The Risk of Inadvertently Establishing State Taxing Jurisdiction through the Internet

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In what amounts to no more than the past two years, the global business community has unreservedly embraced the Internet as a seemingly boundless, yet relatively efficient means for conducting business without regard for traditional geopolitical constraints. The speed, pervasiveness and certainty of this phenomenon are matched only by the enthusiasm and conviction that so plentifully fuel it. Yet, businesses that have embraced, or are preparing to embrace, the Internet might do well to pause and consider some of the tax implications, particularly the state tax implications, of conducting business through the Internet.

Most obvious among these state tax implications are the potential for multistate sales and use taxation of goods and services sold or provided through the Internet and the potential for multistate income taxation of earnings derived through the Internet. The unexplored issues that inevitably arise when considering these implications, however, are too numerous to be fully addressed in this short article, and so, this article will address a specific, but highly fundamental issue: the potential for businesses operating through the Internet to subject themselves inadvertently to the taxing jurisdiction of states in which they do not otherwise operate (and were not previously taxable).

Businesses, that for the first time, subject themselves to the taxing jurisdiction of a state, whether inadvertently or intentionally, can expect to suffer several adverse consequences. First, they can expect to become legally obligated to collect and pay the sales and use taxes imposed by that state. Satisfying this obligation generally will be expensive not only from an administrative perspective but also, and perhaps more importantly, from a competitive perspective, as real economic prices inevitably must rise in order to account for the imposition of these taxes. Second, they can expect that a portion of their total income will be subjected to multistate income taxation. Generally, the portion of their income that will be taxed by a particular state will be determined under an "apportionment" formula that is based on one or more of the following factors: (1) percent of total sales in the state; (2) percent of total property in the state; and (3) percent of total payroll (i.e., work force) in the state.

Thus, businesses should consider carefully whether they might adopt certain strategies for utilizing the Internet in ways that will minimize their exposure to taxation by states in which they do not otherwise operate. At the very least, they should be prepared to defend themselves in the event that one or more states assert their taxing jurisdiction over them based solely on their use of the Internet.

Background

It is well settled that, while the states inherently possess vast power to impose taxes on businesses operating in or deriving profits from within their borders, this power is subject to clearly defined limitations under the "Commerce Clause" [1] and the "Due Process Clause" [2] of the United States Constitution. In particular, in *Complete Auto Transit, Inc. v. Brady*[3], the Supreme Court held that the Commerce Clause -- which technically reserves for Congress the power to regulate commerce among the states -- precludes a state from imposing a tax on a business unless the tax: (1) is applied to an activity that has a substantial nexus with the state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided to the business by the state. Similarly, though less restrictively, in *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*[4], the Supreme Court held that the Due Process Clause -- which technically prohibits a state from depriving any person of life, liberty, or property without due process of law -- precludes a state from imposing a tax on a business unless: (1) there is at least a minimal connection between the state and the business activity being taxed; and (2) the business' connections with the state are substantial enough to legitimate the state's exercise of power over it.

In the specific context of sales and use taxes, the Supreme Court has further provided a bright-line test for determining whether a business has the requisite "substantial nexus" with a state so that the state can assert its taxing jurisdiction over the business. In *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*[5], and then again in *Quill Corporation v. North Dakota*[6], the Supreme Court held that a state cannot subject a business to the requirement of collecting and paying its sales and use taxes unless, at a minimum, the business maintains some "physical presence" in the state. Thus, for example, while a business that maintains a sales office or sales force in a state will be subject to the state's sales and use tax jurisdiction, a business whose only contacts with the state are by mail or common carrier generally will not be subject to the state's sales and use tax jurisdiction.

In the context of income taxes, Congress long ago exercised its powers under the Commerce Clause by legislating a threshold test for determining whether a state can impose its income tax on a particular business. Under P.L. 86-272 [7], no state can impose a net income tax on the income derived from within the state by an interstate business if the only business activities within the state by or on behalf of the business are comprised of "the solicitation of orders by such [business], or [its] representative . . . for sales of tangible personal property, which orders are sent outside the [s]tate for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the [s]tate." For this purpose, "solicitation" generally includes all activities that are essential to making requests for purchases and all other activities that are entirely ancillary to making these requests. [8]

Nexus Through the Internet

Problematically, while the current "physical-presence" and "solicitation" tests have traditionally provided businesses with a fair degree of certainty as to when they can expect to be subject to a state's taxing jurisdiction, neither of these tests were devised with the Internet in mind. Consider, for example, a hypothetical business that advertises and sells (technically licenses) its software over the Internet. An aggressive state might argue that such a business, despite its complete lack of other contacts with the state, should be subject to the state's sales and use taxes and/or income tax. In making this argument, the state might assert that the presence of licensed software, or even just an Internet site or advertisement, in the state is sufficient to constitute a physical presence within the state. Additionally, if the business maintains or engages technical-support, diagnostic, or other personnel to provide service for customers located in the state, or if the business maintains or engages a computer server in the state, then the state might assert that these arrangements also comprise a physical presence in the state. One tax official from the California State Board of Equalization, for example, recently warned that "[i]f you are on a nationwide ISP [Internet service provider] and you have a Web page, you might want to try and get them not to put it on a server in California." [9]

In *Quill*, the Court noted that "although title to a few floppy diskettes present in a [s]tate might constitute some minimal nexus," the Court would reject any "slightest presence" standard of constitutional nexus [10] . Nevertheless, the Court did not elaborate on what it meant by "a few floppy diskettes" and whether it mattered that the software in question had originally been transferred into the state through a tangible medium. Moreover, in *Goldberg v. Sweet*[11], the Supreme Court held that, at least in the analogous context of a telecommunications tax, substantial nexus does exist between a state and a business providing a service in the state where the service originates or terminates in the state and the service is charged to a service address within the state or is billed or paid within the state.

That same aggressive state might also argue that if the business' software was not transferred in diskette or CD ROM form, then it was not tangible personal property, the advertising and licensing of which would have been protected under P.L. 86-272. Indeed, in *Geoffrey, Inc. v. South Carolina Tax Commission*[12], the Supreme Court of South Carolina held that a Delaware business whose only connection with the State of South Carolina was through its licensing of an intangible -- a trademark -- in South Carolina was subject to the South Carolina income tax. Since 1993, several states, including Arkansas, Florida, Massachusetts, and Wisconsin, have formally announced their intentions to follow *Geoffrey*, applying their income taxes to businesses that maintain an intangible-property presence within their borders.

Therefore, under these circumstances, this hypothetical business could be subjected to multistate sales, use, and/or income taxation solely or partly as a result of its use of the Internet. Moreover, the likelihood of such a fate will be greatly enhanced if the business has engaged an agent or independent contractor in the state to create or operate an Internet site, to provide telecommunications or other distribution services, to assist customers, or to solicit potential customers. The Supreme Court has long held that an agent or independent contractor acting on behalf of a business within a state may be sufficient to subject that business to the state's sales, use, and income taxes. [13]

In fact, recent cases suggest that there may be authority (if only by way of analogy) on which states could rely in making the type of arguments suggested in this article. In *CompuServe, Inc. v. Patterson*[14], for example, the Court concluded that an Internet customer who was located in Texas but who used CompuServe's Ohio network to advertise and distribute his software through the Internet was subject to the jurisdiction of the Ohio courts. While this case dealt with the Due Process Clause and not the Commerce Clause, some states may try to rely on this type of case as authority for asserting their taxing jurisdiction over foreign businesses. [15]

Indeed, at least two cases suggest that a state could assert its taxing jurisdiction over a business based solely on the fact that the business advertises or maintains a universally accessible site on the Internet. In *Inset Systems, Inc. v. Instruction Set, Inc.*[16], the Court held that a Massachusetts business was subject to the jurisdiction of the Connecticut courts because the Massachusetts business continuously advertised over the Internet, which included thousands of access sites in Connecticut, and because it maintained an Internet site that could be accessed by Connecticut residents. [17]

Protective Measures

Businesses that operate through the Internet should not readily concede that they are taxable in states in which they are not otherwise present or doing business. Neither the Supreme Court nor Congress has yet made any final pronouncements regarding the taxation of businesses operating through the Internet, and, until they do, powerful arguments, based on the Commerce Clause and the Due Process Clause, can be made to rebut the states' aggressive assertions of jurisdiction. Moreover, Due-Process-Clause standards for finding state court jurisdiction over out-of-state businesses are less stringent than Commerce-Clause standards, and the above Due-Process-Clause cases should have little precedential value as a basis for expanding a state's *taxing* jurisdiction.

In the meantime, businesses should monitor, and if necessary modify, their practices to minimize their exposure to the risk of such aggressive assertions by eliminating any contacts that may be considered a physical presence within a state. Having employees or representatives, or owning or maintaining tangible property within a state may provide the state taxing authorities with a traditional basis for asserting nexus. In this regard, the Multistate Tax Commission -- of which many but not all states are members -- recently suggested certain activities that might support an assertion of sales and use tax jurisdiction over a business:

1. maintaining employees or other representatives in the state (*e.g.*, to create or operate an Internet site or to provide technical-support, repair, or diagnostic services);
2. owning, leasing, or maintaining real property (*e.g.*, an office or storage facility) in the state;
3. owning, leasing, or maintaining tangible personal property (*e.g.*, computers, computer servers, diskettes, or manuals) in the state;
4. either on its own or through a representative, maintaining telecommunication linkage in the state; or

5. either on its own or through a representative, performing services (*e.g.*, technical support, repairs, or diagnostics) in the state. [18]

By eliminating all of the enumerated activities within selected states, businesses will preserve their best defense that a state may not assert its sales and use tax jurisdiction over a business whose only contact with the state is through telecommunications or the mail. Moreover, by abstaining from activities that exceed mere "solicitation" in selected states, businesses should enhance their ability to fend off traditional assertions of income tax jurisdiction by those states. If it is practical from a business perspective to do so, by minimizing the above activities in states in which they generally are not present or otherwise operating, businesses operating through the Internet may be able to protect themselves from unnecessary state taxation.

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1 Art. I, § 8, Cl.3.

2 Amend. XIV, § 1.

3 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), *reh'g denied*, 430 U.S. 976 (1977).

4 *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

5 *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967).

6 *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

7 15 U.S.C. § 381.

8 *See William Wrigley Jr. Co. v. Wisconsin Department of Revenue*, 505 U.S. 214 (1992).

9 *See* Donmoyer, "Computer Software Regs Could Drive Internet Tax Debate," 96 STATE TAX NOTES 221-52 (1996).

10 *See Quill Corporation v. North Dakota*, 504 U.S. 298, at footnote 8.

11 *Goldberg v. Sweet*, 488 U.S. 252 (1989).

12 *Geoffrey, Inc. v. South Carolina Tax commission*, 313 S.C. 15 (1993), *cert. denied*, 510 U.S. 992 (1993).

13 *See, e.g., Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); and *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987).

14 *CompuServe, Inc. v. Patterson, 89 F.3d 1257 (6th Cir. 1996), reh'g denied, 1996 App. LEXIS 24796 (6th Cir. 1996).*

15 *But see State of New York Department of Taxation and Finance, TSB-M-97 (1997) (ruling that "[n]exus with the state [of New York] is not created merely by having a non-New York company's advertising appear on a New York server or through a New York Internet service provider").*

16 *Inset Systems, Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D. Conn. 1996).*

17 *See also Maritz, Inc. v. Cybergold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996) (holding that a state court has jurisdiction over a business where the business has used the Internet to operate in the state). But see Bensusan Restaurant Corp. v. King, 937 F. Supp. 295 (S.D.N.Y. 1996) (holding that merely placing an advertisement on an Internet site accessible in New York but located on a server in Missouri did not establish Due Process Clause nexus with New York).*

18 *See Multistate Tax Commission Staff Working Draft of the Constitutional Nexus Guidelines for Application of a State's Sales and Use Tax to an Out-of-State Business (November, 1996).*

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