

# E-Commerce Taxation

## Federal-Level Uniformity/Predictability Best Route to Follow

### Summary

### Background

The significant growth of e-commerce has given rise to controversy over whether e-commerce transactions should be taxed. Concerns by policymakers in California and a number of other states over potential lost tax revenues have arisen in two primary contexts: 1) More and more consumers purchase products such as music and videos through digital downloads rather than in tangible form. 2) Additionally, online shopping for tangible goods is expanding, yet many out-of-state sellers are able to reach California residents over the Internet without being subject to the obligation to collect sales tax.

### State and Federal Policy

#### Digital Products

Currently, there is no federal tax on sales of digital products, although there are efforts pending to bring uniformity and certainty to taxation of e-commerce by addressing the issue at a national level.

California currently does not tax digital products. Its sales and use tax applies only to tangible property, and digital property is intangible. Fewer than half the states currently tax digital products. A number of those states have tax structures and populations that are vastly different than California's. No digital tax is collected in most of the states considered comparable to California — including New York, Michigan and Florida.

Many in the business community believe that proposals to tax e-commerce overlook characteristics and challenges unique to e-commerce that could be counterproductive for both the state and industry and ultimately lead to fewer tax revenues, including the following:

- Digital media industries are highly mobile and can reach California consumers from outside the state's borders as easily as from within. Thus, a digital tax could trigger an undesirable movement of high-paying, clean and green, technology sector jobs out of the state.
- A new digital tax could open up many potential areas of litigation due to the complexity and amorphous nature of digital and e-commerce transactions. This would mean costly litigation for the state of California, local governments and companies.
- Increasing the cost of California digital purchases by a tax of 7 percent to 9.25 percent, depending on the applicable local sales tax rate, may encourage even more digital piracy. Digital media and its channels of delivery are especially vulnerable to theft due to increasingly faster computers. Moreover, Internet connections have made illegal downloads of software, movies, music and the like easier. Digital piracy leads to lost jobs, lost sales and lost tax revenue. In 2005, in the music industry alone, there were an estimated 20 billion illegal downloads globally and a loss to U.S. firms of more than \$2 billion.

#### Nexus and Out-of-State Sellers

The U.S. Constitution requires a state to have a sufficient physical connection, or nexus, to an out-of-state company before it can require a company to collect the state's sales tax. Out-of-state companies selling products solely through the Internet can reach California consumers without having any physical presence in the state. California consumers making purchases from such out-of-state sellers are required to pay California use tax on these purchases, but there is a reportedly low compliance rate.

Because of the growing number of out-of-state sellers in the online marketplace, some states have become interested in exploring new and unconventional ways to establish nexus with them. For example, the state of New York has a lawsuit pending against it because of a new law requiring a large online retailer to collect the state sales tax on the basis that the retailer has "affiliates" with a physical presence in the state. New York claimed the retailer had physical presence because the affiliates had a click-through to the retailer on their website. States attempting such new ways to establish nexus in the e-commerce setting are vulnerable to lawsuits because the Supreme Court has not ruled whether they are constitutional. The last guidance the U.S. Supreme Court provided on nexus was for mail orders rather than Internet orders in the 1992 *Quill Corp. v. North Dakota* case.

On the other end of the spectrum, some states, in an effort to protect and encourage e-commerce activity, have passed laws establishing safe harbors from nexus — laws explicitly setting forth activities the state has deemed do not establish nexus. One such safe harbor adopted by more than 20 states, including California, protects servers — the mere presence of a company's products and information on a web server located within the state will not in and of itself trigger the obligation to collect the state's sales or use tax. This acts as a safe harbor

## E-Commerce Taxation (continued)

by providing companies certainty and predictability when choosing to give business to California web-service companies, such as online marketplaces or web hosts. Without the safe harbor, there is uncertainty because the U.S. Supreme Court has not ruled whether the presence of a company's information and products on a server does or does not establish nexus.

### Recent California Legislative Developments

In 2008, AB 1956, ABX3 22 and ABX3 23 (C. Calderon; D-Montebello) proposed to impose the sales and use tax on digital downloads, including software, e-books, music, videos, cell phone ring tones, cable television and movies on demand. ABX3 22 proposed to do this through the regulatory process, while ABX3 23 proposed to do so through a statutory change. AB 1956 failed passage in the Assembly Revenue and Taxation Committee, and the latter two did not move.

In addition, AB 1840 and ABX3 2 (C. Calderon; D-Montebello) proposed to change California's current "nexus" standard under California's sales and use tax law. Both bills proposed to eliminate California's server safe harbor. Although the measures purported to target out-of-state sellers, they had the potential to cause significant harm to California companies by undermining their ability to compete nationally and globally for customers. AB 1840 failed passage on the Assembly floor, while ABX3 2 failed to move.

### CalChamber Position

The California Chamber of Commerce is generally opposed to a digital tax, elimination of the server safe harbor, and other tax law changes that could stifle California's national and global competitiveness and leadership role in digital media. CalChamber supports adoption of federal changes to bring greater uniformity and predictability to any taxation of e-commerce.

### Reasons for Position

- Digital media industries are highly mobile and can reach California consumers from outside the state's borders as easily as from within. A state digital tax and increased tax burden on e-commerce could trigger an undesirable movement of high-paying, clean and green, technology sector jobs out of the state.
- Increasing the tax burden on California e-commerce may significantly increase the cost of doing business for a host of California technology sector and entertainment industry companies, as well as harm consumers who purchase digital media.

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