Electronic Commerce and the State and Federal Tax Bases

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Although the papers in this Symposium focus primarily on the challenges posed to the state and local tax bases by electronic commerce,1 it is important to note that electronic commerce also threatens to erode the U.S. federal income tax base. And while a few countries, like the Cayman Islands,2 can afford to be oblivious to this matter because they do not rely significantly on a tax system to fund government operations, the vast majority of countries that tax income or consumption or both, must treat the issues addressed in this Symposium as serious problems indeed.

At the federal level, the taxation of electronic commerce can be thought of as a case of Back to the Future because it begins almost sixty years ago with an early form of electronic commerce in Piedras Negras Broadcasting Co. v. Commissioner.3 That case involved a Mexican corporation operating a commercial radio station on the Mexican side of the Rio Grande River. About ninety-five percent of the corporation’s income came from U.S. advertising, and approximately ninety percent of listener responses to the advertising came from within the United States.4 In short, the case involved a foreign corporation, located hard by the U.S. border, beaming its service into the United States and collecting virtually all of its revenue from U.S. customers. Thus, at an intuitive level, it is easy to feel considerable sympathy for the Internal Revenue Service’s assertion that the station’s profits earned from U.S. advertisers were subject to the U.S. income tax. Nevertheless, the Mexican corporation objected,

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3. 43 B.T.A. 297 (1941), nonacq. 1941-1 C.B. 18, aff’d, 127 F.2d 260 (5th Cir. 1942).

4. See id. at 303.
pursued its day in court, and obtained a decision that its advertising profits were outside the income taxing jurisdiction of the United States Government.\(^5\)

With that precedent on the books, it became very easy for the U.S. Treasury to conclude that the profits on pure mail order sales emanating from foreign countries to customers inside the United States were also beyond the jurisdiction of the United States with respect to the federal income tax.\(^6\)

At the state and local level, matters relating to pure mail order sales proceeded on an independent track and in a somewhat later time period. By decisions in 1967\(^7\) and 1992,\(^8\) the U.S. Supreme Court held that constitutional constraints prevent state and local governments from imposing any kind of consumption tax regime (a retail sales tax or compensating use tax)\(^9\) on pure mail order sales\(^10\) from outside the taxing jurisdiction to customers inside the taxing jurisdiction unless the tax is levied on the in-state customer, rather than on the seller.\(^11\) Collection of such a consumption tax is no problem where the purchased property requires a license in the purchaser’s state of residence (automobiles, trucks, etc.) so that the purchase is revealed to state authorities in the licensing process. A con-

\(^{5}\) Although the Internal Revenue Service’s non-acquiescence in \textit{Piedras Negras} is still outstanding, the Service has never seriously contested the soundness of the decision, and it has effectively become part of settled law. See \textit{Boris I. Bitker & Lawrence Lokken, Fundamentals of International Taxation} \textsection 70.4, at 70-11 (2d ed. 1997); \textit{U.S. Treasury Dep’t, Selected Tax Policy Implications of Global Electronic Commerce} \textsection 7.2.1.1, n. 55 (1996).

\(^{6}\) \textit{See Treas. Reg. \textsection 1.864-4(b) Example (3) (1999); see also U.S. Treasury Dep’t, supra note 5, \textsection 7.2.1.1.}


\(^{8}\) \textit{See Quill Corp. v. North Dakota, 504 U.S. 298 (1992).}

\(^{9}\) The Supreme Court seems to regard both sales taxes and use taxes as subject to the same Constitutional constraints. \textit{See id. at 310-12, 314, 316-17 (1992); Hellerstein, supra note 1, at 482. But see Paull Mines, Converting with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform, 52 Tax L. Rev. 581, 589-90 (1997).}

\(^{10}\) Pure mail order sales involve orders solicited through catalogs and media advertising; these orders are accepted at the seller’s out-of-state headquarters and delivery is effected by the U.S. Postal Service or by common carrier.

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Sumption tax cannot, however, be practically collected from the consumers of goods that are the subject of most mail order transactions, as consumer compliance is effectively voluntary. Not surprisingly, voluntary compliance is quite low, and the consequence of the Supreme Court’s decisions has been to leave state and local governments without any practical means to tax mail order sales emanating from outside the state where the consumer resides.12

As explained above, the federal income tax does not apply to profits generated from pure mail order sales originating from outside the United States, and state and local consumption taxes are effectively inapplicable to pure mail order sales originating from outside the taxing jurisdiction. These conclusions seem fully applicable to federal taxation of income from sales that are initially solicited through Internet advertising and then transacted over the Internet between a customer in the United States and an out-of-country seller’s out-of-country website.13 Similar conclusions are also, arguably, applicable in the case of state and local consumption taxes.14

Extension of the mail order tax exemption to Internet sales has been a cause of concern among taxing officials worldwide.15 Elec-


14. See Walter Hellerstein, Taxing Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation, 75 TAX NOTES 819, 828 (1997); Hellerstein, supra note 1, at 440-41, 445-49, 505; see also Michael J. McIntyre, Taxing Electronic Commerce Fairly and Efficiently, 52 TAX L. REV. 625, 640 (1997). But see Charles E. McLure, Jr., Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws, 52 TAX L. REV. 269, 327-31 (1997); Mines, supra note 9, at 588-613. Even if the U.S. Constitution is ultimately interpreted to permit states to require that Internet vendors collect and remit state and local consumption taxes, this requirement will be effectively unenforceable against offshore vendors.

tronic commerce sales, however, are simply mail order sales using the medium of the Internet instead of the U.S. Postal Service to transact much of the business, although in many cases the final delivery is made by the U.S. Postal Service or by a commercial courier. Since these Internet transactions look a lot like mail order sales, and since the U.S. has endured, and even prospered, in spite of the fact that mail order commerce has a large tax-free component, one might ask why there should be any disquiet over the fact that electronic commerce sales might be able to move in and share a tax-free zone previously monopolized by mail order sales.

The answer is that, potentially, the dollar volumes involved in electronic commerce transactions far surpass anything we have seen in the area of mail order sales.\textsuperscript{16} To illustrate, assume that Microsoft, in Redmond, Washington, sets up a wholly-owned subsidiary in the Irish Republic, which will impose a low rate of tax on the profits earned by the Irish subsidiary.\textsuperscript{17} This subsidiary is tasked with developing Windows 2005 and it does so. The subsidiary then offers Windows 2005 for sale exclusively over the Internet. Customers in the United States place their orders and effect credit card charges from their own computers and then download their purchased copies of Windows 2005. If Microsoft is properly advised, the Irish subsidiary’s profits from these transactions will not be subject to U.S. federal income tax until the distant day that Microsoft decides to repatriate the profits to the United States.\textsuperscript{18} This tax deferral, of course, gives Microsoft a time value of money advantage that greatly reduces

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\textsuperscript{16} If current growth rates continue, it is possible for electronic commerce to account for one-third of all world trade in five years. See Guttman, supra note 15, at 155. It is also appropriate to note that the tax-free treatment of mail order sales is itself ripe for corrective action. In 1995, U.S. mail order sales totaled $219.9 billion. See U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 764 (1998). To the extent that present law leaves this expansive commercial area free of tax, mail order businesses receive an economically distorting advantage over other types of commerce.


\textsuperscript{18} See generally Fleming, supra note 13; Robert J. Peroni et al., Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. REV. 455 (1999); Tillinghast, supra note 13, at 339.
the present cost of the tax liability.\textsuperscript{19} In the meantime, the accumulated profits in the Irish subsidiary presently increase the value of that subsidiary’s stock, which, in turn, presently increases the value of all of Bill Gates’s Microsoft stock.

At the state level, the revenue from Internet sales of Windows 2005 in this scenario will largely escape state and local consumption taxes,\textsuperscript{20} because consumption taxes are basically imposed on the honor system in this situation, and the affected taxpayers (who are the spiritual descendants of the participants in the Boston Tea Party) have little honor when it comes to voluntary compliance with unenforceable taxes.\textsuperscript{21}

The tax revenues at risk for both the states and the federal government are potentially enormous. For example, in 1995, sales of prepackaged software within the U.S. totalled $19.9 billion,\textsuperscript{22} and that volume is growing exponentially as we become ever more dependent on computer software. Moreover, 1995 sales within the U.S. of customized software and related services were $26.2 billion\textsuperscript{23} and growing rapidly. Little imagination is required to see how the Windows 2005 illustration leads to the conclusion that much of the revenues generated by this vital part of our economy can be moved out of the tax system at both the federal and state levels by making the sales over the Internet from a computer server located in either a tax haven country or, in the case of state consumption taxes, in a U.S. state that has chosen to construct a tax haven system in order to make itself attractive as the base for this kind of commerce.\textsuperscript{24}

A second hypothetical is also helpful. IBM, AT&T, and Microsoft are each working independently on technology that would allow customers to buy a sixty-minute music CD over the Internet and download the contents of that CD in ten minutes onto the customer’s blank CD.\textsuperscript{25} And if the customer wants a frightening photo-

\textsuperscript{20} See supra note 14.
\textsuperscript{21} See supra note 12.
\textsuperscript{22} See U.S. DEP’T OF COMMERCE, supra note 16, at 571.
\textsuperscript{23} See id.
\textsuperscript{25} See Martin Peers, Universal Music Cancels Trial of Web System, WALL ST. J., Jan. 10, 2000, at B10; Eben Shapiro, IBM and Record Giants to Demonstrate System to Deliver Music Securely on Net, WALL ST. J., Feb. 8, 1999, at B6; Eben Shapiro, Seagram’s Universal Music
graph of the heavy metal band to wrap around the newly-purchased CD, she can also download this artwork onto her color printer from the Internet. This technology is not yet on the market, but it is being pursued by clever, resource-rich players and will surely arrive in the not too distant future. Let us assume that the technology has arrived and, in response to it, Sony Music Corporation sets up a wholly-owned subsidiary in the Cayman Islands, which have warm water, sandy beaches, and zero income tax.\(^{26}\) This subsidiary makes master recordings at its Cayman Islands studio and then sells the music to U.S. customers over the Internet. In this situation, the subsidiary’s sales profits will not be subject to U.S. income tax until they are repatriated into the United States, and the sales will largely escape state and local consumption taxes. The resulting revenue loss is potentially very large. In 1997, U.S. music CD sales were $9.9 billion and growing.\(^{27}\) Obviously, there is a realistic possibility for moving much of this part of the U.S. economy out of the reach of state and federal taxing authorities through the use of electronic commerce.

Similar examples could be generated for any kind of digitizable product, such as books, magazines, newspapers, and videos,\(^{28}\) and there is no reason why law firms and accounting firms cannot locate offshore and deliver many services through the Internet. And, to be complete, we should not overlook the fact that the worldwide Internet gambling industry is expected to generate $4 billion from U.S. bettors in 2001,\(^{29}\) and much of this activity will be conducted electronically, putting it out of the reach of U.S. tax collectors.

The preceding examples have focused on sales of products and services that can be digitized and transmitted electronically over the Internet, but the conclusions suggested above, with respect to these examples, apply equally to Internet purchases of tangible products that are small enough to be delivered by mail or Federal Express to the customer.

\(^{26}\) See COOPERS & LYBRAND, supra note 2.

\(^{27}\) See U.S. DEPT OF COMMERCE, supra note 16, at 579.


Clearly, there are some very large commercial fields that are susceptible to being removed from the taxing jurisdiction of state and federal authorities through the utilization of electronic commerce. If this happens, all levels of government will suffer a significant revenue loss. But if we learned any lesson from the 1980s federal income tax cuts, it is that a decrease in government revenue will not cause the demand for government services to decline proportionally. 30 If large amounts of tax revenue simply vanish into cyberspace, other revenue sources will have to be found by federal and state governments to pay for a continuing level of governmental services. 31 This can be done by governments borrowing to make up the revenue loss, an approach that has the unlovely consequence of shifting the cost of today's government services to future generations. Many people are uncomfortable with this path. Government can also make up the revenue loss by raising income and consumption taxes on transactions that cannot be moved to the Internet. Examples of these transactions are locally provided services (construction activities, medical services, etc.) and retail sales at brick and mortar locations. But this approach has the unlovely consequence of distorting the U.S. economy by providing a comparative advantage to the forms of enterprise that can be moved to the Internet.

The preferred solution is to find ways to keep Internet commerce in the state consumption tax and federal income tax bases, and to bring mail order commerce into both tax bases at the same time. 32 The challenges of doing that, however, are truly daunting. Those challenges, at the state and local level, with respect to electronic commerce, are the subject of the following Symposium articles.

30. See J. Clifton Fleming, Jr., Ending the IRS as We Know It: Thoughts From Outside the Beltway, 73 TAX NOTES 502 (1996).
32. See supra note 16.