



## **E-Commerce: United States Sales and Use Tax Considerations**

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### **Overview**

- A. A gross-basis sales tax is imposed by most states.
- B. The tax is typically imposed on:
  - 1. Retail sales of tangible personal property (unless specifically exempted) and
  - 2. Services (if specifically enumerated).
- C. Sales of intangible property are generally **not** subject to the tax.
  - 1. In practice, it is sometimes difficult to tell whether certain products (*e.g.*, customized computer software) should be treated as tangible or intangible property.
- D. Sales tax issues relating to e-commerce activities are conceptually very similar to the jurisdictional and product classification issues that out-of-state catalog retailers and computer software vendors have been addressing for years.
- E. Accelerating e-commerce activities have put more pressure on the system and have led to efforts to simplify and rationalize the existing rules:
  - 1. Internet Tax Freedom Act (“ITFA”) and
  - 2. Streamlined Sales Tax Project (“SSTP”).
- 3. “Mixed” sales (*i.e.*, sales that have tangible personal property and service components) are generally taxed based on the portion that corresponds to tangible personal property.
- B. The seller is generally required to collect the tax and remit it to the state in which the sale occurs.
  - 1. A sale is typically considered to occur in the state in which the buyer is located.
- C. A state may generally not impose a sales tax on sales made outside its borders.
  - 1. The U.S. Constitution limits the ability of a state to impose collection responsibility on out-of-state sellers for cross-border sales to in-state buyers.

### *Use Tax General Concepts*

- A. Use tax is a “complementary” tax imposed on the use, storage or consumption of tangible personal property or services within a state where the property was purchased in another state.
- B. The use tax base and rate is generally the same as the sales tax base and rate.
- C. The use tax is generally intended to plug the gap left by a state’s jurisdictional inability to levy a sales tax on sales transactions occurring outside its borders.

### **Sales and Use Taxes**

#### *Sales Tax General Concepts*

- A. Sales tax is a gross-basis tax imposed on the retail sale of most tangible personal property and some services:
  - 1. Sales of tangible personal property are generally taxable unless specifically **exempted**;
  - 2. Services are generally nontaxable unless specifically **included**.

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D. The state may require a seller to collect and remit use tax if the seller has sufficient taxable nexus in the state – otherwise, the in-state buyer is required to self-report and remit the appropriate use tax.

1. In practice, it is almost unheard of for retail buyers to self-report and pay use tax.

#### *Revenue Considerations*

- A. Sales tax and use tax is levied by approximately 7,500 separate state and local governments.
- B. Tax rates range from 0.875% to 11% (depending on jurisdiction and type of product).
- C. Sales and use tax revenue typically represents from 25% to 33% of state and local revenue.
  1. State and local governments collected \$237 billion in sales and use tax revenue in 1999.
- D. There is widespread fear among state legislators and tax administrators that unless out-of-state sellers can be required to report sales and remit taxes, the expansion of e-commerce will significantly increase the volume of remote-selling, thereby eroding the local sales and use tax base.

#### *Collection Responsibilities*

- A. A seller's obligation to collect and remit sales and use tax is a fiduciary obligation (*i.e.*, the seller acts as an agent for the state in collecting the tax).
- B. The administrative burden imposed on sellers in the collection and remittance process can be very substantial:
  1. Sales and use tax return filing requirements (including calculation of proper overall effective rate applicable to all political subdivisions within the state to which sales are made),
  2. Collection and maintenance of supporting documentation (*e.g.*, transaction records, buyer exemption certificates and direct-pay permits),
  3. Electronic funds transfer requirements for volume sellers,
  4. Electronic Data Interchange (bilateral software-based documentation and compliance tool for large-volume transactions) and

5. Sales tax software packages (*e.g.*, Taxware, Vertex).

#### *Basic Sales and Use Tax Issues for E-tailers*

- A. Jurisdictional: Does the seller have a "taxable nexus" in the destination state?
  1. If not, the state cannot require the seller to collect sales or use tax.
- B. Definitional: Is the product tangible personal property or taxable services?
  1. If not, no sales or use tax will be payable.

#### **Tax Nexus Issues**

##### *In General*

- A. A seller must have a "taxable nexus" in a state before the state can require the seller to collect and remit sales and use tax.
- B. Although each state will apply its own nexus standards, the answer will generally depend on an application of an inherently imprecise facts-and-circumstances analysis that asks whether the seller has "sufficient" contacts with a state to be subject to its jurisdiction.
- C. Out-of-state sellers with minimal presence in many states will often have difficulty effectively managing nexus issues due to differing and inherently fuzzy standards applied by different taxing jurisdictions.

##### *U.S. Federal Safe Harbor Jurisdictional Limitation*

- A. Two fundamental Constitutional limitations on the ability of states to subject out-of-state sellers to sales and use tax collection responsibility:
  1. Due Process limitation: requires that seller have "minimum contacts" with destination state (not necessarily including physical presence) for nexus to exist.
    - a. Will not provide much practical assistance to out-of-state sellers since activities such as advertising in the state or sending catalogs into the state will usually be sufficient to establish "minimum contacts."

2. Commerce Clause limitation: requires that seller have "substantial presence" in destination state (including physical presence) for nexus to exist.
  - a. In the context of mail-order retailers, the U.S. Supreme Court has held that out-of-state mail order retailers with no physical presence in the state do not have taxable nexus where their only connection with customers in the state is by U.S. mail and common carrier. See *National Bellas Hess, Inc.*, 386 U.S. 753 (1967); *Quill Corp.*, 504 U.S. 298 (1992).
  - b. This is a somewhat more useful safe harbor, subject to two important limitations:
    - i. "Physical presence" standard is not necessarily clear-cut generally, and can be especially uncertain for e-tailers accessing state markets using in-state communications and computer infrastructure.
    - ii. Unlike Due Process limitations, Congress can legislatively waive or limit the protection afforded to out-of-state sellers.
  - c. As a practical matter, *National Bellas Hess* and *Quill* will probably not be very helpful much beyond the limited mail-order setting in which they arose.

#### Common Situations

##### A. Physical presence:

1. Nexus is usually found where an out-of-state seller has employees or agents physically present in the state (although sporadic or temporary presence may, under some circumstances, not be fatal).

##### B. Agency nexus:

1. Nexus will often be found if the out-of-state seller engages in-state third party contractors to perform certain activities (e.g., sales solicitation or warranty repairs).

##### C. Affiliate nexus:

1. Nexus can sometimes be found due to the in-state activities of an affiliate of the out-of-state seller – especially if the affiliate's activities facilitate (even in a very minor way) the activities of the out-of-state seller.

##### D. Economic nexus:

1. Some states have attempted to assert nexus solely by reason of commercial exploitation of the in-state market by the out-of-state seller (e.g., through advertising or licensing of intangibles by in-state licensees).

#### E-Commerce Issues

##### A. Some states have begun to apply these general rules in certain specific e-commerce contexts. Examples include:

1. **Virginia:** An out-of-state vendor was found not to have a taxable nexus in Virginia where its only connection to the state was the use of in-state computer servers to host web sites for use by in-state customers. See Ruling of Commissioner, Virginia Department of Taxation, P.D. 00-53 (April 14, 2000).
2. **Kansas:** A vendor with both a store in Kansas and a web server in California was required to collect use tax on web sales from California into Kansas because the Kansas store had a computer terminal that some of its customers used to access the California web site. See Kan.Op.Ltr.No. O-2000-042 (December 5, 2000).
3. **Tennessee:** AOL was found not to have a taxable nexus in Tennessee despite the fact that AOL utilized both tangible and intangible property in the state (e.g., telephone lines, computer software, local telephone numbers). See *American Online, Inc. v. Johnson*, No. 97-3786-III (Tennessee Chancery Court).
4. **Arkansas:** Recently amended state statute provides that an out-of-state Internet, mail order and similar vendor is responsible for collecting use tax if it has an in-state affiliate that sells the same products, uses the same business name or utilizes its facilities or employees to advertise or promote sales by the out-of-state vendor. See Ark.Code § 26-53-124(a).

**Tangible vs. Intangible Property – Computer Software**

- A. Longstanding area of dispute: Is software “tangible” (taxable) or “intangible” (nontaxable) property?
- B. Software is not easily classifiable as either “tangible” or “intangible” since the real value is inherent in the information contained in the software, rather than the physical medium.
- C. Many states approach this problem by classifying software as either “canned” or “custom.”
  1. “Canned” or “prewritten” software can usually be purchased off the shelf, and is generally treated for sales tax purposes as a sale of tangible property.
  2. “Custom” software is created to serve a particular customer’s needs, and is generally treated for sales tax purposes as nontaxable (either because it is a sale of intangible property or the sale of a nontaxable service).
    - a. Note that the amount of customization needed to convert “canned” to “custom” software can vary widely from state to state.
  3. Certain states also have a “modified canned” software classification – most (but not all) of these states would treat the sale of “modified canned” software as the taxable sale of tangible personal property.
  4. Some states will not tax software (whether “canned,” “modified canned” or “custom”) that is downloaded by the buyer in electronic format.

**Internet Services**

- A. Some states have imposed sales or transaction taxes on services provided by Internet service providers (ISPs):
  1. **Tennessee:** Internet access services provided by ISPs (even those with no connection to the state other than having customers located there) constitute telecommunications services and are subject to sales tax. See TCA § 67-6-102(30).

2. **Illinois:** Internet access services that include 1-800 service and that separately assess customers with a per minute charge for use of 1-800 numbers are subject to telecommunications excise tax. See IU Dept.of Rev., ST97-0277 GIL (May 21, 1997); Chicago Muni.Code § 3-70-030.
  3. **Connecticut:** Taxable sale includes services related to creation, development, web-hosting or development of a web site. See Conn.Stat.Ann. § 12-407(2)(i)(A).
- B. Some states have exempted Internet access charges from both sales tax and telecommunications excise tax:
    1. **New York:** Internet access charges considered an unenumerated service that is not subject to sales tax or telecommunication excise tax. See NY Dept.of Tax & Fin. TSB-M-97(1)(C), (1.1)(S) (Jan. 1997).
    2. **California:** Sales tax chargeable only on sales of tangible personal property. See Cal.Rev.& Tax.Code § 6051; Cal.Reg. 1684(a).
    3. **Florida:** Internet access service, e-mail, electronic bulletin board service not included in taxable sale of communications service. See Fla.Stat.Ann. § 202.11(3), (12), (13).
  - C. Other Internet-related services have tended to be treated as not taxable:
    1. Fulfillment services (NY Tax Law Code §§ 1101(b)(8)(V)(A), 1101(b)(18), NY Dept.of Tax & Fin. TSB-A-99(49)S (Nov. 17, 1999)).
    2. Web-site creation (NY Tax Law §§ 1101(b)(6), (14); Okla.Admin.Code § 710; 65-19-156(b); D.C. Code Ann. § 47-2001(n)(2)(G)).
    3. Web-hosting services (Fla.Stat.Ann. § 212.05, Fla.Dept.of Rev. TAA 98A-083 (Nov. 16, 1998)).
    4. Advertising services (NY Tax Law Code § 12(c), NY Dept.of Tax & Fin. TSB-A 95(33)S (Aug. 14, 1995); Conn.Legal Rul. 2001-2 (Jan. 17, 2001); Okla.Admin.Code § 710.65-19-156(b)(4); Fla.Dept.Rev. T.AA 98A-083 (Nov. 16, 1998)).

5. Other services incidental to Internet access (*e.g.*, software tools and e-mail, billing and customer care services that involve data processing, remote access, and information storage services) (TSB-M-97(1)(C), (1)(S); TSB-A98 (57)S (Aug. 6, 1998)).
- D. Overall, there is a trend towards legislating exemptions for Internet access.

### Internet Tax Freedom Act ("ITFA")

#### *In General*

- A. Passed by U.S. Congress in 1998 (Public Law 105-277).
- B. Three basic provisions:
  1. Prohibition against "multiple and discriminatory" taxes on electronic commerce.
  2. Moratorium on new sales taxation of Internet access services.
  3. Established the Advisory Commission on Electronic Commerce ("ACEC") to recommend proposals for the taxation of e-commerce.
- C. Contrary to common perception, ITFA does **not** provide a general tax exemption for all goods and services sold online.
- D. ITFA scheduled to sunset on October 21, 2001.
  1. Current prospects for extension are uncertain.

#### *Prohibition of "Multiple and Discriminatory Taxes"*

- A. No "multiple" taxes: an online transaction cannot be taxed more than once (*i.e.*, in both the seller's and buyer's jurisdiction).
  1. Given the lack of clear rules on the sales and use tax consequences of e-commerce transactions, it could be quite difficult for a state to even be able to determine whether another state would seek to tax the same transaction.
- B. No "discriminatory" taxes: the tax burden on an online transaction cannot be heavier than on a similar offline transaction.

#### *Tax Moratorium*

- A. States may not impose taxes (including sales and use taxes) on "Internet access."
  1. Exception: taxes "generally imposed and actually enforced" prior to October 1, 1998.
- B. "Internet access" is defined to include a fairly wide range of e-commerce activities:
  1. Basic access to the Internet (*i.e.*, ISPs) and
  2. Access to both proprietary and non-proprietary "content, information, electronic mail, or other services."

#### *ACEC Report*

- A. The ACEC issued its report in April 2000.
- B. Required 2/3 consensus was only reached on three relatively non-controversial or insignificant issues:
  1. Measures should be taken at both the federal and state level to close the "digital divide" between those with access to the Internet and those without such access.
  2. Congress should explore the privacy issues associated with the collection and administration of taxes on e-commerce activities.
  3. Congress should support the implementation of a standstill on tariffs.

#### *ACEC Majority Proposals*

- A. A "majority" report (mostly representing the views of the ACEC's members from industry, rather than the members representing state and local government) called for the following:
  1. A five-year extension of the tax moratorium,
  2. The passage of a uniform sales and use tax act that would simplify the application and administration of the sales and use tax for remote sellers and

3. The passage of legislation to clarify that the following would not, in and of themselves, cause a remote seller to be considered to have taxable nexus in the buyer's state:
  - a. use of an ISP that is physically located in the state,
  - b. placement of information on a server located in the state,
  - c. use of telecommunications services provided by a telecommunications provider that has a physical presence in the state,
  - d. ownership of intangible property that is used in or is present in the state,
  - e. the presence of the seller's customers in the state,
  - f. the seller's affiliation with another taxpayer that has a physical presence in the state,
  - g. the performance of repair or warranty services in the state,
  - h. the fact that the seller has a contractual relationship with another party located within the state to allow products purchased over the Web from the remote seller to be returned to the other party's physical location within the state and
  - i. the advertisement within the state of the seller's business location, telephone number and Web site address.

#### *ACEC Minority Proposals*

- A. A minority of commission members (mostly representing state and local government) believed that the majority proposals would, if enacted, unjustly benefit e-commerce activities at the expense of local "brick-and-mortar" business.
- B. In order to level the playing field with "old economy" retailers, the minority has recommended the following:
  1. No federally mandated tax nexus standards (*i.e.*, nexus would continue to be determined in non-uniform fashion under the law of each state) and
  2. The voluntary adoption by the state of a simplified sales and use tax system that would impose collection responsibility on remote sellers.

### **Streamlined Sales Tax Project ("SSTP")**

#### *Background*

- A. There is a general perception by state and local governments that the expansion of e-commerce will significantly erode the local sales tax base.
  1. A recent GAO estimate puts this loss at \$20B in 2003.
- B. Recognizing that e-commerce is not going away, state and local governments have come to realize that they need to make it easier for remote sellers to comply with local sales and use tax rules.
- C. Approximately 40 states have now joined together in the SSTP in an effort to simplify, modernize and harmonize sales and use tax administration.
- D. The SSTP has produced a model act (the "Uniform Sales and Use Tax Administration Act") which has been passed or is currently under consideration in a number of states.

#### *Overview*

- A. The primary goals of the project are to
  1. Expand the traditional tax nexus rules to encompass remote sellers and
  2. Encourage remote sellers to comply with their mandatory collection responsibility by simplifying and streamlining the rules to make compliance simpler.
- B. Key features of the SSTP:
  1. Uniform definitions within tax bases (even though states would still decide what was taxable and what was exempt),
  2. Simplified exemption administration for use and entity-based exemptions,
  3. Rate rationalization (*i.e.*, a single rate per state so that remote sellers do not have to calculate differing sales tax rates for each local jurisdiction within a state),
  4. Uniform sourcing rules,

5. Streamlined administration, including central registration and uniform returns, and
6. Uniform audit procedures.

*Voluntary Participation*

- A. Remote sellers would not be forced to participate in the SSTP.
- B. Voluntary participation might be attractive to many remote sellers for several reasons:
  1. The remote seller would receive audit immunity for prior periods.
    - a. This may be quite significant even for remote retailers who don't think they have much audit exposure given the expansive view that individual states have taken on the basic tax nexus issue.

2. The simplified and streamlined system should substantially ease the remote seller's administrative burden associated with proper compliance.
3. The states will generally bear the cost for the compliance infrastructure.
4. Participation in SSTP will not constitute tax nexus for purposes of any other tax (e.g., state corporate income or franchise tax).

