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## Tax Moratorium Expires: Open Season on E-Commerce?

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As discussed in our [August 1, 1999 Internet Alert](#), in 1998 Congress passed, with much fanfare, the Internet Tax Freedom Act (the "ITFA"). The ITFA imposed a three-year moratorium on any new state or local taxes on Internet access and any multiple or discriminatory taxes on e-commerce.

Despite its ambitious title, however, the ITFA did not ban all, or even most, taxes on Internet access and e-commerce. For example, the ITFA did not ban Internet access taxes that were "generally imposed and actually enforced" prior to October 1, 1998; nor did it, in general, ban a state or locality from requiring an e-retailer to collect sales taxes if the e-retailer had a physical presence within the state or locality in question.

To date Congress has failed to pass any of the several bills that would have extended the ITFA moratorium, and, accordingly, the moratorium expired on October 21, 2001. The political rhetoric surrounding this expiration has been somber, and, in all likelihood, Congress ultimately will establish a new moratorium (although an unlikely coalition of certain states and "bricks and mortar" businesses has formed to oppose such action). For now, however, the relevant question is how the expiration of the moratorium could affect e-commerce.

One obvious result of the expiration is that states and localities can again impose taxes on Internet access. Ten states already impose such taxes (which predated and therefore survived the ITFA moratorium), and other states and localities may now use this opportunity to impose their own taxes before another moratorium is imposed. However, Congress could seek to strike down such new taxes by retroactively enacting an extension of the ITFA.

In reality, the expiration of the ITFA moratorium may create fewer foreseeable adverse tax consequences than anticipated for the largest segment of e-commerce, namely business-to-consumer and business-to-business sales. This is because many of the restrictions that the ITFA imposed on Internet taxation did nothing more than confirm that e-commerce businesses were protected by the same type of constitutional limitations that apply when states and localities impose their tax jurisdiction on out-of-state businesses engaged in mail order sales.

In this regard, the Supreme Court had already determined that a state or locality could not impose its sales or use taxes on an out-of-state business that had no physical presence within the state.

Even prior to the expiration of the ITFA, some states continued their aggressive efforts to expand their taxing jurisdiction over e-commerce. Our [June 26, 2001 Internet Alert](#) analyzed a new Arkansas law that seeks to circumvent the Supreme Court's physical-presence requirement by compelling certain out-of-state businesses selling property in Arkansas to collect Arkansas sales taxes. Under that law, which takes effect on January 1, 2002, out-of-state e-retailers will be required to collect Arkansas sales tax if the e-retailer has a substantial interest in a business with a physical presence in Arkansas and either the e-retailer sells products similar to those sold by that business under a similar business name or the facilities of the business with a physical presence are used to advertise or promote sales of the e-retailer. The theory behind this new Arkansas law presumably is that the physical-presence requirement is satisfied by attributing to the e-retailer the in-state physical presence of the related business. While this theory is questionable and subject to constitutional challenge, the expiration of the ITFA moratorium should have little or no impact on whether the Arkansas law survives any such challenge.

Nevertheless, the ITFA's effect on certain positions tentatively asserted by states such as Texas may have been significant. Texas has implied that, under the U.S. Constitution, it has jurisdiction to tax out-of-state e-retailers whose Web sites are hosted by servers located within its borders. Other states, like California and Virginia, have reached the opposite conclusion, and have declared that servers located within their borders do not by themselves create a sufficient taxing nexus. While the courts have not yet resolved this difference, certain provisions of the ITFA could be read to have prevented a state from asserting its taxing jurisdiction based solely on the presence of a server within the state. With this additional protection now gone, out-of-state e-retailers may want to reconsider the locations of the servers that they use if extension of the ITFA is deferred for an extended period and states indicate that they will assert taxing jurisdiction on the basis of in-state location of servers. Accordingly, such retailers should closely monitor the progress of both ITFA extension legislation and state administrative and legislative tax activity.

In any event, although the ITFA has been the subject of an inordinate amount of controversy, most of the rhetoric surrounding its expiration has probably been misplaced. With the exception of its ban on Internet access taxes and the potential safe harbor for in-state servers mentioned above, the ITFA had little impact on e-commerce. Moreover, most of the pending bills that would extend the ITFA are unlikely to resolve finally the key questions surrounding the taxation of e-commerce. Indeed, these questions will remain unanswered until Congress or the Supreme Court provide more specific, definitive guidance.

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