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Special Report: E-Commerce

Rules & Regs

by ANDREW CAFFREY

E-commerce Sales Tax Makes Inroads

A novel Arkansas law that earlier this year made some e-commerce purchases subject to state sales tax is meeting surprising early success: Most retailers affected have agreed to pay up. Minnesota, meanwhile, encouraged by Arkansas's example, enacted a similar law this spring.

Some form of legal challenge is expected, but if these two laws are upheld, they could offer a new way for other states to pursue this controversial area of taxation.

A 1992 U.S. Supreme Court decision forbids states from collecting sales taxes on purchases their residents make from retailers such as e-commerce sites that do not have a physical presence, or nexus, like a warehouse or retail outlet, within their borders. So far that has excluded almost all from having to pay, because most traditional retailers that also sell over the Internet keep their bricks-and-mortar and their online operations legally separate by incorporating them as separate companies.

The Arkansas law, however, is testing this distinction by authorizing the collection of sales tax from e-commerce sites that have affiliated stores in Arkansas. Affiliated in this case means a store that acts as an "agent" by performing services for its e-commerce cousin, such as accepting returns and exchanges for products bought on the Web site -- a common arrangement among retailers with Web sites. Arkansas says that having the physical presence of such an affiliated store creates a nexus for the online site, and thus qualifies as an entity subject to sales tax.

The state of Minnesota, in turn, whose statute is more detailed than that of Arkansas, argues that these so-called clicks-and-mortar arrangements are similar to out-of-state manufacturers that have independent representatives or agents making sales and service calls in the state. The presence of in-state agents creates a nexus that has long allowed the state to tax such manufacturers, says Greg Heck, an attorney for the Minnesota Department of Revenue.

Tax officials in Arkansas say that most of the 50 or so e-commerce sites they've identified as being liable under the new law have registered with the state, indicating their willingness to pay the taxes on sales made to Arkansas residents. Officials theorize that companies are complying because the advantage of being able to offer customers both online service and retail affiliates outweighs the cost of the taxes.

In another case with implications for e-commerce sales taxes, the Tennessee Court of Appeals recently ruled that AOL Time Warner Inc.'s Internet unit America Online could be held liable for state taxes because it leases equipment and has contracts with local telecom providers to service customers in Tennessee. Such activities could be sufficient to give AOL nexus within Tennessee, the court said. The company has until the end of September to file an appeal with the Tennessee Supreme Court. An AOL spokesman says the company is weighing its options.

Separately, challenges may be filed to the Arkansas and Minnesota laws as well. George Isaacson, tax counsel for the New York-based Direct Marketing Association, suggests that it may only confuse matters if each state tries to define clicks-and-mortar relationships differently -- as, indeed, Arkansas and Minnesota do. "Do you really want 45 states that have sales and use taxes to come up with their own fixes?" he asks.