing to a "small sample of the academic discussion" on the issue); see also STEVEN MAGUIRE & NONNA A. NOTO, CONGRESSIONAL RESEARCH SERVICE, INTERNET TAXATION: ISSUES AND LEGISLATION IN THE 109TH CONGRESS 6-11 (2006) [hereinafter INTERNET TAXATION IN THE 109TH CONGRESS] (discussing generally the issues involved).

15. ROBBINS, *supra* note 13, § 10.3-20 (providing examples of states' "increasingly aggressive" attempts to collect sales and use taxes from online businesses); see also Brian Krebs, *Illinois Sues Web Merchants for Taxes*, Technews.com, available at 2003 WLNR 13007801 [hereinafter *Illinois Sues Web Merchants*].

16. Cf. discussion *infra* Part IV.B (exploring the Streamlined Sales Tax Project); see also NAT'L CONFERENCE OF STATE LEGISLATURES, STATE ACTION ON LEGISLATION TO COMPLY WITH THE STREAMLINED SALES AND USE TAX INTERSTATE AGREEMENT (last updated Mar. 30, 2006), <http://www.streamlinedsalestax.org/ssutachart2.pdf>. Also, the governments of North Carolina and South Dakota have begun purchasing "goods and services only from companies that collect sales tax on all sales in the state." New Rules Project - Retail - Internet Sales Tax Fairness, <http://www.newrules.org/retail/inttax2.html> (last visited Mar. 18, 2007) [hereinafter New Rules Project].

17. See, e.g., *Illinois Sues Web Merchants*, *supra* note 15.

Part II provides an overview of sales and use taxes. Part III traces the history of interstate commerce and the precedents that laid the foundation for taxation (or lack thereof) of e-commerce. Part IV looks at the responses of retailers and Congress to e-commerce at the beginning of the millennium. Finally, Part V examines new efforts by the state governments to break down the tax-free realm of e-commerce.

## II. STATE SALES AND USE TAXES: AN OVERVIEW

Today, forty-five states, the District of Columbia, and numerous local jurisdictions levy sales and use taxes.<sup>18</sup> These state and local governments rely on sales and use taxes to contribute approximately a quarter of their total tax revenue.<sup>19</sup>

A sales tax is levied by the taxing jurisdiction on the sale or lease of goods and services.<sup>20</sup> There generally is no difficulty collecting sales tax from an in-state seller.<sup>21</sup> Vendors simply collect the tax from the purchaser at the time of sale and remit the collected tax to the jurisdiction on their monthly sales tax reports.<sup>22</sup>

Complementary to a jurisdiction's sales tax is the use tax, which is levied on the "use or consumption of goods or services purchased outside the taxing jurisdiction for use within the taxing jurisdiction."<sup>23</sup> Therefore, unlike the sales tax for which in-state vendors are held accountable for collecting, a use tax generally depends on self-reporting by the ultimate consumer<sup>24</sup> unless the out-of-state or remote seller has the requisite "substantial nexus"<sup>25</sup> to require the tax collection.<sup>26</sup>

18. See ADVISORY COMM'N ON ELECTRONIC COMMERCE, REPORT TO CONGRESS 17, 72 (2000), available at [http://www.ecommercecommission.org/acec\\_report.pdf](http://www.ecommercecommission.org/acec_report.pdf).

19. *Id.* at 17-18. A unit of the U.S. Department of Commerce reported that states and local governments collected nearly \$237 billion in sales and use taxes in 1999. *Id.* at 18.

20. *Id.* at 49.

21. Swain, *supra* note 12, at 420 n.5.

22. ADVISORY COMM'N ON ELECTRONIC COMMERCE, *supra* note 18, at 49.

23. *Id.*

24. Swain, *supra* note 12, at 420 n.5; Gary Cornia et al., *Sales and Use Tax Simplification and Voluntary Compliance*, PUB. BUDGETING & FIN., 1-2 (2004), available at <http://www.blackwell-synergy.com/links/doi/10.1111/j.0275-1100.2004.02401001.x/enhancedabs> (under heading "This Article" click "Full Text PDF").

25. *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992). The Court in *Quill* created the "substantial nexus" requirement as a means to test a jurisdiction's right to tax interstate commerce under the Commerce Clause. See *id.* A company must have "minimum contacts" as well as a "substantial nexus" with the state to make the tax constitutional. See *id.* The Court did not explicitly state what activities would create a "substantial nexus." See *id.* For more discussion on "substantial nexus" see *infra* Part III.B.3.

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The use tax is where much of the Internet tax problem arises because consumers, the ones purchasing via the Internet, are responsible for paying the use tax to their state of residence, and most people generally do not even know they must report such taxes.<sup>27</sup> In addition, it is often too administratively difficult and costly for states to track consumers' online purchases and enforce the use tax against them.<sup>28</sup> Thus, the most effective way for state and local governments to enforce use taxes is for Internet retailers to collect the taxes on online purchases and remit them in the same manner as sales taxes.<sup>29</sup> Constitutionally, state and local governments usually lack jurisdiction to tax Internet retailers because these remote sellers usually have physical presence in only one state and no "substantial nexus"<sup>30</sup> with any other taxing jurisdictions.<sup>31</sup>

To illustrate, suppose a Texas resident purchases a widget from RemoteSeller.com, an Internet-based company incorporated and headquartered in Vermont that only takes orders through its website. The widget is a good purchased outside of Texas's taxing jurisdiction for use within the jurisdiction, so it should be subject to a use tax. However, it is unlikely that the Texas resident knows about the use tax or will voluntarily remit it to the state of Texas. The easiest way for Texas to collect the use tax is to have RemoteSeller.com collect the tax at the time of purchase, in similar fashion to sales tax collection on in-state purchases. But RemoteSeller.com has no substantial nexus or physical presence in Texas. It does not have property or agents working for it in the state. Furthermore, it delivers all customer orders via common carriers. Under the ruling in *Quill Corp. v. North Dakota*, Texas cannot require RemoteSeller.com to collect the use tax.<sup>32</sup> Because neither the seller nor the purchaser remits the tax to the state, the Internet purchase of the widget escapes taxation. In this fashion, "most online sales remain untaxed and states lose billions of dollars in tax revenue because they cannot require remote sellers lacking physical presence to

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26. Swain, *supra* note 12, at 420 n.5.

27. Ryan J. Swartz, *The Imposition of Sales and Use Taxes on E-Commerce: A Taxing Dilemma for States and Remote Sellers*, 2 J. HIGH TECH. L. 143, 144 (2003).

28. *Id.*; see also New Rules Project, *supra* note 16.

29. See Swartz, *supra* note 27, at 144.

30. See *Quill Corp.*, 504 U.S. at 313.

31. Swartz, *supra* note 27, at 144.

32. See *Quill Corp.*, 504 U.S. at 311 (affirming *Bellas Hess* and requiring more than contact by common carrier to establish a "substantial nexus." Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753 (1967), *overruled in part by* 504 U.S. 753 (1992)).

collect and remit use taxes.”<sup>33</sup>

### III. BACKGROUND

#### A. *Tracing E-Commerce Sales to the Constitution’s Regulation of Interstate Commerce*

For years, states have attempted to tap into the lucrative e-commerce market to no avail.<sup>34</sup> Because many Internet businesses exist solely in cyberspace, incorporate in only one state, and sell their products nationwide, their sales transactions fall within the realm of interstate commerce.<sup>35</sup> Internet retailers find their protection laid out in the Constitution’s Due Process<sup>36</sup> and Commerce Clauses.<sup>37</sup>

The Due Process clauses set out in both the Fifth and Fourteenth Amendments afford citizens fairness and prevent them from being deprived of “life, liberty, or property, without due process of law.”<sup>38</sup> The Supreme Court has extended this to mean that citizens cannot be unfairly taxed, and thus deprived of their tax dollars.<sup>39</sup> Satisfaction of the clauses requires proof of minimum contacts between the seller and state.<sup>40</sup>

The Commerce Clause enables Congress to regulate most e-commerce transactions because they fall under the auspices of interstate commerce.<sup>41</sup> The Supreme Court has ruled that the Commerce Clause requires a “substantial nexus” with, or physical presence in, the taxing state be established before a state can tax a seller.<sup>42</sup> This is “to ensure that state taxation

33. *Id.*

34. *See, e.g.,* *Wabash Power Equip. Co. v. Lindsey*, 897 So. 2d 621, 626 (La. Ct. App. 2004) (“[T]he Commerce Clause[] authorizes Congress to regulate commerce among the several states. Despite this express grant of power to Congress, the United States Supreme Court has consistently held this language contains a further negative command, known as the [D]ormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject.”).

35. *See* STEVEN MAGUIRE, *STATE AND LOCAL SALES AND USE TAXES AND INTERNET COMMERCE 1* (2005) [hereinafter *STATE AND LOCAL SALES AND USE TAXES*].

36. U.S. CONST. amend. V; *id.* amend. XIV, § 1.

37. *Id.* art. I, § 8, cl. 3.

38. *Id.* amend. V; *id.* amend. XIV, § 1.

39. *See* Sidney S. Silhan, *Fresh Looks: If It Ain’t Broke Don’t Fix It: An Argument for the Codification of the Quill Standard for Taxing Internet Commerce*, 76 CHI.-KENT L. REV. 671, 679 (2000).

40. *Id.*; *see generally* *State Taxation of Electronic Commerce*, *supra* note 5, at 435 n.26 (providing examples of minimum contacts).

41. *STATE AND LOCAL SALES AND USE TAXES*, *supra* note 35, at 1; *see* U.S. CONST. art. I, § 8.

42. *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992) (citing *Complete Auto*

does not unduly burden interstate commerce.”<sup>43</sup> Thus, an out-of-state seller like an e-retailer “whose only contacts with the taxing State are by mail or common carrier lacks the ‘substantial nexus’ required by the Commerce Clause.”<sup>44</sup>

### B. *E-Commerce’s Forerunner: The Mail-Order Catalogues*

These Constitutional requirements for interstate commerce are backed by Supreme Court rulings from the past century.<sup>45</sup> The mail-order catalogue, the predecessor of e-commerce, was involved in the same interstate commerce tax predicament with the states between the 1960s and early 1990s.<sup>46</sup>

#### 1. *Scripto, Inc. v. Carson*<sup>47</sup>

One of the earliest cases on which the Court ruled involved a suit between the state of Florida and Scripto, Inc. (“Scripto”), a Georgia corporation based in Atlanta.<sup>48</sup> Florida wanted to collect \$5,150.66 in use taxes from Scripto.<sup>49</sup> Scripto did not have any premises, employees, or bank accounts in the state of Florida, but it regularly sold mechanical writing instruments to Florida businesses and residents.<sup>50</sup> It collected orders from Florida residents through contracted middlemen, “wholesalers or jobbers,” who resided in the state.<sup>51</sup> The Court held that the activities between Scripto and its middlemen in Florida satisfied the minimum connection needed to prove the link between a state and the thing it seeks to tax.<sup>52</sup>

#### 2. *National Bellas Hess, Inc. v. Department of Revenue of Illinois*<sup>53</sup>

Although *Scripto* proved to be an initial stumbling block for the mail-order catalogue, less than a decade later the Supreme

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Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977)).

43. *Id.* at 313.

44. *Id.* at 311.

45. *See, e.g., id.*

46. *See id.* at 301; Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill., 386 U.S. 753 (1967), *overruled in part* by 504 U.S. 753 (1992); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); discussion *infra* Part III.B.1-3.

47. 362 U.S. 207 (1960).

48. *Id.* at 207-08.

49. *Id.* at 208.

50. *Id.* at 208-09.

51. *Id.* at 209.

52. *Id.* at 210-11.

53. 386 U.S. 753 (1967), *overruled in part* by 504 U.S. 753 (1992).

Court ruled in favor of the mail-order catalogue seller.<sup>54</sup> National Bellas Hess, Inc. (“Bellas Hess”) was incorporated in Delaware with its principal place of business in Missouri, but it operated a mail-order catalogue and sold to customers nationwide.<sup>55</sup> Its contacts with customers in other states (catalogue advertisements and order shipments) were solely through the United States mail or common carriers.<sup>56</sup> It had no offices, employees, or agents in the state, unlike the situation in *Scripto*.<sup>57</sup>

Bellas Hess mailed catalogues to customers in Illinois twice each year and accrued sales of \$2,174,744 in that state during the fifteen-month period at issue.<sup>58</sup> An Illinois statute imposed use taxes on businesses that solicited orders within the state through catalogues, under which Illinois attempted to collect taxes on Bellas Hess’s Illinois sales.<sup>59</sup> Bellas Hess argued the statute “violate[d] the Due Process Clause of the Fourteenth Amendment and created an unconstitutional burden upon interstate commerce.”<sup>60</sup>

The Court found the two claims were “closely related” and considered both the Due Process and Commerce Clause issues together.<sup>61</sup> Concerned that upholding the Illinois statute would open the doors to indiscriminate taxation of interstate commerce at all levels of government,<sup>62</sup> the Court ruled that Bellas Hess’s sole contact with Illinois through the United States mail, a common carrier, was not a sufficient minimum connection to satisfy either the Due Process or Commerce Clause.<sup>63</sup>

*National Bellas Hess* was the first time the Court considered the Due Process and Commerce Clauses together to determine whether an out-of-state seller could be taxed.<sup>64</sup> The Due Process Clause requisite was the Court’s attempt at creating fair taxation by requiring “some definite link” between an out-of-state seller and the state which was attempting to collect taxes.<sup>65</sup> The Due

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54. *See id.*

55. *Id.* at 753-54.

56. *Id.* at 754-55.

57. *Id.* at 754; *see also* *Scripto, Inc. v. Carson*, 362 U.S. 207, 208-09 (1960).

58. *Nat’l Bellas Hess*, 386 U.S. at 761.

59. *Id.* at 754-55.

60. *Id.* at 756.

61. *Id.*

62. *Id.* at 759. “The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.” *Id.* at 760.

63. *See id.* at 758.

64. Silhan, *supra* note 39, at 681.

65. *Nat’l Bellas Hess*, 386 U.S. at 756.

Process Clause, together with the Commerce Clause, required at least some kind of physical presence in the state for taxation to be fair.<sup>66</sup> It is important to note that the Court in *National Bellas Hess* did not examine the Due Process and Commerce Clause issues separately, but instead reserved such analysis for a similar case two decades later.

### 3. *Quill Corp. v. North Dakota*<sup>67</sup>

Twenty-five years later, the Supreme Court reworked the *National Bellas Hess* test in *Quill Corp. v. North Dakota*, a case with facts similar to *National Bellas Hess*.<sup>68</sup> Quill was a Delaware company with offices and property in Illinois, California, and Georgia.<sup>69</sup> It sold office supplies and equipment nationwide through mail-order sales,<sup>70</sup> including approximately \$1 million in such sales to customers in North Dakota.<sup>71</sup> North Dakota sued to impose its use tax on Quill even though the corporation had no physical presence within the state.<sup>72</sup>

In its ruling for Quill, the Supreme Court distinguished the Due Process and Commerce Clause analyses for the first time.<sup>73</sup> Declaring that the nexus requirements for both are “not identical” and are “animated by different constitutional concerns and policies,” the Court created two separate tests.<sup>74</sup> It backed away from its “physical presence” requisite for the Due Process Clause, and instead determined that Due Process was concerned with “fundamental fairness,” with “‘notice’ or ‘fair warning’ as the ‘analytic touchstone’ of [the] due process nexus analysis.”<sup>75</sup> Ultimately this takes the Due Process test back to requisite minimum contacts that provide a “definite link” between the state and seller.<sup>76</sup>

The “substantial nexus” analysis became the Court’s test for the Commerce Clause.<sup>77</sup> The substantial nexus was not “a proxy

66. *See id.* at 756-59.

67. 504 U.S. 298 (1992).

68. *Id.* at 301.

69. *Id.* at 302.

70. *Id.*

71. *Id.*

72. *Id.* at 302-03.

73. *See id.* at 305 (recognizing that although the Supreme Court has “not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct”).

74. *Id.* at 312-13.

75. *Id.* at 312; *see also* Swain, *supra* note 12, at 431.

76. *Quill Corp.*, 504 U.S. at 306-07.

77. *See id.* at 315 n.8.

for notice, but rather a means for limiting state burdens on interstate commerce.”<sup>78</sup> “Physical presence” has been interpreted as satisfying the Court’s substantial nexus test as set forth in *Quill*.<sup>79</sup> But it should be noted that the Court expressed concern that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.”<sup>80</sup> To clarify its ruling for future cases, the Court said an out-of-state seller “whose only contacts with the taxing State are by mail or common carrier lacks the ‘substantial nexus’ required by the Commerce Clause.”<sup>81</sup>

#### 4. Post-*Quill*

The Court’s attempt to set a clear-cut rule for taxation of out-of-state retailers has not been without problems. Since the 1992 *Quill* ruling, courts throughout the country have grappled with the substantial nexus test.<sup>82</sup> There has been general agreement that a state can levy sales taxes on an out-of-state seller if the company has “a continuing presence in the state by one or more” salespersons employed by the out-of-state vendor.<sup>83</sup> But one court has also ruled that teachers who order and deliver student books from out-of-state book companies do not qualify as local salespersons for the vendor to satisfy the “substantial nexus” requirement.<sup>84</sup> In *Scholastic Book Clubs v. State*, the Michigan Court of Appeals seemed to base its decision on the facts that the company had “no control over the teachers [and] the teachers [were] under no obligation to participate” in certain book clubs.<sup>85</sup> Although the state argued that the teachers were acting as agents who created taxing jurisdiction under *Scripto*, the court found the teachers, like the students, were merely

78. *Id.* at 313.

79. *See* *Guardian Indus. Corp. v. Dep’t of Treasury*, 499 N.W.2d 349, 356 (Mich. Ct. App. 1993). Although the Court reworked the *National Bellas Hess* test, it also “affirmed the continuing vitality of *Bellas Hess*’[s] ‘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.’” *Quill Corp.*, 504 U.S. at 311 (first alteration added).

80. *Quill Corp.*, 504 U.S. at 311; *see also* Swain, *supra* note 12, at 432.

81. *Quill Corp.*, 504 U.S. at 311.

82. Nathaniel T. Trelease & Andrew W. Swain, *Multistate Sales and Use Taxation of Electronic Commerce*, in *ADVISING HIGH-TECHNOLOGY COMPANIES* § 12:4.4 (PLI 2006), WL *Advising High-Tech Companies* s 12:4.4.

83. 68 AM. JUR. 2D *Sales and Use Taxes* § 26 (2006); *see also* *Scholastic Book Clubs, Inc. v. State*, 567 N.W.2d 692, 694 (Mich. Ct. App. 1997). As part of the “substantial nexus” requirement, the court has emphasized a need for continued presence within the state to satisfy the test. *See Scholastic Book Clubs*, 567 N.W.2d at 695.

84. *Scholastic Book Clubs*, 567 N.W.2d at 695-96.

85. *Id.* at 695.

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consumers invited to purchase from the company's program.<sup>86</sup> Appropriately, the key factor appeared to be the lack of control.

*Scholastic Book Clubs* is analogous to any situation where a company's customer introduces or refers his or her friend to purchase from the company; in these situations the original customer may even procure the purchase for his or her friend. The teachers in *Scholastic Book Clubs* are like the aforementioned original customer who is making the referral to his or her students. It would be unfair and even unconstitutional for a company to be subjected to state taxation if every customer who referred a friend to the company became the company's agent. The referral and the ordering for a third party are both instances of good will on the part of the original customer. The company certainly invites these customers and hopes they will help increase its sales, but by no means does it employ or use them as selling agents. As such, these transactions should not create a "substantial nexus." Furthermore, even if companies have agents or employees in a state, courts have disagreed over the length of time necessary for vendor personnel's presence to establish a sufficient nexus.<sup>87</sup>

Commentators have interpreted the *Quill* decision to mean that a "company may have the 'minimum contacts' with the state required by the Due Process Clause, and yet lack a 'substantial nexus' with that state as required by the Commerce Clause."<sup>88</sup> The basic reason is because the Due Process Clause takes fairness into consideration and seeks to ensure that an individual or company knows when an activity within a state will allow that state to exercise jurisdiction.<sup>89</sup> Therefore, courts have held "notice" or "fair warning" as adequate in the due process analysis.<sup>90</sup> However, such notice, fair warning, or minimum contacts would not satisfy the substantial nexus requirement, which seeks to limit "state burdens imposed on interstate

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86. See *id.* at 694-95.

87. See Trelease & Swain, *supra* note 82, § 12:4.4 (comparing *In re Appeal of Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000) (ruling vendor's personnel's eleven visits in Kansas were "isolated" and "sporadic" and did not establish nexus); *Dep't of Revenue v. Share Int'l, Inc.*, 676 So. 2d 1372 (Fla. 1996) (ruling vendor's employee's three-day-a-year visit to a medical exhibition in Florida did not create a nexus); and *Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995) (ruling four sales-related visits a year to New York established nexus)).

88. *Sales and Use Taxes*, *supra* note 83, § 26 (citing *Brown's Furniture, Inc. v. Wagner*, 665 N.E. 2d 795, 802 (Ill. 1996)).

89. Edward A. Morse, *State Taxation of Internet Commerce: Something New under the Sun?*, 30 CREIGHTON L. REV. 1113, 1145 (1997).

90. *Id.* (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992)).

commerce, rather than merely ensur[e] fairness.”<sup>91</sup>

“The physical presence standard remains in force, and is the standard applied currently to all remote sellers, Internet sellers included.”<sup>92</sup> This substantial nexus requirement of physical presence is what allows most Internet sellers to escape taxation.

States have relied on the *Quill* ruling to determine the nexus requirements for tax jurisdiction.<sup>93</sup> For example, the Illinois Department of Revenue has cited to *Quill* in numerous letter rulings.<sup>94</sup> In one of its responses, the Department wrote:

The United States Supreme Court in *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), set forth the current guidelines for determining what nexus requirements must be met before a person is properly subject to a state’s tax law. The Supreme Court has set out a two-prong test for nexus. The first prong is whether the Due Process Clause is satisfied. Due process will be satisfied if the person or entity purposely avails itself or himself of the benefits of an economic market in a forum state.

The second prong of the Supreme Court’s nexus test requires that, if due process requirements have been satisfied, the person or entity must have physical presence in the forum state to satisfy the Commerce Clause. A physical presence is not limited to an office or other physical building.<sup>95</sup>

The Supreme Court’s attempt in *Quill* to clarify the meaning of “substantial nexus” has left much to be desired. Instead of providing a concrete test for states and businesses to determine when “substantial nexus” exists, the ruling has only opened myriad uncertainties and confusion about taxation of interstate commerce.<sup>96</sup> Moving away from the bright line rule of physical presence laid out in *National Bellas Hess* to favor “more flexible balancing analyses,”<sup>97</sup> the Court seems to have left businesses dealing in interstate commerce more vulnerable to tax attacks by

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91. *Id.* (citing *Quill Corp.*, 504 U.S. at 313).

92. Silhan, *supra* note 39, at 685.

93. *See, e.g.*, Ill. Priv. Ltr. Rul. 05-0123-GIL (Nov. 29, 2005), 2005 WL 3283591.

94. *Id.*

95. *Id.* (citation omitted).

96. *See* discussion *supra* Part III.B.4 (regarding post-*Quill* developments).

97. *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

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states. Businesses must be aware that the Court has only said what “substantial nexus” is *not*: contact with a state solely through “common carrier.”<sup>98</sup> The Court has not said what affirmatively constitutes “substantial nexus,” and may have left the door open for businesses to argue that “substantial nexus” requires physical presence.<sup>99</sup>

What is “substantial nexus” but a broad range between something more than a common carrier connection and leading up to physical presence? The Court desired to make fair the burdens of interstate commerce taxation,<sup>100</sup> but its ambivalent treatment of “substantial nexus” only made interstate businesses’ uncertain tax situation more precarious. Now, more than a decade later, it is time for the Supreme Court to address the issue and refine a test that has divided and confused states, courts, and businesses alike.

#### IV. INTERSTATE COMMERCE WELCOMES ELECTRONIC COMMERCE TO THE FAMILY

E-commerce arrived on the business scene after *Quill* set out the restrictions on taxing interstate sales,<sup>101</sup> namely, the substantial nexus requirement.<sup>102</sup> Most e-businesses that exist solely in cyberspace, or are incorporated in only one state but sell nationwide, have taken advantage of the stringent standard and operated for many years without paying state sales and use taxes.<sup>103</sup>

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98. *Id.* at 311.

99. *Id.* at 314 (“Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.”).

100. *Id.* at 315-18 (describing its own law on this subject as a “quagmire” and noting that although “a bright-line rule in the area of sales and use taxes also encourages settled expectations,” the Court has occasionally found reason to “replace such tests with more contextual balancing inquiries”).

101. For example, two of the most prolific Internet vendors in business today are Amazon.com and eBay.com, which were both launched in 1995, three years after the Supreme Court’s ruling in *Quill*. See Amazon.com—Media Kits: Overview, [http://media.corporate-ir.net/media\\_files/irol/17/176060/OverviewQ12006.pdf](http://media.corporate-ir.net/media_files/irol/17/176060/OverviewQ12006.pdf) (last visited Mar. 18, 2007); eBay: The World’s Online Marketplace, <http://investor.ebay.com/faq.cfm> (under heading “General Company Information” click “How long has eBay been in business?”) (last visited Mar. 18, 2006).

102. *Quill Corp.*, 504 U.S. at 313.

103. *Internet’s Days as Tax-Free Sales Venue are Numbered*, BALTIMORE SUN, Aug. 17, 2005, at 1D. For example, Amazon.com has operated for more than a decade as an Internet-based company and a spokesman has said the company “will continue to collect sales tax only in the few states where it has distribution centers or headquarters.” *Id.*

A. *Entity Isolation: "Click-and-Mortar" Businesses Search for a Tax-Free Virtual Haven*

While businesses that operated solely on the Internet were able to escape taxation, those having both online commerce and offline physical stores in the any state (e.g., nationwide retail chains) were often subjected to state tax jurisdiction.<sup>104</sup> These "click-and-mortar"<sup>105</sup> retailers unquestionably have sufficient physical presence within states to satisfy the substantial nexus requirement under *Quill* and should continue to collect sales taxes.<sup>106</sup> However, many of these retailers do not remit these taxes.<sup>107</sup> Instead, they have capitalized on the strict *Quill* ruling and incorporated separate Internet departments to escape collecting sales tax.<sup>108</sup> "They contend that their e-commerce operation is a distinct legal entity, unrelated to their bricks and mortar stores," and therefore their Internet store lacks the substantial nexus required to collect sales taxes.<sup>109</sup> "This practice is called 'entity isolation.'"<sup>110</sup>

Some critics of entity isolation argue the tax-avoidance strategy poses a detriment to the sales tax system and question the legality of the practice,<sup>111</sup> while others have criticized the court cases that have upheld the system:

[M]ost of the judicial decisions invalidating the inference of nexus by affiliation seem to be absolutely absurd. There is no reason that a group of affiliated companies engaged in closely related activities should be able to avoid nexus for use tax for part of their activities simply by placing them in a distinct corporation . . . .<sup>112</sup>

104. ADVISORY COMMISSION ON ELECTRONIC COMMERCE, *supra* note 18, at 14.

105. *Id.* at 11 (stating the advantages a "click-and-mortar business" has over a "brick-and-mortar business" because it is "a firm that conducts business through both physical and electronic mechanisms").

106. *See id.*

107. *Id.* at 14.

108. *Id.*

109. New Rules Project, *supra* note 16.

110. *Id.*; see Swain, *supra* note 12, at 420 ("In essence, entity isolation occurs when a taxpayer separately incorporates its nexus-creating assets (or conversely, its remote selling assets), thus protecting its remote selling operations from state tax jurisdiction.").

111. Swain, *supra* note 12, at 422 (quoting Michael Mazerov, senior tax analyst at the Center on Budget and Policy Priorities, and John Mikesell, professor of public finance and policy analysis at Indiana University).

112. *Id.* at 423 (alterations in original) (quoting Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 423 (1997)).

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Against such harsh criticism, academic supporters of entity isolation accept it as a “necessary consequence of American corporate law.”<sup>113</sup> Likewise, states remain split on how they treat entity isolation. Several states have amended their sales tax statutes to say that “entity isolation does not absolve [I]nternet retailers of state sales tax obligations.”<sup>114</sup> Meanwhile, three state courts have upheld entity isolation.<sup>115</sup>

The contradicting jurisprudence is unlikely to be resolved soon because the U.S. Supreme Court has denied review of the issue without comments on the merits.<sup>116</sup> This is yet another complex tax question created after the confusing jurisprudence of *Quill*. The Court has given no guidance to determine “substantial nexus,” so big companies have seemingly created their own tax havens and have taken advantage of the Internet’s legal loopholes.<sup>117</sup> Such blatant loopholes in the system should not be condoned. When a company creates separate entities for its physical brick stores and its virtual Internet stores, they should be considered as one unit, and the Internet sales should be subjected to the same taxation as the brick-and-mortar store sales. Most consumers who purchase on the company’s web site are probably not aware of this difference between a store purchase and an Internet purchase from the same company. In addition, businesses often use similar logos and fonts for both their brick-and-mortar and Internet stores. Thus, a determination of “substantial nexus” should involve analysis of factors such as logos and customer identification. If a customer visits a website and purchases an item he believes can be purchased at the same brick-and-mortar store down the street, it seems logical not to allow that Internet transaction to escape taxation.

The courts and legislatures must continue to stop businesses from muddling the line between legitimate Internet-only businesses and those who take advantage of Internet benefits. Perhaps only then, states will be able to collect more sales and use taxes, and the debate between e-commerce taxation and states will be less contentious.

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113. *Id.* (citing JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, I STATE TAXATION PP 6.13, 6.13[1] (3d ed. 1998 & Supp. 2001)).

114. New Rules Project, *supra* note 16 (identifying at least six states that have amended their sales tax statutes: Alabama, Arkansas, Kansas, Indiana, Louisiana, and Minnesota).

115. *Id.* (specifying the relevant jurisdictions as Ohio, Pennsylvania, and Connecticut).

116. *Id.*

117. ADVISORY COMM’N ON ELECTRONIC COMMERCE, *supra* note 18, at 14.

B. *The Internet Tax Freedom Act*<sup>118</sup> and the Advisory Commission on Electronic Commerce

Internet businesses are also escaping state and local taxes through the help of Congress, which has worked to protect Internet access and sales from taxes.<sup>119</sup> In 1998, Congress passed the Internet Tax Freedom Act (the “Act”), which imposed a moratorium on new Internet and electronic commerce taxes.<sup>120</sup> The Act also created the Advisory Commission on Electronic Commerce (the “Commission”) to study, among other issues, the

effects of taxation, including the absence of taxation, on all interstate sales transactions, including transactions using the Internet, on retail businesses and on State and local governments, which examination may include a review of the efforts of State and local governments to collect sales and use taxes owed on in-State purchases from out-of-State sellers . . . .<sup>121</sup>

1. Beginning with the Internet Tax Freedom Act

The Internet Tax Freedom Act placed a moratorium on three specific categories of taxation: (1) taxes on Internet access, (2) multiple taxes on electronic commerce, and (3) discriminatory taxes on electronic commerce.<sup>122</sup>

The first restriction prohibited taxes on Internet access and Internet service providers (ISPs) with a few exceptions.<sup>123</sup> First, the Act did not abrogate or apply to taxes on Internet access that were “generally imposed and actually enforced prior to October 1, 1998” if the tax was statutorily authorized and the ISP had

118. Internet Tax Freedom Act, Pub. L. No. 105-277, 112 Stat. 2681-719 (1998).

119. See, e.g., *id.*

120. *Id.* § 1101(a), 112 Stat. 2681-719. Although the Internet Tax Freedom Act expired in 2001, Congress “reinstated” it by passing the Internet Tax Nondiscrimination Act. Xuan-Thao N. Nguyen, *Internet Law for the Practical Lawyer: The Internet, E-Commerce and Tax Considerations*, (ALI-ABA Course of Study, Apr. 21-22, 2005), WL SK102 ALI-ABA 219, 221. In an effort to make the Internet Tax Freedom Act’s moratorium permanent, Congress extended the Internet Tax Nondiscrimination Act, which expired on November 1, 2003, through November 1, 2007. Pub. L. No. 108-435 § 2(a), 118 Stat. 2615, 2615 (2004).

121. Internet Tax Freedom Act § 1102(g)(2)(E), 112 Stat. 2681-724. The Commission delivered its report to Congress on April 12, 2000. Advisory Commission on Electronic Commerce, <http://www.ecommercecommission.org/index.htm> (last visited Mar. 18, 2007).

122. See Walter Hellerstein, *Internet Tax Freedom Act Limits States’ Power to Tax Internet Access and Electronic Commerce*, 90 J. TAX’N 5 (1999) [hereinafter *Act Limits States’ Power*]; see also Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(a), 112 Stat. 2681-719, -719 (1998).

123. *Act Limits States’ Power*, *supra* note 122, at 6.

“reasonable opportunity to know” such tax would be applied or if the jurisdiction allowed such taxes for the access charges.<sup>124</sup>

Second, the multiple tax restriction means a jurisdiction cannot impose a tax on “the same or essentially the same electronic commerce that is also subject to [another jurisdiction’s tax] without a credit . . . for taxes paid in the other jurisdictions.”<sup>125</sup>

Third, the nondiscriminatory tax restriction prevents a state from levying different taxes on the same goods based on whether the good is sold on the Internet or offline.<sup>126</sup> Therefore, if a state does not tax a certain item sold within the state, it may not tax that same item sold on the Internet.<sup>127</sup> The nondiscriminatory component also means a state cannot levy tax at different rates for e-commerce transactions.<sup>128</sup> If a state does tax an item sold on the Internet, it must do so at the same tax rate imposed on that item sold within the state.<sup>129</sup> Under the Act, it is considered a “discriminatory tax” if such tax is “imposed by a state or local government on an out-of-state vendor if ‘the sole ability to access a site on a remote seller’s out-of-state computer server is considered a factor in determining a remote seller’s tax collection obligation.’”<sup>130</sup> Such a tenuous connection through a computer server does not satisfy the “substantial nexus” requirement in *Quill*.<sup>131</sup>

The Act did not, however, eliminate the Internet seller’s duty to collect sales and use taxes if that seller has a substantial nexus with the state.<sup>132</sup>

## 2. The Commission’s Report to Congress

Pursuant to the Internet Tax Freedom Act, the Commission’s mandate was to study “Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable

124. Internet Tax Freedom Act § 1101(d)(1), 112 Stat. 2681-719. Nine states fall within this exception: Connecticut, Iowa, Nebraska, North Dakota, Ohio, South Carolina, South Dakota, Tennessee, Texas, and Wisconsin. *Act Limits States’ Power*, *supra* note 122, at 6 n.3.

125. Internet Tax Freedom Act § 1104(6)(A), 112 Stat. 2681-725.

126. Nguyen, *supra* note 120, at 221.

127. *Id.* (explaining, in the context of taxation of food, that if a state does not generally tax food stuffs sold in stores within the state, then the Internet Tax Freedom Act prevents the state from taxing the same food sold online).

128. *Id.* at 221-22.

129. *See id.*

130. *Id.* at 222 (citing Internet Tax Freedom Act § 1104(2)(B)).

131. *Id.* (citing *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)).

132. *See* Trelease & Swain, *supra* note 82, § 12:3.3.

intrastate, interstate or international sales activities.”<sup>133</sup> Its report to Congress released formal findings and recommendations for issues on the digital divide, privacy implications of Internet taxation, and international taxes and tariffs.<sup>134</sup> The Commission did not, however, issue a formal finding for sales and uses taxes and instead laid out a “Majority Proposal”<sup>135</sup> which recognized a clear need for “substantial sales tax simplification” and “fundamental uniformity” of tax rates among all the taxing jurisdictions.<sup>136</sup> The commissioners found a “need for nationwide consistency and certainty for sellers as well as the need to alleviate the financial and logistical tax collection burdens and liability of sellers.”<sup>137</sup>

Two major points of the proposal were as follows:

1. For a period of five years, extend the current moratorium barring multiple and discriminatory taxation of e-commerce and prohibit taxation of sales of digitized goods and products and their non-digitized counterparts.<sup>138</sup>

2. Clarify that the following factors would not, in and of themselves, establish a seller’s physical presence in a state for purposes of determining whether a seller has sufficient nexus with that state to impose collection obligations:

- (a) a seller’s use of an Internet service provider (“ISP”) that has physical presence in a state;

- (b) the placement of a seller’s digital data on a server located in that particular state;

- (c) a seller’s use of telecommunications services provided by a telecommunications provider that has physical presence in that

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133. Internet Tax Freedom Act § 1102(g)(1), 112 Stat. 2681-720.

134. ADVISORY COMM’N ON ELECTRONIC COMMERCE, *supra* note 18, at 4 (indicating that the three topics received more than two-thirds of the Commissioners’ votes).

135. *Id.* at 5, 19-20 (noting that the proposal passed by a majority vote with eleven Yeas, one Nay, and seven abstentions).

136. *Id.* at 19.

137. *Id.*

138. *Id.* To date, Congress has extended the tax moratorium twice, and the latest extension is set to expire on November 1, 2007. See discussion *infra* Part IV.B.3. There have also been several attempts to introduce bills that would make the moratorium permanent, but they have faced much opposition. See generally STEVEN MAGUIRE & NONNA A. NOTO, CONGRESSIONAL RESEARCH SERVICE, INTERNET TAXATION: ISSUES AND LEGISLATION IN THE 108TH CONGRESS 13-18 (2004) [hereinafter INTERNET TAXATION IN THE 108TH CONGRESS] (recapitulating various bills on extending the moratorium).

state;

(d) a seller's ownership of intangible property that is used or is present in that state;

(e) the presence of a seller's customers in a state;

(f) a seller's affiliation with another taxpayer that has physical presence in that state;

(g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state;

(h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller's Web site or catalogue to be returned to the other party's physical location within that state; and

(i) the advertisement of a seller's business location, telephone number, and Web site address.<sup>139</sup>

Congress has yet to discuss these terms or provide a suitable explanation clarifying these factors. As such, the reluctance of both Congress and the Supreme Court to clarify the "substantial nexus" issue has stymied the progress of e-commerce and left a gaping hole in a tax issue that must be addressed as quickly as possible to help ensure maximum economic utility. Until the federal government definitively says what factors establish a "substantial nexus," the state judicial system will continue to be flooded with cases regarding e-commerce sales and use taxes.

The last two points of the proposal were:

3. Encourage state and local governments to work with and through NCCUSL [(National Conference of Commissioners on Uniform State Laws)] in drafting a uniform sales and use tax act within three years after the expiration of the current Internet Tax Freedom Act moratorium (i.e., by October 21, 2004) that would simplify state and local sales and use taxation policies so as to create and maintain parity of collection costs (net of vendor discounts) between remote sellers and comparable single-jurisdiction vendors that do not

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139. ADVISORY COMM'N ON ELECTRONIC COMMERCE, *supra* note 18, at 19.

offer remote sales . . . .

4(a). Establish a new advisory commission responsible for oversight of the progress of NCCUSL's efforts to create a uniform sales and use tax act.<sup>140</sup>

Although the government has failed to meet the goal of simplifying state and local sales taxes within three years, several states have attempted a form of simplification through the Streamlined Sales Tax Project.<sup>141</sup>

### 3. The Internet Tax Nondiscrimination Act

Six years after the Commission's initial reports, perhaps the only element of the proposal Congress had chosen to follow was the extension of the tax moratorium. The Internet Tax Freedom Act has since been extended twice. As mentioned above, the Internet Tax Nondiscrimination Act of 2001 first extended the Internet Tax Freedom Act's expiration date to November 1, 2003.<sup>142</sup> The two-year extension was a compromise among the supporters of the moratorium,<sup>143</sup> who initially introduced the bill with a moratorium through 2006.<sup>144</sup>

When the moratorium expired on November 1, 2003, the Internet Tax Freedom Act was not immediately renewed.<sup>145</sup> The House and the Senate both introduced bills during the 2003 session but could not compromise on the "grandfather clause" allowing certain states to tax Internet access and municipal line access fees.<sup>146</sup>

The House approved a bill that permanently extended the moratorium, eliminated the grandfather clauses, and exempted from taxation telecommunications used for Internet access.<sup>147</sup> The Senate only approved a temporary four-year extension of the moratorium and continued with the grandfather clauses through the end of the moratorium.<sup>148</sup> In late 2004, the House and the Senate eventually agreed to the Senate version, which provided for a moratorium extension through November 1, 2007 and

140. *Id.* at 19-20.

141. *See* discussion *infra* Part V.B.

142. Internet Tax Nondiscrimination Act, H.R. 1552, 107th Cong. (1st Sess. 2001); *see supra* note 121 and accompanying text.

143. INTERNET TAXATION IN THE 108TH CONGRESS, *supra* note 138, at 13-18.

144. Internet Tax Nondiscrimination Act, H.R. 1552, 107th Cong. (1st Sess. 2001).

145. Trelease & Swain, *supra* note 82, § 12:3.3.

146. INTERNET TAXATION IN THE 108TH CONGRESS, *supra* note 138, at 5-6.

147. *Id.* at 14-15.

148. *Id.* at 17-18.

continued to allow grandfather protection for Wisconsin and Texas to levy access taxes and fees.<sup>149</sup> The amended Internet Tax Nondiscrimination Act was signed into law on December 3, 2004<sup>150</sup> and retroactively reinstated the extension as effective on November 1, 2003 when the second extension expired.<sup>151</sup>

#### 4. Past Congressional Bills

Those who are trying to predict how Congress will eventually write the laws for Internet taxation may face more legal uncertainty than they imagine. Bills have been introduced in both the House and Senate that range across the wide spectrum of opinion,<sup>152</sup> and both chambers have considered bills advocating a permanent moratorium. Representative Christopher Cox, author of the Internet Tax Nondiscrimination Act,<sup>153</sup> has consistently introduced legislation “[t]o amend the Internet Tax Freedom Act to make permanent the moratorium on certain taxes relating to the Internet and to electronic commerce.”<sup>154</sup> While the House bill leaves the moratorium open generally to “certain taxes,” the Senate’s latest bill for a permanent moratorium focuses only on “multiple and discriminatory taxes on electronic commerce” payment.<sup>155</sup>

On the other hand, several senators have introduced bills that would eventually create a uniform system for states to eventually tax Internet sales.<sup>156</sup> These various proposed bills cited as the “Internet Tax Moratorium and Equity Act” were introduced in 2001 as amendments to the initial Internet Tax Freedom Act.<sup>157</sup> They were more in line with the Commission’s proposal of temporary moratorium extensions coupled with development of a nationwide uniform sales and use tax system. In general, the bills called for the extension of the Internet Tax

149. *Id.* at 1.

150. Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, 118 Stat. 2615 (2004).

151. *See id.*

152. *See generally* Joseph R. Feehan, *Surfing Around the Sales Tax Byte: The Internet Tax Freedom Act, Sales Tax Jurisdiction and the Role of Congress*, 12 ALB. L.J. SCI. & TECH. 619, 640-46 (2002) (specifying such proposed bills).

153. Internet Tax Freedom Act, H.R. 1684, 109th Cong. (1st Sess. 2005); *see also* Feehan, *supra* note 152, at 640-41.

154. H.R. 1684; *see also* H.R. 49, 108th Cong. (1st Sess. 2003); H.R. 1552, 107th Cong. (1st Sess. 2001).

155. S. 849, 109th Cong. (1st Sess. 2005); *see also* S. 52, 108th Cong. (1st Sess. 2003); S. 777, 107th Cong. (1st Sess. 2001).

156. *See, e.g.*, S. 1567, 107th Cong. (1st Sess. 2001); S. 1542, 107th Cong. (1st Sess. 2001); S. 512, 107th Cong. (1st Sess. 2001). The House also introduced a similar bill that same year. *See* H.R. 1410, 107th Cong. (1st Sess. 2001).

157. *See* sources cited *supra* note 121.

Freedom Act for three years through 2005.<sup>158</sup>

During this extension time, Congress planned to call for state and local governments “to work together to develop a streamlined sales and use tax system.”<sup>159</sup> As the streamlined tax system was being developed, Congress would consent to and authorize an Internet Sales and Use Tax Compact that would “describe a uniform, streamlined sales and use tax system.”<sup>160</sup> States joining in this Compact would be required to adopt the uniform taxes.<sup>161</sup>

However, these bills ultimately have been set aside in favor of the Internet Tax Nondiscrimination Act’s temporary extensions of the Internet Tax Freedom Act<sup>162</sup> as Congress continues to decide how to approach the e-commerce industry. Almost eight years after the initial passage of the Internet Tax Freedom Act,<sup>163</sup> one would hope Congress could make a decision on the moratorium issue, yet the constant debate about making the Internet tax moratorium permanent seems unlikely to reach a conclusion anytime soon.

#### V. WITH LITTLE HELP FROM THE FEDERAL GOVERNMENT, STATES TAKE CHARGE OF THEIR TAX SITUATIONS

States are now finding new ways to fit online businesses into the physical presence requirement,<sup>164</sup> and coalitions are organizing to persuade Congress to create a nationwide uniform tax standard for Internet sales.<sup>165</sup> Only in the past few years have individual state efforts gained ground through maverick cases like *Borders Online, L.L.C. v. State Board of Equalization*<sup>166</sup> and state coalitions like the Streamlined Sales Tax Project.<sup>167</sup> These are both turning points in the states’ struggle to claim their tax rights on Internet sales.

In late 2003, the State of Illinois joined in a lawsuit against

158. See sources cited *supra* note 121.

159. See, e.g., S. 512 § 4.

160. *Id.* § 5.

161. *Id.*

162. See Internet Tax Nondiscrimination Act, Pub. L. No. 107-75, § 2, 115 Stat. 703, 703 (2001).

163. Internet Tax Freedom Act, Pub. L. No. 105-277, 112 Stat. 2681-719 (1998).

164. See *Borders Online, L.L.C. v. State Bd. of Equalization*, 29 Cal. Rptr. 3d 176, 188-92 (Cal. Ct. App. 2005).

165. See, e.g., NAT’L CONFERENCE OF STATE LEGISLATURES, *supra* note 16 (charting the status of states’ legislation to tax e-commerce); Streamlined Sales Tax Project, <http://www.streamlinedsalestax.org> (last visited Mar. 18, 2007).

166. See *Borders Online*, 29 Cal. Rptr. 3d at 176.

167. See discussion *infra* Part V.B.

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sixty-two online retailers, accusing them of failing to collect taxes for Internet purchases.<sup>168</sup> The main targets of the lawsuit were click-and-mortar businesses engaged in entity isolation, including Gateway, Blockbuster, and Barnes & Noble.<sup>169</sup> Illinois contended that these isolated entities were not legally distinct corporations and therefore had a physical presence or nexus in the state.<sup>170</sup>

Earlier that year, several large click-and-mortar retailers signed an agreement to collect sales and use taxes on Internet purchases.<sup>171</sup> By early 2003, retailers including Toys “R” Us, Wal-Mart, Target, and Amazon.com had begun levying taxes on their orders.<sup>172</sup> Those click-and-mortar businesses who are not voluntarily collecting sales and use taxes are finding themselves in the cross-hairs of a state lawsuit.

A. *Borders Online v. State Board of Equalization*<sup>173</sup>

In May 2005, a California appellate court held that Borders Online (“Online”), a separate entity from Borders Books and Music Store (“Borders”), must pay more than \$100,000 in use taxes for Internet sales to California residents.<sup>174</sup> The court found the bookstore was acting as an agent for the online company primarily because it accepted returns of items bought online and advertised the Borders website on store receipts.<sup>175</sup> The court also found that Online’s contacts with Borders bookstores located within California were enough to satisfy the “substantial nexus” requisite in *Quill* and allow California to tax the online company.<sup>176</sup>

Both Online and Borders, which has stores within the state of California, are owned by Borders Group, Inc.<sup>177</sup> Online was incorporated in Delaware and headquartered in Michigan.<sup>178</sup> For the tax years in question, 1998 and 1999, Online’s only dealings

168. *Illinois Sues Web Merchants*, *supra* note 15.

169. *See id.*

170. Declan McCullagh, *Illinois Demands Taxes from Net Retailers*, CNETNews.com, Sept. 19, 2003, [http://news.com.com/Illinois+demands+taxes+from+Net+retailers/2100-1028\\_3-5079897.html](http://news.com.com/Illinois+demands+taxes+from+Net+retailers/2100-1028_3-5079897.html).

171. Brian Krebs, *Retailers’ Online Tax Deal Faces New Challenges*, Washingtonpost.com, Feb. 25, 2003, *available at* 2003 WLNR 5697864.

172. *Id.*

173. 29 Cal. Rptr. 3d 176 (Cal. Ct. App. 2005).

174. *Id.* at 180, 193.

175. *Id.* at 182.

176. *See id.* at 188.

177. *Id.*

178. *Id.* at 178-79.

with customers in California were through its Internet website.<sup>179</sup> It did not collect sales or use taxes on its transactions in California.<sup>180</sup>

In its analysis, the California appellate court looked at the different activities of Borders, which helped to create the nexus with Online.<sup>181</sup> The store accepted returns and exchanges of merchandise bought through Online's website.<sup>182</sup> Some of the Borders store receipts printed during the time in question included the phrase "Visit us online at [www.Borders.com](http://www.Borders.com)."<sup>183</sup> Also, Borders employees referred store customers to Online's web site to buy merchandise not available at the store.<sup>184</sup> The court found all of these activities combined to meet the constitutional requirements for California to impose state use taxes on an out-of-state seller, including the creation of a "substantial nexus" between Online's activities and California.<sup>185</sup> The court also found part of Online's objective was to "build a market in California."<sup>186</sup>

The *Borders Online* decision proves that entity isolation is no longer a safe tax haven for big corporations. Companies with local brick-and-mortar stores will likely find themselves contesting and losing lawsuits on state taxes.<sup>187</sup> In light of these developments, it seems the safest way to stay as tax-free as possible is to have businesses operate solely online with no physical brick-and-mortar stores. Remaining in a complete, virtual world vacuum should protect a retailer from taxes in most states, except for those states in which it is incorporated, headquartered, or retains either premises or employees.

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179. *Id.* at 179.

180. *Id.*

181. *See id.* at 179, 182-88.

182. *Id.* at 179-80.

183. *Id.* at 179. The website named on the store receipts provided a link to the Borders Bookstores website, [www.bordersstores.com](http://www.bordersstores.com), "which provided advertising and promotional information for Borders stores, including a list of store locations." *Id.*

184. *Id.* at 190.

185. *Id.* at 192. The court particularly focused on the case of *Orvis Co. v. Tax Appeals Tribunal* for its analysis of commerce clause jurisprudence and its requirements of sufficient physical presence in a state to subject a mail-order vendor who marketed its products to state residents. *Id.* at 190-91 (citing *Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995)).

186. *Id.* at 190.

187. *See generally* Brian Krebs, *States Move Forward on Internet Sales Tax*, [Washingtonpost.com](http://Washingtonpost.com), July 1, 2005, available at 2005 WLNR 11529067 (discussing *Borders Online* and Illinois' lawsuit against several major retailers for millions of dollars in sales and use taxes, which resulted in a \$2.4 million settlement with several of the retailers).

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B. *The Streamlined Sales Tax Project*<sup>188</sup>

The Streamlined Sales Tax Project (SSTP) is an organization developing sales and tax systems for the unique commerce of the twenty-first century.<sup>189</sup> Comprising more than forty participating states,<sup>190</sup> SSTP takes aim at the largely untaxed realm of e-commerce and Internet sales.<sup>191</sup> Member states work to “simplify” their tax methods and provide interstate taxation uniformity in an effort to encourage sellers to pay taxes based on easier calculations.<sup>192</sup>

Mere months after the watershed *Borders Online* ruling, another major tax evolution occurred involving the SSTP. On October 1, 2005, the SSTP took its first major step towards its goal of taxing Internet sales<sup>193</sup> as the voluntary Streamlined Sales and Use Tax Agreement (“SSUTA”) went into effect.<sup>194</sup> Initially, eighteen states signed on to the SSUTA,<sup>195</sup> which provides states with “uniform definitions and simplified administrative and sourcing rules” while still allowing states the flexibility to pick and choose which terms and items they want to subject to sales tax.<sup>196</sup>

As of January 2007, there are fifteen “full member” states

188. See STEVEN MAGUIRE, THE STREAMLINED SALES AND USE TAX AGREEMENT: A BRIEF DESCRIPTION 2-3 (2006).

189. Press Release, Streamlined Sales Tax Project, States Continue Development of New Sales Tax System (Apr. 17, 2000), [http://www.streamlinedsalestax.org/press\\_rel/4-17pres.pdf](http://www.streamlinedsalestax.org/press_rel/4-17pres.pdf).

190. Streamlined Sales Tax Project, Participating States, <http://www.streamlinedsalestax.org/participatingstates.html> (last visited Mar. 18, 2007). It should be noted that while SSTP lists more than forty “participating states,” not all of these are “member” states. For example, although SSTP’s web site lists Texas as a “participating state,” the Texas Comptroller of Public Accounts web site specifically states that the Texas is not a member of SSTP. Texas and the Streamlined Sales Tax Project, <http://www.window.state.tx.us/taxinfo/sales/ssstp.html> (last visited Mar. 18, 2007). However, Texas does encourage online retailers to collect sales taxes through a “voluntary disclosure program.” *Id.*

191. Streamlined Sales Tax Project, About the Project, <http://www.streamlinedsalestax.org/oprules.html> (last visited Mar. 18, 2007).

192. *Id.*

193. See Press Release, National Conference of State Legislatures, States Make It Easier to Collect (Online) Sales Taxes: Voluntary Program for Retailers Goes into Effect, Provides Compensation, Immunity (Oct. 3, 2005), <http://www.ncsl.org/programs/press/2005/pr051003.htm> [hereinafter Online Sales Tax Press Release].

194. See *id.* Texas is not a part of this agreement. See Texas and the Streamlined Sales Tax Project, *supra* note 190.

195. Press Release, Streamlined Sales Tax Project, Sales Tax Simplification Agreement Becomes Effective Today and Launches Key Element: Amnesty Program (Oct. 3, 2005), [http://www.streamlinedsalestax.org/press\\_rel/Press Release Inaugural Gov Board - Final.pdf](http://www.streamlinedsalestax.org/press_rel/Press%20Release%20Inaugural%20Gov%20Board%20-%20Final.pdf) [hereinafter Sales Tax Simplification Press Release].

196. See Online Sales Tax Press Release, *supra* note 193.

and six “associate member” states.<sup>197</sup> As part of the SSUTA initiative, SSTP is aiding Internet sellers with tax software issues.<sup>198</sup> SSTP believes the software will make calculating state sales tax easier for the businesses,<sup>199</sup> and in turn, businesses will choose to collect sales and use taxes for states in which they may not be physically.<sup>200</sup> SSTP’s goal is to prove to Congress that uniform taxation is workable and will not constitute an “undue burden to interstate commerce.”<sup>201</sup>

SSTP’s uniform tax software project is not without problems. Businesses with less than five-million dollars in gross receipts are exempt from the tax collection, and when tax rates change, businesses are allowed sixty days to comply with the new rates.<sup>202</sup> Additionally, SSTP’s tax proposal is not without its critics. One such critic has called the project a “screw your buddy system.”<sup>203</sup> Opponents of the proposal see state sales tax as a method for states to compete with each other for business, and as such, there is incentive for states not to abide by the rules.<sup>204</sup>

For now, SSUTA members are offering sales and use tax amnesty as an incentive for Internet sellers to register to collect and remit the taxes.<sup>205</sup> Under the amnesty program, if the seller registers “within [twelve] months of the effective date of the state’s participation in the Agreement,” any uncollected sales and use taxes and associated interest and penalties for that member state will be put aside.<sup>206</sup>

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197. The full member streamlined states are Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont, and West Virginia. Streamlined Sales Tax Project, Governing Board States: SST State Status Map, <http://www.streamlinedsalestax.org/govbrdstates.htm> (last visited Mar. 18, 2007). The associate member states are Arkansas, Nevada, Ohio, Tennessee, Utah, and Wyoming. *Id.*

198. Sales Tax Simplification Press Release, *supra* note 195.

199. *See id.*; *see also* Online Sales Tax Press Release, *supra* note 193.

200. Streamlined Sales Tax Project, Resolution No. 08-05 (Mar. 9, 2005), <http://www.streamlinedsalestax.org/resolutions/SSTPResolution%2008-05.pdf>.

201. *See* Online Sales Tax Press Release, *supra* note 193.

202. Frank Jossi, *The Taxing Issue of E-Commerce: District States Are in the Middle of the Debate on Internet Sales Tax*, FEDGAZETTE, Nov. 2003, <http://www.mpls.frb.org/pubs/fedgaz/03-11/ecommerce.cfm>.

203. *Id.* (quoting Adam Thierer, director of telecommunications studies for the Cato Institute, a libertarian-leaning think tank in Washington, D.C.).

204. *Id.* (noting that Texas is one such state that already has tried to circumvent the rule, in that “Texas agreed to the streamlined tax proposal but asked to exempt one jurisdiction, Round Rock. Why? Because Round Rock is the headquarters of Dell Computers, the largest mail-order computer manufacturer in the country.”).

205. Streamlined Sales Tax Project, Amnesty, <http://www.streamlinedsalestax.org/amnesty.html> (last visited Mar. 18, 2007).

206. *Id.*

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Two bills introduced during the 109th Congress seek congressional consent to the SSUTA.<sup>207</sup> If passed, the bills would authorize each member state to “require all sellers not qualifying for [a] small business exception . . . to collect and remit sales and use taxes with respect to remote sales sourced to that Member State under the Agreement.”<sup>208</sup> Considering the unsuccessful history of previous bills on Internet retail taxes, these two bills are unlikely to make their way through Congress.<sup>209</sup> But tracking these bills in Congress will likely give businesses an idea of what laws are being entertained by the legislatures.

## VI. CONCLUSION

The recent developments in case law and the SSTP’s launching of the SSUTA prove the issue of Internet sales and use taxes is approaching its breaking point. States reacting to the obstacles of taxation are taking it upon themselves to fight for their tax revenues despite the Constitutional uncertainties of their actions. If Congress and the federal government continue to delay resolution of the issue, states may very well continue to solve the problem through lawsuits and coalitions, thereby slowly encroaching into the federal government’s interstate commerce realm.

Almost six years after the Commission submitted its report to Congress, numerous bills related to Internet taxation have been introduced in Congress, but none have been seriously considered as feasible legislation for working out the complications of Internet taxation.<sup>210</sup> While Congress has acted in accordance to the Commission’s proposal by extending the Internet Tax Freedom Act moratorium,<sup>211</sup> it nevertheless has failed to clarify the most contentious issue identified in the report six years ago, which continues to be the crux of the legal uncertainty today: what establishes a seller’s physical presence in a state to determine sufficient nexus.<sup>212</sup> Temporary extensions

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207. Sales Tax Fairness and Simplification Act, S. 2152, 109th Cong. (1st Sess. 2005); Streamlined Sales Tax Simplification Act, S. 2153, 109th Cong. (1st Sess. 2005). Both bills were introduced in December 2004 and referred to the Senate Committee on Finance. S. 2152; S. 2153.

208. S. 2152; S. 2153.

209. See *supra* Part IV.B.

210. See INTERNET TAXATION IN THE 108TH CONGRESS, *supra* note 138, at 13-19 (discussing the House and Senate bills introduced during the 108th Congress).

211. Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, 118 Stat. 2615 (2004); see also ADVISORY COMM’N ON ELECTRONIC COMMERCE, *supra* note 18, at 19 (proposing a five-year extension).

212. See ADVISORY COMM’N ON ELECTRONIC COMMERCE, *supra* note 18, at 19

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do not solve the problem. Without a permanent ruling on this complex issue, litigation between states and businesses inevitably will increase with the growth of e-commerce sales. Not only is it time for Congress to define “physical presence,” but it must take a permanent stance on Internet taxation and provide clear guidance to states and e-commerce businesses.

*Christina T. Le*

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(suggesting that Congress should clarify that the factors suggested by the commission would not establish sufficient nexus).