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# The Sales and Use Tax Dilemma: Multiple Taxation

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## I. INTRODUCTION

At least over the foreseeable future, the largest potential for electronic commerce will be business transactions with other businesses. Substantial multiple taxation will occur if these business-to-business services are subjected to state and local sales taxes. This taxation scheme would result in an excessive burden on business inputs and intermediaries in the chain of electronic commerce prior to their final consumption by non-business consumers. Because of this feature of multiple taxation, the present structure of sales and use taxes are ill-suited as an Indirect Tax System for 21st Century America.

The contemporary state governmental focus and debate on nexus, while important, is solvable within the current structure of state sales and use taxes. In light of the U.S. Supreme Court decision in *Quill Corporation v. North Dakota*,<sup>1</sup> under our constitutional system, resolution of this nexus question with regard to final consumers may require congressional action. However, the Interstate Commerce Tax Act provides precedence for such a solution in the income tax arena.<sup>2</sup> The Act also protects vendors selling tangible goods over the Internet from state tax nexus, assuming there are no other contacts with the customer's jurisdiction.<sup>3</sup> Nevertheless, when addressing the multiple taxation of business, nexus is not the issue, since it has never been a serious issue for business-to-business transactions because of the parallel use tax structure. Local businesses file sales tax returns and are required to include a use tax on out-of-state purchases where no sales tax was charged. Furthermore, as verifiable audit trails are built into the technol-

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1. 504 U.S. 298 (1992).

2. Pub. L. No. 86-272, 73 Stat. 555 (codified as amended at 15 U.S.C. §§ 381, 382 (1997)).

3. See *id.* § 381.

ogy, nexus questions involving electronic commerce will be resolvable depending on decisions about source or residency primacy.

On the other hand, the tax-pyramiding, currently existing where services have not been exempted from sales taxes, is not receiving the attention necessary for resolution. It is the first-order problem that will interfere with the economic growth of the Internet system of electronic commerce. To date, tax-pyramiding has been predominantly controlled by exempting Internet access and content services from the sales tax base.

States have raised the concern that electronic commerce will significantly reduce their tax bases. However, quite the opposite is more likely to occur, as electronic commerce will increase all commerce, including traditional commerce at the local level, subject to sales taxation. A more likely circumstance of Internet services between and among businesses being subjected to state and local sales taxes, is that the state tax base will increase far beyond what is conceivably fair or required by projected governmental expenditures. This increase will harm and burden emerging electronic commerce.

## II. ELIMINATION OF DOUBLE TAXATION

No society can grow and prosper economically under a system of high double and multiple tax burdens. Economic activity will be distorted by finding ways and making structural decisions to avoid such burdens. It was precisely for this reason that, at its formation, the European Union replaced the turnover tax with the value added tax (VAT), where the former had serious double tax features similar to the existing sales tax. The VAT virtually eliminated this condition.

Numerous provisions in existing tax systems work to eliminate double taxation. At the international level, the United States employs a foreign tax credit system. Other countries exempt income arising outside of their borders to avoid the double taxation of income already subjected to tax in the source jurisdiction. States provide those domiciled in their jurisdiction with a credit for taxes imposed by other states on income realized in the other source state, but which is also included in the domiciliary state tax base. The general state sales tax laws provide both indirect and direct measures to avoid double taxation, but this has not proven to be a complete remedy. In general, states provide a credit for sales taxes paid to another jurisdiction against a use tax liability, although some states refuse to provide a credit for the local portion of another state's sales tax. States also provide businesses with resale exemptions where the commodity or service is purchased by an intermediary reseller for resale in the form in which it was originally purchased.

Applying this direct method of eliminating double taxation is more difficult in the case of services as contrasted with goods, which are more easily traceable in a resale context.

### III. SALES TAX BASE

To avoid pyramiding of sales tax on business-to-business services, the tax rules require special attention. Historically, the sales tax developed primarily as a tax on the sale of tangible goods; services were mainly exempted. Most states do not broadly tax services. Florida and Massachusetts recently broadened their sales tax base to include services, but repealed their tax on services shortly thereafter, because of problems with business-to-business services and tax-pyramiding. Many states continue to resist extending their sales tax base beyond services of electric, telephone (telecommunication), and other utilities. Even for utility services, exemptions are provided to manufacturers and other business users. Also, sales by telecommunications "resellers," companies that make large volume, bulk purchases (such as carriers) for resale in smaller increments to individual customers, have been afforded a resale exemption.

Unfortunately, some state tax administrators have broadened the interpretation of telecommunications utility-service sales taxes to include Internet access and content services. This practice has elicited a strong response from the industry, which is still in its infancy, resulting in:

*California* adopting regulations treating the maintenance of a world wide web site on a computer server as not to constitute being engaged in business.<sup>4</sup>

*Florida* enacting a prohibition on sales taxation of Internet access and related services.<sup>5</sup>

*New York* exempting Internet service provider monthly subscription charges, including e-mail and newsletter services.<sup>6</sup> Also, New York exempted advertising agency charges for design services and computer programming services for world wide web sites.<sup>7</sup>

*Massachusetts* enacting legislation imposing a moratorium on sales taxation of Internet services until July 1999.<sup>8</sup>

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4. CAL. CODE REGS. tit. 18, § 1684 (1998).

5. FLA. STAT. ANN. §§ 203.012, 212.05 (West Supp. 1998). See also *Vertex Tax Cybrary* (July 29, 1997) <[http://www.vertexinc.com/taxchannel170/tax/sum\\_\\_73.html](http://www.vertexinc.com/taxchannel170/tax/sum__73.html)>.

6. See N.Y. TAX LAW § 1105 (Consol. 1997).

7. See N.Y. Adv. Op. Comm. T & F TSB-A-95(33)S.

8. See MASS. GEN. LAWS ANN. ch. 64H, § 1 (West Supp. 1998).

*South Carolina* exempting electronic delivery of computer software.<sup>9</sup>

*Virginia* exempting Internet service providers.<sup>10</sup>

The sales tax system has so many anomalies, that a logical structure does not prevail. Alabama, as well as a number of other states, imposes a sales tax on "canned computer software," but exempts "custom software programming" services.<sup>11</sup> Florida taxes information services differently, depending on whether they are delivered on hard copy (paper) or electronically. On July 8, 1997, the Florida Department of Revenue ruled that e-mail was exempt from sales tax. A telemarketing company's fees for information sold to cable television operators (business-to-business services) was tax-free when delivered by e-mail, but taxable if delivered by hard copy.<sup>12</sup> This hardware-versus-software dilemma has also plagued the computer industry's sales to other businesses, resulting in the need for states to find ways to differentiate transactions in order to avoid pyramiding.

Hawaii, New Mexico, and South Dakota are the only states that currently have a sales tax on a broad group of services. Other states tax services on a selective basis. Hawaii, at least, reduces tax-pyramiding by applying a reduced tax rate to intermediary service providers.<sup>13</sup> South Dakota exempts intercompany service charges.<sup>14</sup> Five states impose no general sales tax on goods or services: Alaska, Delaware, Montana, New Hampshire and Oregon.<sup>15</sup>

#### IV. CONSULTING, COMPUTER AND INFORMATION SERVICES

Engineering services have long been recognized as an important component of product and intangible transactions. However, enhanced computer and information service and consulting companies that provide a wide array of services are a recent phenomena.<sup>16</sup> New capabilities, advances in computer technologies, and business solutions will exist for electronic commerce. These consulting services combine business process re-engineering with information technology transformation, encompassing software development, acquisition, implementation, training,

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9. See S.C. CODE ANN. § 12-36-60 (Law. Co-op. 1997).

10. VA. P.D. 97-306 (enacted July 18, 1997), available in 1997 Va. Tax LEXIS 305, at \*3.

11. Ala. Admin. Code r. 810-6-1-.37 (1997).

12. See Tech. Assistance Advisement 97(A)-045 (July 8, 1997).

13. See HAW. REV. STAT. § 237-13(6) (1997).

14. See *Department of Revenue v. Sanborn Tel. Coop.*, 455 N.W.2d 223 (S.D. 1990) (interpreting the legislative intent behind S.D. CODIFIED LAWS § 10-45-4 (Michie 1997) as not creating sales and service taxation for services provided between a parent company and its wholly owned subsidiary).

15. All St. Tax Guide (CCH) ¶ 60-100.

16. Examples of these new "mega-firms" include: EDS, SAP, Anderson Consulting, IBM's global service business unit, and the merged Compaq-Digital service businesses.

and ongoing support. For example, Deloitte & Touche has provided such services to Digital, Fujitsu, H-P, INTEL, Lucent Technologies, Microsoft, and Toshiba.

While multinationals will be out-sourcing and purchasing large dollar volumes of such services, they will also be providing on-line, cross-border services to their affiliated groups from competency centers. The provision of services is often an important element in a contract for the license or other transfer of intangible property. The services component of integrated transactions may involve training, installation, provision of upgrades and improvements, maintenance and repair services, and marketing and administrative services.

Connecticut, Iowa, and West Virginia have extended their sales tax laws to include consulting services.<sup>17</sup> This could open up a significant area for tax-pyramiding, since the largest volume of such services are purchased by other businesses. Connecticut exempts intercompany services, and sales tax on computer services is being phased out over the next three years.<sup>18</sup> Both Iowa and West Virginia, however, exempt consulting services provided by "licensed, certified or registered" professionals, which, in effect, eliminates any broad application of the tax to consulting services.<sup>19</sup>

There is a maze of numerous conflicting rules relating to the taxation of information services under various state sales tax laws. Ohio applies its tax to electronic information services, making it unlikely that such service providers will locate there.<sup>20</sup> Both New York and Texas exempt information services provided to a particular business when it is of a proprietary nature to that particular company.<sup>21</sup> As one would expect, state courts are flooded with cases requiring them to examine the definitions relating to business-to-business services and various exemptions. Additionally, due to the enormity of the compliance task for a multistate business, the lack of uniformity coupled with the existence of substantial definitional issues creates significant risk of a high-level of error in sales tax administration.

Under most states' sales tax laws, services are exempted unless specifically taxed; whereas, goods are taxed unless specifically exempted. Such definitional issues create a presumption *against* taxing new services. Unfortunately, state tax administrators do not follow this

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17. See CONN. GEN. STAT. § 12-407 (1997); IOWA CODE § 422.43 (1997); W. VA. REGS. § 110-15-8.1.1 (1997).

18. See *id.*

19. See *id.*

20. See OHIO REV. CODE ANN. § 5739.01(B)(3)(e) (Anderson 1998).

21. See N.Y. TAX LAW § 1105(c)(1) (Consol. 1997); TEX. ADMIN. CODE § 3.342(d), (i) (West 1997).

tendency and are inclined to expand taxing bases whenever possible. While the states, and in particular the Multistate Tax Commission, argue in principle for "full accountability" of taxpayer transactions as a corollary, states need to recognize that "full" does not mean "multiple," and that greater accommodation is needed to eliminate tax-pyramiding.

## V. FEDERAL LEGISLATION

The Telecommunications Act of 1996 contains two provisions that could apply to the taxation of Internet transactions.<sup>22</sup> Generally, the Act states that "No state or locality may inhibit telecommunication services."<sup>23</sup> Scenarios can be envisioned where an excise or transaction tax could operate as an inhibitor. Moreover, the Act specifically prohibits "local taxation of direct to home satellite communications services."<sup>24</sup>

The U.S. Constitution grants Congress the power to regulate commerce among the several states.<sup>25</sup> Clearly, electronic commerce over the Internet would fall within this congressional authority. In this context, the Cox/Wyden "Internet Tax Freedom Act" would regulate the states' authority to tax electronic commerce.<sup>26</sup> In late-March of 1998, a year after its first introduction, California Representative Cox offered an amendment to the Act, and an Internet state tax moratorium bill<sup>27</sup> was introduced by Ohio Representative Chabot in the House Judiciary Committee. These proposals reflect a compromise by both business and state government tax administrators. Under the compromise, Internet commerce would be exempt from six specified categories of state and local taxes:

- "Bit" taxes (based on the amount of digital information transmitted electronically)
- Bandwidth taxes
- Discriminatory taxes on electronic commerce
- Taxes on Internet access
- Taxes on on-line services (including content and information processing services)
- Multiple taxes on electronic commerce

The authors of the bill based the need for this legislation on a finding that:

[I]nconsistent and inadministrable taxes imposed on the Internet,

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22. The Telecommunications Act of 1996, Pub L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.).

23. 47 U.S.C. § 253(a) (1997).

24. 47 U.S.C. § 602(a) (1997).

25. See U.S. CONST. art. I, § 8, cl. 3.

26. H.R. 3529, 105th Cong. (1998).

27. *Id.* § 3.

Internet access, and on-line services by Federal, State and local governments would subject consumers, businesses and other users engaged in interstate and foreign commerce to multiple, confusing and burdensome taxation, and restrict the growth and continued technological maturation of the Internet itself. The twenty-first century marketplace requires a twenty-first century sales tax system that is more uniform, consistent and streamlined.<sup>28</sup>

This legislative statement seems to sum up the dilemma, challenge, and opportunity quite well. It establishes an agenda worthy of our attention.

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28. *Id.* § 2.