Taxing Electronic Commerce Fairly and Efficiently

52 *Tax Law Review* 625-654 (1997)

by Michael J. McIntyre

Contents

Taxing Electronic Commerce Fairly and Efficiently

52 *Tax Law Review* 625-654 (1997)

by Michael J. McIntyre[*]

I. Introduction

On October 21, 1998, President Clinton signed the so-called Internet Tax Freedom Act (ITFA), which Congress had passed that same day as part of the Omnibus Consolidated Appropriations Act.[1] ITFA imposes a three-year moratorium, beginning October 1, 1998, on certain new state and local taxes on the Internet.[2] More importantly, it establishes an Advisory Commission on Electronic Commerce to "conduct a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access, and other comparable intrastate, inter state or international sales activities."[3] From the perspective of the Advisory Commission, the publication of this symposium issue on electronic commerce is timely, for many of the topics that Congress has deposited on its plate are addressed therein.

My assignment for this symposium is to comment on two articles by distinguished academics, one by an economist and the other by a lawyer. Both provide an extensive introduction to the challenges that electronic commerce poses for the tax collector. Charles McLure has produced the *Encyclopedia Britannica* of electronic commerce, addressing state, local, and international issues under the sales tax and the income tax, prefaced by his own theory of the history of communications and an extended introduction to the technology on which the Internet is based.[4] Walter Hellerstein limits himself to state and local

---

[*]Professor of Law, Wayne State University. The author is grateful to Richard D. Pomp, Paull Mines, Michael Mazerov, and Kingsley Browne for assistance in this Article.

[1]Pub. L. No. 105-277, 112 Stat. 2681 (1998).

[2]Id. at 1101(a), 112 Stat. 2681.

[3]Id. at 1102(g)(1), 112 Stat. 2681.

[4]Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technology Constraints, and Tax Laws*, 52 Tax L. Rev. 269 (1997).

tax issues; he succeeds, nevertheless, in producing a formidable tome that defies easy summary.[5] Both authors make constructive contribu [*626] tions to the ongoing debate over Internet taxation. Their articles are required reading for the Advisory Commission on Electronic Commerce.

Both recognize that the tax problems posed by the Internet are largely extensions of a set of problems that were around before the dawn of the digital age. McLure takes the position that these ancient problems must be addressed squarely for any reform of Internet taxa tion to be meaningful.[6] Hellerstein suggests that fundamental reform, although desirable, is probably not practical in the current political environment.[7] He proposes fairly modest reforms that would mitigate, but not solve, the problems that he and McLure have identified.[8] The Advisory Commission must be substantially more venturesome than Hellerstein if it hopes to make a mark. The root and branch restructuring of tax systems proposed by McLure, however, goes well beyond the Commission's mandate.

In Section II, I offer caveats to some of the advice McLure and Hellerstein offer, at least by implication, to the Advisory Commission, and highlight some of their recommendations to which I attach great importance. I also offer some opinions of my own. As suggested above, both authors provide much that the Advisory Committee should find useful. I make no effort in Section II, however, to address even a fair sampling of the matters addressed in these lengthy articles.

Section III deals with the problem presented under the sales tax that commonly is referred to as "entity isolation." A remote seller engages in entity isolation when it seeks to avoid having to collect a state sales

---

[5]Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 Tax L. Rev. 425 (1997).

[6]McLure, note 4, at 277 (stating that he believes strongly that the goal of a "level play ing field" for electronic commerce in the sales tax area cannot be achieved without addressing fundamental problems of the sales tax that should have been addressed long ago).

[7]Hellerstein, note 5, at 480.

[8]Id. at 483-84 n.244 (describing his proposals for change as "incremental").

tax on sales to customers located in that state by transferring its nexus-creating assets and activities to an affiliated company.

As an example of the problem of entity isolation, assume that P Co, a remote seller, makes mail-order sales into Michigan. It also owns a warehouse in Michigan. The black letter rule is that ownership of real property located in a state confers nexus on a company under the Due Process and Commerce Clauses.[9] In an attempt to avoid nexus, and thereby avoid the obligation to collect the Michigan sales and use tax [*627] on sales to its Michigan customers, P Co transfers the warehouse to S Co, its wholly-owned affiliate.

Many practitioners use the term "nexus by attribution" to refer to attempts by a state to defeat the goal of entity isolation by finding nexus with the remote seller through the nexus-creating property or activities of an affiliated company.[10] They mean to imply with that sobriquet that the asserted nexus claim is illegitimate. A company, however, can never have nexus with a state except by attribution. It is, after all, a legal entity with no physical attributes. Individuals can have nexus with a state through their physical presence in the state. A corporation, in contrast, can be physically present in a state only indirectly, through, for example, the ownership of property or through employees, agents, or other representatives acting on its behalf.[11]

McLure addresses the issue of entity isolation briefly, chiefly to announce that it should not be tolerated in a sensible sales tax

---

[9]See National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 559 (1977) (indicating that "mail order sellers with retail outlets, solicitors, or property" within a taxing state are not protected from a collection obligation imposed by that state) (quoting National Bellas Hess, Inc. v. Illinois Rev. Dept. 386 U.S. 753, 758 (1967)). The rule that real property creates nexus apparently is so well understood by taxpayers and tax officials that it has not been the subject of litigation.

[10]See, e.g., Michael H. Lippman, *State Challenges to Related-Party Transactions*, 14 St. Tax Notes 1999, 2010-13 (June 22, 1998).

[11]Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin* 95-1, 11 St. Tax Notes 177, 181 (July 15, 1996); see also Paull Mines, *Commentary, Conversing With Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 Tax L. Rev. 581 (1997).

regime.[12] Hellerstein does not address the issue at all. The issue, nevertheless, is of critical importance. If entity isolation is permitted, then all of the nexus rules discussed in such detail by McLure and Hellerstein have no practical import. Collection of sales and use tax on remote sales becomes elective. Given the election, most, if not all, sellers can be relied upon to elect not to collect the tax.

Because of the importance of the entity-isolation issue and the lack of coverage given to it in other articles in this symposium issue, I address it here at length. I argue that several Supreme Court precedents provide strong support for state attempts to combat entity isolation. In addition, I offer a new approach that the states could follow to impose a collection duty on an affiliated group composed of a remote seller and a company that has nexus-creating assets or nexus-creating activities in the state. This new approach does not require "nexus by attribution," as that term is understood by practitioners.

Section IV contains some brief concluding remarks.

II. Potpourri of Advice to Advisory Commission

I discuss below a variety of loosely connected topics that are likely to be of interest to the Advisory Commission on Electronic Commerce. Most of these topics relate to the state retail sales tax.
[*628]

A. Facing the Problem of Cross-Border Shopping

A notable feature of state governments is that they are able to exer cise very limited control over their borders. For example, they cannot interdict commerce passing into or out of their territories. Because they relinquished control over their borders to form a more perfect union, their ability to levy sales taxes can be threatened by cross-bor der shopping.[13] Cross-border shopping is a particularly difficult problem

[12] McLure, note 4, at 402.

[13] For discussion of the problem of cross-border shopping in the context of NAFTA, see Michael J. McIntyre, *Commentary, The Design of Tax Rules for the North American Free Trade*

for small states that are surrounded by states that do not attempt to levy a sales tax, or that levy it at low rates, or that exempt certain goods and services from the tax. Rhode Island, for example, would have difficulty levying a sales tax on clothing if the malls located just outside its borders were selling clothing free of sales tax. To prevent putting its merchants at a significant commercial disadvantage, Rhode Island might feel compelled to exempt clothing as well.

Shopping over the Internet is cross-border shopping on stilts. Remote sellers using the Internet to communicate with their customers can set up shop almost anywhere, as states generally do not attempt to tax sales to customers located outside the state. In theory, the destination state could impose its sales and use tax on Internet sales. Collecting that tax is nearly impossible, however, without the assistance of the remote seller. The states have so far had little success in obtaining that assistance.

In my view, the primary duty of the Advisory Commission on Electronic Commerce is to develop a practical strategy for saving state retail sales taxes from the corrosive effects of cross-border shopping, through catalogs and over the Internet. Whatever that strategy, it will need to take account of the reasonable needs of the states and their concern about the erosion of their sovereignty to tax. It also will need to take account of the political power of the remote sellers, reinforced by voter preferences for purchasing goods free of sales taxes. To have any hope of success, the Commission must create an environment conducive to compromise. At the same time, it must be prepared to move towards a solution even if some of the participants in the process it creates should prove to be recalcitrant.

As McLure and Hellerstein make clear, the Supreme Court's decision in *Quill*,[14] which prevents the states from imposing an obligation to collect a use tax on certain mail-order sellers, has made it difficult for the states to develop solutions to the problem of cross-border shopping

---

Alliance, 49 Tax L. Rev. 769 (1994).

[14]Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

on their own. Congressional action may be needed. One avenue [*629] of reform that the Advisory Commission ought to consider is the replacement of the *Quill* rule with a rule that is more responsive to the Court's concern about the burdens of state taxation on interstate commerce.

McLure suggests replacing the *Quill* rule with one allowing states to impose a collection duty on remote sellers whenever the volume of their sales into a state exceeded some *de minimis* amount.[15] I endorse that approach.[16] That revision of *Quill* would need to be accompanied by changes in state practices that would reduce significantly the compliance burdens imposed on vendors selling through catalogs and over the Internet. It also would have to be part of a package that resulted in comparable treatment of electronic commerce and traditional mail-order sales.

B. Trojan Horse

To succeed in stimulating state tax reform, the Advisory Commission must work to create consensus among the major players. Indeed, its charter requires that its recommendations be endorsed by a two- thirds majority of the Commission.[17] It will not promote the needed consensus if it becomes a vehicle for advancing various right-wing fan tasies, such as the replacement of the progressive income tax with a flat tax or a national value-added tax. Far left fantasies, such as the creation of a global taxing authority, also should be off the Commission's agenda.

---

[15]McLure, note 4, at 400-01.

[16]Commentators refer to nexus created under such a rule as "sales threshold nexus." See Mines, note 8, at 584. As a law student some decades ago, I wrote a research paper for the late Elisabeth Owens in which I proposed replacement of the permanent establishment rule contained in most tax treaties with a rule based on volume of sales. See Michael J. McIntyre, *Proposals for Change in the Source of Income Rules for Tax Treaties Between the United States and the Developing Countries*, (1969) (unpublished paper on file with International Tax Program, Harvard Law School).

[17]ITFA, note 153, 1103, 112 Stat. 2681.

McLure's proposal for scrapping state sales taxes and replacing them with a value-added tax,[18] however well intended, almost certainly would be viewed by the states and by liberal tax reformers as a Trojan horse for some form of national consumption tax if it were taken up by the Advisory Commission. Thus, the Commission ought to view that proposal as going beyond its mandate. Of course, McLure is correct that the state retail sales taxes are flawed and that those flaws are not fully correctable within the context of autonomous state taxes. My favored solution would be for the states to move away from their heavy reliance on the sales tax by placing greater reliance [*630] on income taxes. That suggestion also should be considered to be outside the mandate of the Commission.[19]

C. What to Fix in the Sales Tax

State sales taxes are transactional taxes that bear only a vague re semblance to a tax on personal consumption. Excluded from the re tail sales tax base are such important components of personal consumption as housing, large categories of personal services, many categories of intangible property, such as software, and purchases made and consumed outside the taxing jurisdiction. Goods purchased outside the taxing jurisdiction and consumed within are formally taxable, although they rarely are taxable in practice—with a few notable exceptions, such as automobiles and boats, which must be registered with the state. Many state sales taxes also exempt food, clothing, and medicines.[20]

---

[18]McLure, note 4, at 414-15.

[19]McLure believes that a direct national consumption tax is a capital idea. McLure, note 4, at 366; see also Charles E. McLure, Jr. & George Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, in Frontiers of Tax Reform 70 (Michael Boskin, ed. 1996). I disagree. Even at their best, consumption taxes are highly regressive with respect to income. They exempt the rich on their surplus income. They cause parents, who traditionally invest in the future of their children rather than in stocks and bonds, to bear a disproportionate share of the tax burden. See Michael J. McIntyre & C. Eugene Steuerle, Federal Tax Reform: A Family Perspective 65-70 (The Finance Project, 1996). McLure and I obviously do not need the auspices of the Advisory Commission on Electronic Commerce to engage in this debate, which has been carried on in academic quarters for over two decades.

[20]For example, Connecticut, Massachusetts, Minnesota, New Jersey, and Pennsylvania, either fully or partially exempt clothing. II Karen S. Boucher & John C. Healy, 1998

The state retail sales taxes also include in their tax base many busi ness inputs. Inclusion is inconsistent with the consumption tax ideal. Some potential items of consumption, such as telecommunication services, are taxed in some states under an entirely separate tax regime.[21] McLure would fix most or all of these departures from a normative consumption tax. Hellerstein would fix only those that directly implicate electronic commerce. Neither approach provides an appro priate agenda for the Advisory Commission.

As noted above, the Advisory Commission must address the prob lem of cross-border sales, by traditional mail-order and by electronic [*631] commerce, to justify its creation. Both authors probably would agree on this point. I agree with McLure that it also should address issues relating to taxation of intangible property and issues relating to special tax regimes for telecommunication services. Unless these sets of issues are addressed, the Advisory Commission has little prospect of eliminating major disharmonies in the taxation of competing industries.

I do not think that the states are capable of administering rules that would exempt all forms of business inputs. They can and should move toward more uniform rules for exempting business inputs, and, when administratively feasible, they should expand the current exemptions. One obstacle to more extensive exemptions for inputs is that the states rely on the revenues from taxing those inputs. In theory, the revenue loss could be recovered by raising the sales tax rate significantly.[22] Raising the rate, however, may be difficult politically and may increase

---

Multistate Corporate Tax Guide 65-83 (1998). About one-half the states exempt food. Id. California, Connecticut, Idaho, Maryland, Massachusetts, New Jersey, and New York either fully or partially exempt medical supplies.

[21] Iowa recently amended its rules to include access to the Internet and charges to send a facsimile (within Iowa) as taxable communication services. Id. at 303. In contrast, New York recently found that Internet access services were not a service subject to New York state tax. Id. at 304; see also id. at 306-09 (table listing the various telecommunication services subject to state tax in each state). Id. Finally, Alaska, Delaware, Montana, New Hampshire, and Oregon impose no state sales tax. Id.

[22] McLure seems to accept an estimate that 40% of state sales tax revenue comes from taxing business inputs. McLure, note 4, at 340. I suspect the estimate is on the high side.

competitive pressures on the tax. Indeed, taxing inputs may be seen as a crude mechanism for keeping down nominal rates.

The failure to allow a deduction for inputs is particularly acute in the case of electronic commerce, especially software delivered on- line. Thus, the Advisory Commission needs to tackle this issue head on, despite the difficulties that will be encountered. Hellerstein suggests that coordination of retail sales tax rules with the taxation of telecommunications should help some.[23] I agree. Making clear that intangible property is to be included in the sales tax base also would help; doing so would eliminate the need for the complex work-around rules that states have adopted to tax intangible property indirectly.[24]

The exemptions for food, clothing, medicines, and the like have been adopted to mitigate the regressivity of the retail sales tax. How well these exemptions succeed is unclear.[25] What is certain is that they add complexity to the tax system,[26] particularly for remote [*632] sellers. Some local retail stores can program their cash registers to deal with some of the complex exemption provisions of state law.[27] That option is generally not available to remote sellers.

---

[23]Hellerstein, note 5, at 994.

[24]See, e.g., Dine Out Tonight Club, Inc. v. Department of Rev. Serv., 556 A.2d 580 (Conn. 1989) (holding that the sale of cards entitling holder to discount on restaurants meals was not taxable because the cards merely represent an ownership right to intangible property). A similar problem arises with the sale of prepaid telephone calling cards. See Walter Nagel, Linda P. Holman, & Douglas A. Richards, *One Approach to State and Local Taxation of Prepaid Calling Cards*, 11 St. Tax Notes 1747 (Dec. 16, 1996).

[25]The exemption for food probably reduces regressivity and the exemption for clothing probably increases it. The overall impact of the state retail sales taxes is that they are highly regressive, as measured by the ratio of taxes paid to income. See Citizens for Tax Justice & Inst. on Tax'n and Econ. Pol'y, Who Pays? A Distributional Analysis of the Tax Systems in All 50 States 8-9 (1996).

[26]For discussion, see Richard D. Pomp & Oliver Oldman, State & Local Taxation 6-20 to 6-23 (3rd ed. 1998).

[27]The ability of smart cash registers to adjust for exempt items is limited by the data encoded on the bar code labels attached to merchandise. It is doubtful that the bar code labels typically include enough data to allow for proper treatment of some of the complex exemptions provided in some states for various food items.

McLure is certainly correct that a rational retail sales tax should tax personal services.[28] Many services, however, are business inputs and ought to be exempt. McLure argues that services should be taxed on a destination basis.[29] A common practice, however, has been to tax services where they are performed, that is, on an origin basis.[30] Taxing on an origin basis would create some competitive problems for the states, although the magnitude of the potential problems is unclear. Taxing services where they are consumed would solve the competitiveness problem, although it might create some intractable administrative problems. This is a topic on which more work needs to be done. Nothing can be done about including in a state's tax base the value of goods and services purchased and consumed outside the tax jurisdiction. For example, a state cannot tax the consumption that takes place when one of its residents spends money on high living at some vacation resort outside the United States. That omission creates fairness problems, in that wealthy people are more likely than middle class and poor people to travel for consumption reasons. It is, how ever, an inevitable defect of any destination-based tax. The fairness problem would be mitigated if all other states also imposed a sales tax at approximately the same level.

D. Level Playing Field

McLure and Hellerstein agree that tax reform should seek to achieve the metaphorical level playing field.[31] I do not quarrel with [*633] that

[28]McLure, note 4, at 274.

[29]Id. at 407-08.

[30]See, e.g., La. Rev. Stat. Ann. 47:301(14) (West 1990) (taxing, *inter alia*, furnishing in the state of printing, cleaning, and repairs to tangible property). Note that an origin rule and a destination rule would produce the same results in many cases. For example, printing services performed in a state for the benefit of a resident would be sourced in that state under either rule.

[31]McLure, note 4, at 277; Hellerstein, note 5, at 481 ("competitive equality"). I do not fully understand the meaning of the "level playing field" metaphor. In broad terms, the metaphorical meaning is clear enough: Competitors in the global marketplace should compete under tax rules that give no competitive advantage to anyone. It is the literal meaning that escapes me. It appears to be a sports metaphor, but the sport being referenced is uncertain. If the sport is American, the reference probably would be to either baseball or football. Neither sport, however, requires a level playing field for competitive balance. In

objective, if all that is meant is that reformers should eliminate, whenever possible, major disharmonies between the tax treatment of electronic commerce and other competing forms of commerce. I would not give high priority, however, to achieving full neutrality be tween all modes of commerce. One of the legitimate functions of a tax system is to channel commerce away from forms that are hard to tax into essentially equivalent forms that are easy to tax. A tax penalty for bearer bonds, for example, is a good idea because interest on bearer bonds is hard to tax and the nontax benefits of bearer bonds over registered bonds are fairly trivial in the modern world.[32]

Channeling of activities into a form susceptible of taxation is likely to be an important strategy in taxing electronic commerce under both the sales tax and the income tax. That strategy presents some signifi cant dangers, as inappropriate channeling could have negative com mercial consequences. The most promising use of a channeling strategy would be to discourage transactions in which the seller does not know and cannot ascertain the identity of the buyer. Buyers may like to be anonymous, especially when they are purchasing goods or services that they do not want anyone to know about. The commercial importance of such anonymity, however, is small; sellers, after all, go to some trouble to know their customers. Some degree of anonymity is inevitable and perhaps even desirable on the Internet. Efforts at limiting anonymity may prove to be excessively costly. At a minimum, however, the government should reject as a policy goal the preservation of the anonymity of likely tax evaders.[33]

---

baseball, the teams take turns hitting and fielding on the same field; in football, the teams switch directions—that is, they change the goal they are defending— after each quarter. My suspicion is that the term was coined by an economist to refer to some hypothetical sport in which sloping playing fields would favor some participants over others.

Because the metaphor has no obvious literal meaning, it easily can be extended inappropriately. The metaphor does not justify, for example, an unabashed commitment to economic neutrality at the expense of fairness and good sense.

[32]See IRC 163(f)(1) (denying interest deduction “on any registration-required obligation unless such obligation is in registered form”).

[33]A section of the ITFA is devoted to an exemption from the moratorium on new taxes for taxes directed at discouraging child pornography. ITFA, note 153, at 1101(e), 112 Stat. 2681. The whole point of such hypothetical taxes would be to undermine anonymity.

E. Formulary Apportionment Under a Corporate Income Tax

The states already confront serious problems in imposing an income tax on corporations that operate within their borders, and those problems are likely to increase as electronic commerce becomes a larger contributor to corporate profits. Some of the problems can be laid directly at the door of state legislators. The preferred method for taxing corporations is to require the members of an affiliated group to [*634] file a combined report, with the total net income of that group then apportioned between the taxing state and the rest of the tax universe by formula. A majority of states, however, have failed to adopt legislation requiring affiliated companies to file a combined report.[34] The reason, almost certainly, is political.

States that do not require combined reports have great difficulty preventing corporations from siphoning off profits from their in-state activities and putting them in a tax haven state, such as Delaware. The *Geoffrey* case,[35] discussed by both Hellerstein[36] and McLure,[37] illustrates the problem. In that case, Toys "Я" Us, a national toy store, set up a subsidiary company, Geoffrey, Inc., in Delaware and transferred to it a trademark for "Geoffrey the Giraffe." It paid Geoffrey, Inc. a royalty for use of that trademark in South Carolina, deducting the amount of the royalty from South Carolina taxable income. The result was that income derived in South Carolina was shifted for tax purposes to Delaware.

The *Geoffrey* problem, which is analogous to the entity-isolation problem that arises under the retail sales tax, is likely to get worse as

[34] Pomp & Oldman, note 26, at 10-42. For a useful discussion of the many advantages to the states of requiring a combined report, see id. at 10-39 to 10-46.

[35] Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (S.C.), cert. denied, 510 U.S. 992 (1993).

[36] Hellerstein, note 5, at 441-45. Hellerstein was counsel of record for the taxpayer in Geoffrey on its unsuccessful petition for certiorari. Id. 443 n.71.

[37] McLure, note 4, at 337 ("The answer reached in Geoffrey . . . was undoubtedly correct, even if the reasoning was a bit strained. It blocked use of an outrageous tax avoidance technique."). McLure goes on to note possible problems from extensions of Geoffrey.

electronic commerce becomes a significant part of the profits of major companies. The reason is that much of the income derived from elec tronic commerce is highly mobile and thus easily shifted to tax haven states. The problem in *Geoffrey* could have been solved without fuss if South Carolina had required Geoffrey, Inc. and Toys "Я" Us to file a combined report. The Supreme Court has held repeatedly that the states have no problem under either the Commerce Clause or the Due Process Clause in requiring affiliated companies engaged in a unitary business to file a combined report.[38]

The Advisory Commission could contribute to the improvement of state corporate income taxes in two important ways. First, it could develop a strategy for encouraging states to adopt combined report ing. Second, it could encourage the development of more uniform ap portionment rules. Many of the states, acting primarily through the Multistate Tax Commission, have attempted to promote uniformity, but with only limited success. Competition among the states, fanned [*635] by savvy lobbyists for corporate interests, has made the goal of uniformity elusive. The Advisory Commission might have more success at encouraging more uniform apportionment rules if it is successful in encouraging more states to adopt combined reporting. Federal legislation that required the states to adopt combined reporting and uniform apportionment rules is likely to be resisted by the states, due to concerns about lost sovereignty.[39] Industry also may oppose a uniform approach, fearing that the simplification gains from uniformity would be outweighed by the loss of flexibility in playing one state against another. Thus, the Advisory Commission can expect some tough sledding if it attempts major state reform of the corporate income tax. Still, the attempt is worth making. The states are much less

[38]See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994).

[39]Tracy A. Kaye, *Show Me The Money: Congressional Limitations on State Tax Sovereignty*, 35 Harv. J. on Legis. 149, 164-77 (1998) (describing in detail congressional en croachment on state taxing sovereignty over the past several decades and quoting with approval Laurence Tribe's statement that the danger of congressional encroachment lies in the prospect that Congress "will nibble away at state sovereignty, bit by bit, until some day essentially nothing is left but a gutted shell.").

likely to object to efforts by the Advisory Commission to promote combined reporting and uniformity if the method of persuasion is the carrot rather than the stick of compulsory congressional action.

One possible carrot would be for the federal government to allow corporations filing a combined report in a state to take a credit against their federal corporate income tax for some portion of the corporate income tax paid to that state. This incentive might help overcome the political obstacles to adoption of a combined reporting rule in many states because the prospect of a federal tax credit might cause some companies to relax their opposition to combined reporting. The credit approach has been used successfully to support the estate tax at the state level.[40] The credit might be viewed as a federal downpayment on the many unfunded mandates that Congress has imposed on the states.[41]

The federal government could do the states a great service by reforming its antiquated international tax rules by adopting worldwide combined reporting.[42] McLure, once associated with Treasury's attack on worldwide combined reporting in California,[43] suggests that [*636] the United States should explore that option.[44] A consideration of

[40]IRC 2011 (allowing a credit against the federal estate and gift tax for state inheritance and estate taxes).

[41]For discussion of the unfunded mandates, see Kaye, note 39, at 157-60.

[42]A proposal for adopting a combined reporting system within NAFTA was addressed in a prior symposium issue of this journal. See Symposium, Colloquium on NAFTA and Taxation, 49 Tax L. Rev. 525 (1994).

[43]While serving as Deputy Assistant Secretary (Tax Analysis) during the Reagan ad ministration, McLure also served as staff director of Treasury's Task Force of the World wide Unitary Taxation Working Group. See The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views (1984), reprinted in Charles E. McLure, Jr., Economic Perspectives on State Taxation of Multijurisdictional Corporations 235 (1986). The final report was released on August 31, 1984 under the signature of its chairman, Donald T. Reagan. The major recommendation of the report was that the states should abandon worldwide combined reporting. The responsibility for that recommendation rests with the chairman and the working group members, not with the staff.

[44]For the OECD's full-throated opposition to worldwide formulary apportionment, see OECD Comm. on Fiscal Affairs, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, I-6, PP 1.13-1.14, III-24, P 3.74. For its more favorable view of

formulary apportionment at the federal level, however, should not be on the Advisory Commission's agenda.

III. Entity Isolation Under the Sales Tax

A major issue in the design of nexus rules to govern Internet sales is whether companies will be permitted to avoid those rules by transfer ring their nexus-creating activities in a state to a related legal entity that is not making remote sales into the state. McLure discusses this issue of entity isolation and concludes that it should not be permitted.[45] He describes the reasoning of the several state tax cases that have permitted entity isolation as "absolutely absurd."[46] For reasons discussed below, I agree with McLure. Hellerstein remains silent on this critical issue.

Entity isolation has become an increasingly important issue under the retail sales tax. One piece of evidence of its importance is the movement of many leading retail store chains in the United States into catalog sales. Traditional department store chains now operating a mail-order business include Abercrombie & Fitch, Dillard's, Macy's, Marshall Field's, and Saks Fifth Avenue.[47] The Multistate Tax

---

formulary apportionment, see Jeffrey Owens, *The Tax Man Cometh to Cyberspace*, 14 Tax Notes Int'l 1833, 1849-50 (June 2, 1997).

[45]McLure, note 4, at 402-03.

[46]Id. at 403. Elsewhere, McLure has come down very hard against entity isolation:

> One potentially serious threat to revenues (and to local merchants who do not engage in the scam) involves what the Multistate Tax Commission has called "entity isolation." In one scenario a corporation that has physical presence in a state establishes a separate legal entity that has no physical presence in the state and uses it to make mail-order sales in the state, without collecting use tax. Because state judicial decisions rejecting the concept of "nexus by affiliation" in such instances do not pass the "idiot test," one hopes that this threat will not withstand judicial challenge at higher levels.

Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World,* 14 St. Tax Notes 1169, 177 n.55 (Apr. 13, 1998).

[47]See Rekha Balu & Calmetta Y. Coleman, *Is Land's End's Turmoil a Ghost of Christmas '98*, Wall Street J., Oct. 29, 1998 at B1, B4. I offer no opinion as to whether these companies are legally obligated to collect sales and use taxes on their remote sales.

Commission (MTC) is taking the issue very seriously. Over the past two years, it has been working on the draft of a Guideline that would give [*637] guidance to the states and to taxpayers on the scope of the nexus rules under the negative Commerce Clause. Its most recent draft addresses entity isolation in some detail.[48]

A. Scope of the *Quill* Safe Harbor Rule

To understand the implications of entity isolation and why it should not be given constitutional protection, it is useful to review the Com merce Clause nexus rules endorsed by the Supreme Court in *Quill*.[49] That landmark case provides, *inter alia*, that a state is prohibited under the negative Commerce Clause from requiring a remote seller to collect the tax due on sales made to customers located within the state unless the seller has "substantial nexus" with the state.[50]

In general, the substantial-nexus standard is a facts-and-circum stances test. The Court, nevertheless, has established two safe-harbor rules governing the collection obligations of remote sellers, one favor ing the states and the other favoring the remote seller.

The first safe-harbor rule, drawn from *National Geographic*[51] is that the remote seller has nexus with a state, for purposes of the collection duty, if it has a physical presence in the state and that physical presence is not *de minimis*.[52] Under the second safe-harbor rule, drawn from *Bellas*

---

[48]Multistate Tax Comm'n, State Participation Revised Public Participation Working Group Draft of the Constitutional Nexus Guideline for Application of a State's Sales and Use Tax to an Out-of-State Business (Jan. 1998). The preamble to this draft states that it is a work in progress, that substantive changes in the draft will be considered, and that citations to the draft "should make clear reference to the inevitability of future revisions." The process of developing the draft Guideline has involved extensive discussions with representatives of the states and interested industry groups. Various drafts have been produced. The MTC engaged Richard D. Pomp and me to provide an academic perspective to that process.

[49]Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[50]Id. at 311; for a detailed explication of *Quill,* see Pomp & McIntyre, note 8.

[51]National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551 (1977).

[52]*Quill*, 504 U.S. at 315. The Court determined that the possession of four floppy diskettes within North Dakota was a *de minimis* physical presence under the facts of the case.

Hess,[53] a remote seller does not have nexus with a state if it does not have a physical presence in the state (other than the *de minimis* amount) and its "only connection with customers in the [taxing] state is by common carrier or the United States mail."[54] To avoid confusion between the two safe-harbor rules, I refer to the second rule, favoring the taxpayer, as the "brown truck" rule, brown being [*638] the color of the trucks used by United Parcel Service (UPS), the ubiquitous common carrier.[55]

These two rules do resolve many nexus issues arising from remote sales, but they leave some important issues unresolved. By their own terms, they do not determine whether a remote seller has nexus if it does not have a physical presence in the state but has connections with the state more substantial than the delivery of its goods into the state through the U.S. mail or a common carrier. The gap between these rules leaves open the possibility that remote sellers engaged in electronic commerce in the state would not be protected by the brown truck rule.[56] It also leaves open the possibility that a remote seller with substantial links to a state through an affiliated company would satisfy the substantial-nexus standard.[57]

Id. at 315 n.8.

[53]National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967).

[54]*Quill*, 504 U.S. at 315.

[55]The Court in *Quill* refers to this rule as the "physical-presence requirement that *Bellas Hess* established," id. at 314, the "bright-line test," id. at 318, the "bright-line exemp tion," id. at 316, and the "safe-harbor for vendors," id. at 315. The term "physical-presence requirement," can cause confusion, as it is not at all clear from *Quill* and *Bellas Hess* that physical presence is necessary for Commerce Clause nexus, except in the special case of the mail-order vendor that connects with customers only through the U.S. mail or a common carrier.

[56]See Hellerstein, note 5, at 437-38.

[57]Mines, note 8, at 605 ("The problem with the Court's dichotomy [between those with a physical presence in the state and those that communicate with customers only through the U.S. mail or common carrier] is that the boundary line of physical presence, on the one hand, and contact by common carrier and the mail, on the other, in their common usage do not establish a contiguous frontier. There is a gap between the two categories...").

As indicated above, the *Quill* Court did not invent the brown truck rule. *Bellas Hess* applied it to remote sellers in 1967.[58] *Quill*'s novel feature was the grounding of that rule solely on the Commerce Clause. The *Bellas Hess* Court had discovered the rule in the penum bras of the Due Process Clause and in the Commerce Clause.[59] The practical effect of moving the brown truck rule from its old Due Pro cess Clause home to the Commerce Clause is that Congress now can revoke or amend the rule without provoking a constitutional debate over the efficacy of its action.

According to the Court in *Quill*, what I have termed the brown truck rule, is "a means for limiting state burdens on interstate commerce."[60] "Like other bright line tests," the Court asserted, this test "appears artificial at its edges: Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office."[61] The underlying premise of the test appears to be that "physical presence" is a rough [*639] proxy for the level of penetration of a remote seller into the market of the taxing state. According to that premise, many remote sellers not having a physical presence in a state may have so little market penetration that the collection obligation would be onerous.

The Court clearly recognized that the protection afforded by the brown truck rule is sometimes too broad. Some remote sellers —Quill Corp. is a good example—can have millions of dollars of sales into a state without satisfying that rule.[62] The Court apparently concluded, however, that this obvious defect in its bright-line rule did not justify its

[58]National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967).

[59]Id. at 756.

[60]*Quill*, 504 U.S. at 313.

[61]Id. at 315.

[62]The brown truck rule also may give inadequate protection in some cases. For example, a vendor with few sales into a state might have Commerce Clause nexus with the state as a result of sending a single salesman into the state. The Due Process Clause might offer protection in this case if the vendor had not purposefully availed itself of the market in the state.

repeal, given the mail-order industry's reliance interests in that rule and the power of Congress to fashion a more refined rule.[63]

As discussed above, the brown truck rule of *Quill*, by its own terms, applies only to a subset of companies engaging in remote sales into a state.[64] That rule is perfectly adequate to do what it was designed to do—to protect pure mail-order companies, such as L.L. Bean and Quill Corp., against a state-imposed obligation to collect taxes due from in-state customers. The asserted purpose of this protection is to prevent burdensome state rules from stifling interstate commerce.[65] The downside of the rule, highlighted by Justice White in his prescient dissent in *Quill*, is that it gives an unfair competitive advantage to a certain subset of remote sellers.[66] Quill Corp., for example, can sell office supplies by mail order into North Dakota on a tax-free basis, whereas competitors with local stores, such as OfficeMax and Staples, are required to collect the North Dakota sales tax. If Quill Corp. became more like its in-state competitors, however, it should lose its special tax advantage over them. For example, it should be required to collect the North Dakota tax if it opened a display center in that state or began sending sales representatives into the state.

B. Supreme Court Jurisprudence and Economic Realism

Entity isolation is a tax-planning technique for expanding the brown truck rule to protect remote sellers that are required by business exigencies to have a physical presence in the state of sale.[67] If a remote [*640] seller is permitted to satisfy the bright-line test of *Quill* by

---

63 *Quill*, 504 U.S. at 315.

64 Id. at 315-16.

65 Id. at 313.

66 Id. at 328-29 (White, J., dissenting).

67 See Balu & Coleman, note 47, at B1 ("The synergy between stores and catalogs is so crucial, in fact, that some formerly catalog-only companies are rushing to buy and build retail space. Eddie Bauer, a unit of Spiegel Inc., and J. Crew Group now operate stores. And at some well-known catalog merchants, like Banana Republic and Pottery Barn, stores are now the tail that wags the dog.").

isolating its nexus-creating property and activities into an affiliated company, however, all remote sellers will be able to avoid sales tax on their remote sales.

Such an extension of the bright-line test clearly is inconsistent with the Court's stated intention in *Quill* to limit that test to the subset of remote sellers that have no physical presence in the state of sale and that deal with their customers in that state only though a common carrier or U.S. mail.[68] "Remote selling", as a practical matter, would become a tax- exempt activity. In effect, the Court would be retreating from *Complete Auto*, which held that activities labeled "interstate commerce" are not exempt from state taxation.[69] There is no evidence that the Court intended, *sub silentio*, to overturn *Complete Auto* when it adopted the bright line test in *Quill*. Indeed, *Quill* claims to have discovered in *Complete Auto* the "substantial nexus" standard that the bright-line test purportedly implements.[70]

The implications of entity isolation for the taxation of remote sellers are nicely illustrated by the efforts of Barnes & Noble, Inc., the well-known bookseller, to create a tax-exempt on-line book vendor to compete with Amazon.com, Inc., the originator of the on-line virtual bookstore. Amazon sells books on the Worldwide Web. It generally does not collect tax on those sales, presumably because it believes that it falls within the safe-harbor rule of *Quill*.[71] Barnes & Noble has retail

---

[68]Id. at 315-18.

[69]Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 288-89 (1977).

[70]Id. at 311.

[71]No opinion is offered here as to whether Amazon should be collecting sales and use taxes from its customers on behalf of the states. In its Form 10-K Annual Report, filed for the year ended December 31, 1997, File No. 000-22513, Amazon.com, Inc. stated as follows:

> The applicability to the Internet and other online services of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. . . . The application of existing laws and regulations to the Internet and other online services could have a material adverse effect on the Company's business, prospects, financial condition and results of operations.

Amazon.Com, Inc., 1997 Form 10-K Annual Report 10 (1998), available in LEXIS, Fed SEC Library, 10-K File.

stores all over the country, giving it nexus, for Commerce Clause [*641] and Due Process Clause purposes, in virtually all of the states.[72] It has established an on-line retail vendor, organized as a wholly-owned subsidiary, that it operates under the name BarnesandNoble.com, Inc. BarnesandNoble.com has announced on its Web site that it collects sales tax only for New Jersey, New York, and Virginia.[73] Presumably, the company is relying on some theory of entity isolation to avoid a collection obligation in the other states in which it has retail stores.

As noted above, Hellerstein argues that taxpayers engaged in electronic commerce may fall outside the brown truck rule of *Quill*.[74] Thus, states into which Amazon.com regularly makes sales may be able to impose a collection duty on it. BarnesandNoble.com would appear to have even less protection under *Quill*. Amazon.com may be able to argue, based on the premise of *Quill*, that it would face a significant burden in determining the appropriate sales and use tax to collect on behalf of the thousands of state and local jurisdictions that have the legal power to impose such taxes on their customers.[75]

Amazon is organized under the laws of Delaware, a tax haven, and has its principal office in Seattle, Washington. Id. at 1. The author can state from personal experience that Amazon does not attempt to collect sales and use tax on behalf of the State of Michigan. It apparently set up its operation in Seattle rather than California in the hope that it could sell books tax-free into California, a major market. See Mines, note 11, at 585 n.21.

[72]According to its Form 10-K Annual Report, filed for the fiscal year ended February 1, 1997, Barnes & Noble, Inc. is the world's largest bookseller, operating 431 "super" book stores in 47 states and the District of Columbia and 577 mall-based bookstores in 46 states and the District of Columbia as of February 1, 1997. Barnes & Noble, Inc., 1997 Form 10- K Annual Report 4 (1997), available in Lexis, Fed SEC Library, 10-K File.

[73]See BarnesandNoble.com at <http://www.barnesandnoble.com/help/pay salestax.asp?userid=iK4M15QB75&mscssid=2JVBS9A5SKS12L7V00LHRVi8M8JU1RE8&pcount=O>. (visited Mar. 10, 1999). According to its Web site, BarnesandNoble.com also collects the Canadian Goods and Services Tax on behalf of the Government of Canada. Id. The author can state from personal experience that BarnesandNoble.com does not attempt to collect the sales or use tax on behalf of the State of Michigan on remote sales into Michigan. No opinion is offered here as to whether BarnesandNoble.com is acting properly under the laws of Michigan or any other state.

[74]See Hellerstein, note 7, at 24-25.

[75]The Court in *Quill* suggested that mail-order firms would face a significant compliance burden if they were required to collect taxes on behalf of the nation's 6,000-plus

taxing jurisdictions. Quill Corp. v. North Dakota, 504 U.S. 298, 313 n.6 (1992). McLure believes these potential burdens are substantial. He states: “This decision [*Quill*] makes no economic sense, but was virtually inevitable in the light of state refusal to rationalize their systems in the wake of the decision in *Bellas Hess* to reduce the costs of compliance for out-of-state vendors.” McLure, note 6, at 372 (footnote omitted). McLure formed this view, at least in part, from conversations with a representative of the Direct Marketing Association, which is notorious for exaggerating compliance burdens on its members. The software firms providing solutions to the compliance problems faced by the mail-order industry apparently believe they can substantially eliminate those burdens. Taxware International, Inc., one of the industry leaders on sales and use tax software, asserts:

> Today, the SALES/USE Tax System stands as the industry’s most accurate, secure and flexible tax calculation and reporting system. It automatically calculates and applies accurate sales, use and consumer’s use tax rates to transactions. The system operates as an integral part of a user’s existing financial or accounting system and offers the only fully populated Product Taxability Matrix. The system’s Tax Master File, covering all U.S. tax jurisdictions and Canadian provinces, is kept current with monthly updates. The database accommodates over 60,000 potential tax jurisdiction combinations. TAXWARE’s other system components, when used with the SALES/USE Tax System, provide a seamless, comprehensive, yet customizable solution.

See Taxware web site at <http://www.taxware.com/ZProducts/salesuse/sutaxsys.htm>.

Taxware does not list the price of its software on its Web site. In response to the question of whether only large businesses should use it products, it states:

> Any business that collects a sales tax is a potential user of Taxware’s software. Typically, companies with $50 million and up in annual revenues are Taxware users, but increasingly, smaller companies are finding that Taxware products make good business sense for them, too.

See <http://www.taxware.com/znewinfo/faq/FAQS.htm>.

Even allowing for some hyperbole in the above claims, it would appear that the software industry now can provide, for a price, an effective solution to the compliance problem that troubled the Court in *Quill*. For small and medium-sized vendors that do not need a high level of integration between their billing software and their tax software, the price is not high. For around $300, vendors can purchase the *Sales Tax Rate Finder* from Tax Analysts that will determine sales and use taxes for all U.S. states and localities.

The problem of multiple local sales and use taxes referred to in *Quill* is serious in only a handful of states. Texas, with over 1,000 local and regional taxing authorities, is the prime example of a problem state. See 1 Advisory Comm. on Intergovernmental Relations (ACIR), Significant Features of Fiscal Federalism 95-96 tbl. 27 (1995). For a full listing of sales and tax rates for all Texas cities and counties, see the Web site for the Texas Comptroller of Public Accounts. <http://www.window.state.tx.us/taxinfo/local/city.html>. Even in Texas, however, the problem is overstated; remote vendors selling into Texas pay their aggregate local and regional taxes to the state tax authorities on one tax return; they are not required to make separate reports to each of the local or regional governments. See Texas Sales and Use Tax Return, Form 01-114 and Texas List Supplement: Sales and use Tax, Form 01-116A. These forms are available for downloading at the Web site for the Texas Comptroller of Public Accounts. <www.window.state.tx.us/taxinfo/taxforms/01- 114.pdf> and <www.window state.tx.us/taxinfo/taxforms/01-116.pdf>, respectively.

[*642] BarnesandNoble.com can make no such claim. Its parent corporation, Barnes & Noble, Inc., is making sales on a regular basis into virtually all of those jurisdictions and is regularly collecting the appropriate sales and use taxes from its customers. As a practical matter, BarnesandNoble.com has no greater difficulty learning about the tax rules of state and local jurisdictions than a company that directly oper ated retail stores in those jurisdictions.

Whether BarnesandNoble.com is obligated to collect sales and use taxes for the states in which Barnes & Noble, Inc. has nexus is a mat ter to be decided initially by the tax departments in those states and ultimately by the courts. The outcome of whatever litigation may en sue will depend in part on the tax laws of the states into which BarnesandNoble.com is making sales. The point here is that if the negative Commerce Clause were held by the Court to be a barrier to the imposition of a collection obligation on BarnesandNoble.com, [*643] only companies with inept tax counsel would collect sales and use taxes on remote sales.

Notwithstanding the importance of entity isolation to its negative Commerce Clause jurisprudence, the Supreme Court has never ruled directly on that issue. It has strongly indicated, however, that it will not permit the androgynous nature of corporations to defeat the goals of the Commerce Clause.[76] Dealing with an attempt by an electric company to avoid regulation under the Commerce Clause by drop ping its operating assets into a separate company, the Court declared:

> The findings of the District Court ... leave no room for doubt that these defendants are engaged in transactions in interstate commerce. That they conduct such transactions through the

---

The fact that compliance burdens sometimes are exaggerated does not mean they are not real enough in many cases. Administrative burdens are created, for example, by interstate differences in tax bases, by differences in the tax bases used by the state and its local governments, and by the lack of congruence between the jurisdictional boundaries of local taxing jurisdictions and ZIP code boundaries. The states ought to address those issues; indeed, they cannot expect much progress on reform of the rules governing remote sales unless they are prepared to do so. See Mines, note 11, at 617.

[76] See Electric Bond & Share Co. v. SEC, 303 U.S. 419 (1938).

> instrumentality of subsidiaries cannot avail to re move them from the reach of the federal power. It is the substance of what they do, and not the form in which they clothe their transactions, which must afford the test. The constitutional authority confided to Congress could not be maintained if it were deemed to depend upon the mere mo dal arrangements of those seeking to escape its exercise.[77]

The Court has adopted a similar approach to entity isolation in approving state income tax statutes that require a unitary business enter prise having nexus with the state to file a worldwide combined report for all of its affiliated companies engaged in that unitary business.[78] For example, the State of California required the Barclays Group, a multinational banking enterprise based in the United Kingdom that "includes more than 220 corporations doing business in some 60 nations" to report to the California tax authorities the income derived by those corporations on their worldwide operations.[79] A portion of that total income then was taxed by California.[80] Only two of the corpo rations had business activities in California.[81] Yet, the Court upheld the taxing scheme.[82] It was no defense that the entities engaged in business in California did not have the legal authority to require all of the other affiliated companies to cooperate with the California tax authorities.[83] For purposes of determining the constitutional status of [*644] the California taxing scheme, the Court concluded that the organizational structure of the Barclays Group was irrelevant.[84]

Although the Court has not decided an entity isolation case involving collection of a sales or use tax, it has decided several cases, all in favor

---

[77]Id.

[78]See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 165-66 (1983).

[79]Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298, 307 (1994).

[80]Id. at 302.

[81]Id. at 307.

[82]Id. at 303.

[83]Id. at 312-14.

[84]Id.

of the state,[85] that illustrate what I call "branch isolation." By that term, I mean the isolation of nexus-creating property or activities in a branch that is operated separately from the remote selling busi ness. The leading case is *National Geographic*.[86]

In *National Geographic*, the taxpayer operated a mail-order business for the sale of maps, atlases, globes, and books out of its Washington, D.C., office. It also published a monthly magazine, the National Geographic Magazine. As part of that latter publishing business, it had two offices in California, used to solicit advertisements for the magazine.[87] Its mail-order business had no property or representatives in California.[88] Under the California sales and use tax statute, the taxpayer was obligated to collect the tax on mail-order sales of maps and other items to California customers.[89] It objected, claiming its mail-order business had no nexus with California under the Commerce Clause and the Due Process clause.[90] The Court held for California.[91] It concluded that nexus between the remote seller and the taxing state was enough to justify the imposition of a collection obligation on the remote seller. Nexus between the activity that the state was attempting to tax and the taxpayer's activity within the state was not required.[92]

The same result had been reached many years before in *Sears, Roebuck*[93] and in *Montgomery Ward,*[94] a companion case. Sears operated various

---

[85]See, e.g., National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551 (1977).

[86]Id.

[87]Id. at 552.

[88]Id. at 560.

[89]Id. at 554.

[90]Id. at 560.

[91]Id. at 562.

[92]Id. at 560.

[93]Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941).

[94]Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941).

retail stores in Iowa.[95] It also conducted a mail-order business apart from the retail stores, through which it made remote sales to Iowa customers. The Iowa tax authorities imposed on Sears the duty of collecting the sales and use tax on its mail-order sales to Iowa cus tomers. Sears objected, claiming protection under the Commerce Clause.[96] It asserted that imposition of a collection obligation would [*645] put it at a competitive disadvantage with pure mail-order firms.[97] The Court responded that the taxpayer "is in no position to found a constitutional right on the practical opportunities for tax avoidance which its method of doing business affords Iowa residents."[98]

In summary, the Court has decided two parts of the issue raised by taxpayer attempts, through entity isolation, to avoid a state obligation to collect sales and use taxes on remote sales into the state. First, it has concluded that, in general, the form of organization of an enter prise should not determine outcomes under the Commerce Clause. Second, it has held that "branch isolation" does not work. What is left for the Court to decide is whether taxpayers, in the specific case of sales and use tax collection, should be permitted to obtain the benefits of branch isolation through the simple expedient of separately incorporating their branches.

C. State Cases

Several state courts have decided cases in which the fact patterns present the entity isolation issue. Some of those cases were decided based on an interpretation of the state taxing statute; others were decided on constitutional grounds. The most recent cases have been decided in favor of the taxpayer. As noted above, McLure describes the reasoning of these recent cases as "absolutely absurd."[99]

---

[95]Sears, 312 U.S. at 362.

[96]Id.

[97]Id. at 365.

[98]Id. at 366.

[99]McLure, note 4, at 403.

The state was victorious in two cases in which a remote seller at tempted to avoid assuming a collection obligation by placing nexus-creating activities in an affiliated entity.[100] In *Franklin Mint v. Tully*, the taxpayer engaged in mail-order sales of coins, medals, and other collectibles.[101] It owned two subsidiaries, one of which, Sloves Mechanical Binding Co., operated and held property within New York City. The taxpayer also had some direct activities in New York, including the use of representatives to exhibit its products at trade shows and the carrying on of certain financial dealings in New York City.[102] After disposing of some statutory objections to the imposition of the collection obligation, the court addressed the taxpayer's constitutional challenge. It concluded that ownership of Sloves was sufficient to give New York nexus to require the taxpayer to collect the New York City sales and use tax.[103] It stated: [*646]

> Through Sloves, petitioner unquestionably was able to enjoy the advantages of services provided by the state and local governments much like the taxpayer in *National Geographic v. California Equalization Bd.* (. . . .). The corporate organization adopted by petitioner and Sloves cannot obscure the fact that the Sloves plant, New York property, was indeed controlled and owned by petitioner.[104]

A dissenting opinion took the position that Sloves should not give nexus to New York because Sloves was operated "as a distinct business enterprise."[105] Mere ownership and control, the dissent argued, does not meet the requirement of *National Geographic* that the tax payer maintain something more than the "slightest presence" in the state to

[100] Reader's Digest Ass'n, Inc. v. Mahin, 255 N.E.2d 458 (Ill. 1970); Franklin Mint Corp. v. Tully, 463 N.Y.S.2d 566 (App. Div. 1983), aff'd, 463 N.E.2d 621 (1984).

[101] 463 N.Y.S.2d 566, 567.

[102] Id.

[103] Id. at 568.

[104] Id. at 568-69.

[105] Id. at 570 (Kane, J., dissenting).

be subject to its tax jurisdiction.[106] That position was rejected by the majority.[107]

The second case decided for the state is *Reader's Digest*.[108] In that case, the taxpayer was selling a monthly magazine known as Readers Digest into Illinois. The sales of the magazine were exempt by statute. The taxpayer also sold books and albums into Illinois, shipping the books by U.S. mail.[109] It claimed that it was exempt from the obligation to collect the Illinois sales and use tax under the bright-line test of *Bellas Hess*.[110] The tax authorities objected, contending that the state had nexus to impose a collection obligation on the taxpayer on account, *inter alia*, of the activities in the state of Reader's Digest Sales and Services, Inc., a wholly-owned subsidiary of the taxpayer.[111] The subsidiary was not involved in the taxpayer's mail-order sales of albums or books during the years at issue. It had an office in Illinois, however, and it "solicited advertising for plaintiff's 'Reader's Digest' magazine on a contract basis."[112] The taxpayer conceded that the activities of the subsidiary created nexus over the exempt sales of the Readers Digest magazine. It contended, however, that nexus did not extend to the mail-order sales, in that the subsidiary did not act on behalf of the taxpayer with respect to those sales.[113] The court concluded otherwise. The court was not required to decide the issue of entity isolation because it concluded that the taxpayer had a [*647] representative in Illinois through the activities that its subsidiary performed on its behalf.[114]

---

[106]Id.

[107]Id. at 568-69.

[108]Reader's Digest Ass'n, Inc. v. Mahin, 255 N.E.2d 458 (Ill. 1970).

[109]Id. at 458.

[110]Id. at 459-60.

[111]Id. at 460.

[112]Id. at 459.

[113]Id. at 460.

[114]Id.

Three cases reviewed by the highest state court that present the issue of entity isolation have been decided in favor of the taxpayer.[115] None of those cases, however, addressed the entity isolation issue directly. One was decided on statutory grounds,[116] and the other two treated the issue of entity isolation as if it were an issue of ignoring the separate corporate existence of affiliated companies.[117] In addition, several lower court cases that presented the entity isolation issue have been decided for the taxpayer.[118] The reviewed cases are discussed below.

The first case, *Bloomingdale's By Mail*, deals with a mail-order subsidiary of Federated Department Stores, Inc.[119] A branch of Federated owns and operates department stores throughout the United States under the name of Bloomingdale's. Bloomingdale's has several department stores in Pennsylvania and clearly has nexus with the state for all

---

[115]SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991); SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995); Bloomingdale's By Mail, Ltd., v. Pennsylvania Dep't of Revenue, 567 A.2d 773 (Pa. Commw. Ct. 1989), aff'd, 591 A.2d 1047 (Pa. 1991), cert. denied, 504 U.S. 955 (1992).

[116]Tracy, 652 N.E.2d at 696-97.

[117]Bannon, 585 A.2d at 673-74; Bloomingdale's, 567 A.2d at 778.

[118]See Current, Inc. v. State Bd. of Equalization, 29 Cal. Rptr.2d 407 (Ct. App. 1994) (holding that the bright-line test of *Quill* protected taxpayer from collection duty on mail-order sales, although an affiliated company in a different line of business had physical presence in the state); G.P. Group, Inc. v. Director of Revenue, 1993 Mo. Tax LEXIS 34 (Mo. Admin. Hearing Comm'n Feb. 4, 1993) (holding that the taxpayer could not be required to collect use tax on its sales to Missouri customers notwithstanding the assumed fact that an affiliated company held storage racks in the state); NADA Services Corpora tion, DTA No. 810592, 1996 N.Y. Tax LEXIS 45 (N.Y. Div. Tax App. Feb. 1, 1996) (holding that the taxpayer was not subject to collection duty on account of its close business relationship with its parent corporation, which had nexus with the state, on the ground that the parent was not the alter ego of the taxpayer). Country Shop, Inc. v. Limbach, Case No. 90-K-90, 1993 Ohio Tax LEXIS 83 (Ohio B.T.A. Jan. 15, 1993) (holding that the taxpayer making regular mail-order sales of furniture to Ohio customers was not subject to collection duty on account of its use of an affiliated company as a contract carrier to deliver the furniture to Ohio customers, arguing that the affiliated company was an independent con tractor, not an agent, and characterizing, incorrectly, the Court's decision in Scripto v. Carson, 362 U.S. 207 (1960), as applicable to agents and not independent contractors).

[119]Bloomingdale's, 567 A.2d at 775.

relevant purposes.[120] Bloomingdale's By Mail ("By Mail") has no stores or offices in Pennsylvania and uses common carriers or the U.S. mail to fill its orders.[121] It does not directly solicit sales in Pennsylvania except through its catalogs.[122] Prior to the incorporation of [*648] By Mail, Bloomingdale's conducted the mail-order business itself.[123] By Mail's catalog states that customers should return unwanted purchases to By Mail's fulfillment center in Connecticut. Employees of the tax department, however, made purchases from By Mail and successfully returned the purchased goods to Bloomingdale's stores in Pennsylvania for a full refund. Refund checks were mailed to those employees from Bloomingdale's.[124] The court characterized these refund transactions as "aberrations from normal practice."[125]

The tax department argued that By Mail had nexus with Pennsylvania because Bloomingdale's acted as its agent in accepting returns, citing *Reader's Digest*. The court distinguished *Reader's Digest* by asserting, incorrectly, that "the subsidiaries of Reader's Digest were actively soliciting orders in the state on behalf of Reader's Digest," whereas Bloomingdale's did not solicit orders for By Mail.[126] In fact, as noted above, the nexus-creating subsidiary in *Reader's Digest* solicited advertising for the Reader's Digest magazine, an activity not directly related to the mail-order sales of books and albums that occasioned the case.

In addition, the tax department argued, according to the court, that "By Mail's separate corporate existence from Bloomingdale's department stores is a mere legal formalism that cannot control constitutional considerations and, in essence, that Bloomingdale's acts

---

[120]See id. at 776.

[121]Id. at 775-76.

[122]Id. at 776.

[123]Id. at 775.

[124]Id. at 776.

[125]Id. at 778.

[126]See id. at 777.

as an agent or representative for By Mail."[127] The court responded only to the second half of the quoted statement. It found as a fact that "clearly, By Mail does not have agents acting on its behalf in Pennsylvania."[128] It then had no difficulty concluding that the tax department had failed to meet its burden of proving that an agency relationship existed between By Mail and Bloomingdale's. The court did not respond, except by implication, to the department's assertion that "By Mail's separate corporate existence from Bloomingdale's department stores is a mere legal formalism which cannot control constitutional considerations."[129]

The two other cases holding for the taxpayer both involve SFA Folio Collections, Inc., the mail-order subsidiary of Saks & Company.[130] Saks & Company also has subsidiaries that operate Saks Fifth Avenue [*649] department stores in many states, including Connecticut and Ohio. One case involving SFA Folio arose in Connecticut,[131] and the other in Ohio.[132] An issue in both cases was whether SFA Folio could be required to collect the sales and use tax on in-state, mail-order sales on account of the nexus-creating property and activities of the Sax Fifth Avenue department stores.[133]

In *Bannon*, the tax department argued that entity isolation was in consistent with the form-over-substance doctrine articulated by the Supreme Court in *Container*[134] and other unitary-business cases.[135] The

---

[127]Id. at 778.

[128]Id.

[129]See id.

[130]SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666, 669 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991); SFA Folio Collections, Inc. v. Tracy, 652 N.E. 2d 693, 696-97 (Ohio 1995).

[131]Bannon, 585 A.2d at 666.

[132]Tracy, 652 N.E.2d at 693.

[133]Bannon, 585 A.2d at 670; Tracy, 652 N.E.2d at 695-96.

[134]Container Corp. of America v. Franchise Tax Bd, 463 U.S. 159 (1983).

[135]Bannon, 585 A.2d at 672.

court rejected that argument on statutory grounds, holding that "the line of cases pursuant to the 'unitary business principle' are inapplicable" in the absence of statutory authority "to treat separate corporations as part of one enterprise for the purpose of imposing sales and use tax liability."[136] The court muddied the waters unnecessarily by stating its unwillingness to "disregard the corporate structure and pierce the corporate veil," although it acknowledged that "the commissioner does not assert that we should find a nexus pursuant to a 'piercing the corporate veil' or 'alter ego' theory."[137]

The department also argued that various acts of SFA Folio on its own behalf were sufficient to create nexus with Connecticut.[138] After reviewing the facts, the court concluded otherwise.[139]

The third case for the taxpayer is the Ohio Supreme Court's decision in *Tracy*.[140] The approach of the court in that case is baffling. The lower court held that the Ohio taxing statute required SFA Folio to collect the sales and use tax on its sales to Ohio customers.[141] That statute provided, in relevant part, that nexus exists for purposes of imposing a collection duty if the seller "maintains a place of business within this state, whether operated by employees or agents of the seller, [or] by a member of an affiliated group,... or by a franchisee [*650] using a trade name of the seller."[142] This language appears to say quite clearly that entity isolation does not work in Ohio.

---

[136]Id. at 672-73. The actual issue, recognized elsewhere by the court, was whether a collection duty could be imposed on SFA Folio, not whether it had "sales and use tax liability."

[137]Id. at 671-72.

[138]Id. at 674-75.

[139]Id. at 675-76. The department also asked the court to reject the bright-line test of Bellas Hess, making the argument, accepted by the Supreme Court of North Dakota in *Quill*, that the bright-line test had been overtaken by the Supreme Court's evolving Due Process Clause jurisprudence. Id. The court declined that invitation. Id.

[140]SFA Folio Collections Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995).

[141]Id. at 696.

[142]Id. at 696, (quoting R.C. 5741.01(H)(1)) (emphasis added).

The Ohio Supreme Court, however, interpreted the statutory language as imposing a collection obligation on a mail-order company only if the affiliated group member operates an in-state place of business in which it sells merchandise on behalf of the mail-order company.[143] This tortured reading of the statute is required, the court asserted, so as to conform it to federal constitutional law, as stated in *Quill*, and to Ohio corporation law, which the court asserted has recognized that "parent and subsidiary corporations are separate and distinct legal entities."[144] As discussed above, *Quill* does not address the issue of entity isolation. If the Ohio court is to destroy the integrity of an Ohio statute to conform it to the requirements of *Quill*, it should feel some obligation to the state legislature to explain why *Quill* renders the statute unconstitutional. The reliance on Ohio corporation law to overturn a taxing statute also shows disrespect to the legislature. The tax statute at issue does not require the tax authorities to disregard the separate existence of related corporate entities. It simply takes that relationship into account in determining whether to impose a collection obligation on one of the related entities.[145] In any [*651] event, the court has no

[143]Id. at 697.

[144]Id. at 696. In fact, SFA Folio and the Saks Fifth Avenue department stores were subsidiaries of a common parent; they did not have a parent-subsidiary relationship. Id. at 695. In any event, there is hardly a lawyer on the planet who would deny the general proposition that "parent and subsidiary corporations are separate and distinct legal entities." Surely the Ohio tax department was not contesting that bromide.

[145]The department also argued that the Saks Fifth Avenue department stores acted as representatives of SFA Folio by accepting returns from SFA Folio's customers. Id. at 697. In response, the court stated: "Saks-Ohio accepted Folio's returns according to its policy, not Folio's, and charged the returns to its inventory; it did not charge Folio. Moreover, the returns were a minimal part of the returns Saks-Ohio received." Id. This response has no bearing on the issue of whether the department stores created nexus with Ohio for SFA Folio. *Quill* did apply a *de minimis* test in holding that four floppy diskettes were not enough to create nexus. Whether the return arrangement is *de minimis*, however, depends on its impact on SFA Folio's business in Ohio, not on the relationship of the returns from SFA Folio's customers to the business of the department stores. The question for the court was whether it was *de minimis* to SFA Folio's customers to have a local place where they could return unwanted merchandise. Absence some special facts not presented in the case, the answer would seem to be no. In addition, the fact that the department stores accepted returns without charging SFA Folio is no evidence that they were not assisting their affiliate. On the contrary, the absence of a charge is evidence of the close working relationship one would anticipate from affiliates. Under traditional transfer pricing concepts, the Ohio tax

authority to overturn the clear and specific intent of a taxing statute simply to make it conform with its understanding of general corporate law.

Despite its discussion of federal constitutional issues, *Tracy* turns out to be a statutory case. The Ohio legislature presumably could overturn it by adopting a statute that more clearly prohibits entity isolation. Of course, the Ohio Supreme Court has strongly intimated that it would find that such a statute violated the Commerce Clause, as interpreted by the Supreme Court in *Quill*.

D. An Alternative Approach

Contrary to the position taken in some of the state court decisions discussed above, a tax department seeking to prevent entity isolation is not asking the courts to ignore the separate corporate existence of affiliated companies. It is simply asking the courts to take into account the real relationship between affiliated companies in determining whether the imposition of a collection duty on a remote seller imposes an unreasonable burden on interstate commerce. Because some state courts have concluded otherwise, however, I have developed an alternative legal theory that places the collection obligation on the company clearly having nexus with the state.

To employ my approach, the legislature would need to impose the collection obligation on the affiliated company that directly has nexus in the state through its operation of a business within the state or through its holding of property in the state. That company would be expected to discharge that obligation by instructing its remote selling affiliate to collect the taxes on its behalf.

department would have been justified under the facts to impute a payment from SFA Folio to the department stores to allow them to make a reasonable profit on the returns. The self-serving claim of the department stores that they were accepting returns from SFA Folio's customers as a service to their own customers should be treated with great skepticism by the court, absent convincing proof that they also were accepting returns from unrelated competitors under comparable circumstances.

For example, assume that the Ohio legislature wishes to collect the sales and use tax due on remote sales by BarnesandNoble.com to Ohio customers. It arguably is blocked by the Ohio Supreme Court's decision in *Tracy* from imposing a collection duty on BarnesandNoble.com. The holding of *Tracy*, however, does not place any barrier to placing the collection duty on Barnes & Nobles, Inc., which operates several stores in Ohio. Even in the cramped view of the Ohio Supreme Court, the legislature would not be ignoring the separate corporate existence of the affiliated companies by placing a collection duty on a corporation that directly has nexus in the state.

Supreme Court nexus decisions also place no obstacle to putting a collection obligation on the affiliated company with the nexus-creating attributes. The bright-line test of *Quill* applies only to remote sellers that make sales into a state through a common carrier or the U.S. mail. It does not apply to an affiliate company that operates stores [*652] within the state. Thus, Barnes & Noble, Inc., in the example above, has no protection under the bright-line test.

The Commerce Clause would protect Barnes & Noble, Inc., from the imposition of a collection duty that would, in the language of *Quill*, "unduly burden state commerce." That burden is measured by a facts and circumstances test, however, not by the bright-line test of *Quill*. The Court has already concluded that the collection duty is not unduly burdensome on interstate commerce when it is imposed on a company that operates a mail-order business and also operates retail stores in the state.[146] The burden on Barnes & Noble is not any greater simply because the mail-order book business of BarnesandNoble.com is organized as a separate legal entity rather than as a division of its parent company. In both cases, the employees making the remote sales would be directed to collect the tax from customers at the time of sale. The only difference would be that in one case the directive would come from the manager of the mail-order division, whereas in the other case, it would come from the manager of the affiliate. Placing a collection

[146]See Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941); Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941).

duty on Barnes & Noble also would pass muster under the Due Process Clause. Ohio clearly has Due Process nexus with Barnes & Noble from that company's operation of stores within the state. It also has Due Process nexus over BarnesandNoble.com, assuming that the mail-order seller has purposefully availed itself of the benefits of the Ohio market through the "continuous and widespread solicitation of business within the state."[147] Ohio also has nexus with the activity with respect to which that collection duty is imposed. That activity is the sale of books into the state by BarnesandNoble.com. Thus, there is nexus aplenty under both the Due Process Clause and the Commerce Clause.

The alternative approach outlined above is relevant to all states, not just the states where the courts have confused an attack on entity isolation with an attack on the separate corporate existence of affiliated companies. Because of the availability of this alternative approach, a state could impose a collection obligation on a corporate group engaging in remote sales even if the Supreme Court were to hold that the states do not have nexus to impose that duty directly on the remote seller. All a state would need to do would be to modify its statute to place the duty on the affiliated company that clearly has nexus—by holding property located in the state or by operating through representatives located in the state. The availability of this alternative approach ought to convince the Court that it should not erect [*653] constitutional barriers to reasonable efforts by the states to combat entity isolation.[148]

---

[147] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[148] In light of the availability of the alternative approach, a decision by the Supreme Court in favor of entity isolation would be a return to the bad old days of Spector Motor Serv., Inc. v. O'Connor, 340 U.S. 602 (1951), and Freeman v. Hewit, 329 U.S. 249 (1946). According the Court in Complete Auto, "the Spector rule had come to operate only as a rule of draftsmanship, and served only to distract the courts and parties from their inquiry into whether the challenged tax produced results forbidden by the Commerce Clause." Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 285-86 (1977). The central message of Complete Auto was that the Court no longer would rely on magic words and statutory labels in determining the limits of a state's sovereign power to tax under the negative Commerce Clause. Id. at 288-89.

IV. Concluding Remarks

“Keep the tax man out of Cyberspace” was the rallying cry of the early supporters of the Internet Tax Freedom Act. The very name of the act suggests that the goal is to make the Internet a tax-free zone. The idea that people who surf the Net for bargains should be free of tax while those who support the local mall or the neighborhood book store must pay the costs of government is absurd on its face. No reputable economist would contend that a tax preference for Internet sales over local sales makes any economic sense. McLure, who is nothing if not reputable, certainly does not take that position. And Hellerstein, always the sensible lawyer, views exemption of Internet sales as the problem, not the solution.[149]

According to its early supporters, the purpose of ITFA is to prevent the states from strangling electronic commerce in its infancy by imposing new and highly burdensome taxes on Internet sales. The fear of such taxes, however, is unfounded. States do not have any interest in imposing unreasonable taxes on Internet transactions, and none has tried to do so.

State governors ultimately came to support a substantially amended version of ITFA.[150] Their hope, I presume, is that the Advisory Commission on Electronic Commerce would endorse legislation that would allow the states, at a minimum, to collect sales taxes on high-volume, cross-border sales by major vendors.

Whether the Commission will do constructive things remains to be seen. The membership of the Commission, however, gives cause for pessimism. As McLure, notes, the Commission is stacked heavily in [*654] favor of the mail-order industries and computer companies that

---

[149] Hellerstein, note 5, at 481.

[150] NGA Online Press Releases, Governors Hail Senate Passage of Internet Bill, Oct. 8, 1998, <http://www.nga.org/Releases/PR-08October1998Internet.htm> (“The Senate’s action is an important step toward realizing the promise and potential of a 21[su’st’] Century electronic commerce marketplace,” said National Governors’ Association (NGA) Chairman Delaware Gov. Thomas R. Carper and Vice Chairman Utah Gov. Michael O. Leavitt.).

service the Internet.[151] Local and national retailers that might be devastated if the Internet becomes a tax-free zone are not represented, and state and local governments are under represented.[152] The one "taxpayer representative" is in fact a lobbyist for Microsoft.[153] Notwithstanding a handful of good appointments, the balanced Commission that was promised by the Internet Tax Freedom Act did not materialize.

The lobbying success of remote sellers and the electronic commerce industries in dominating the Commission strongly suggests that the states will not be successful in collecting sales and use taxes from remote sales over the Internet unless they solve the problem of entity isolation. The natural allies of the states in preventing the Internet from becoming tax-free zone are the many Main Street businesses that face unfair competition from tax-free Internet sales. The apparent strategy of the major retailers, however, has been to seek tax-free status themselves by conducting remote sales over the Internet through affiliated companies. The states need to take that option away by reforming their sales tax laws when necessary and by pursuing an aggressive auditing program directed at remote sellers that have nexus through affiliated local retailers. If the states are successful in taking away the entity-isolation option, the major retailers might be prepared to join with the states in promoting rational rules for taxing sales over the Internet.

---

[151] Charles E. McLure, Jr., *Electronic Commerce and the State Retail Sales Tax: A Challenge to American Federalism*, Int'l Tax Pub. Fin. 5.1 (forthcoming 1999) ("The ITFA Commission: Foxes Guarding the Henhouse?").

[152] Id.

[153] Id.